Internal Revenue
bulletin

Bulletin No. 2000–6
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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. 2000–9, page 497.

Federal rates; adjusted federal rates; adjusted federal long-term rate, and the long-term exempt rate. For purposes of section 1274, 1288, 382, and other sections of the Code, tables set forth the rates for February 2000.

T.D. 8862, page 466.

Final regulations under section 367(b) of the Code relate to the transactions involving certain foreign corporations and the application of nonrecognition exchange provisions under subchapter C of the Code.

T.D. 8863, page 488.
REG–116048–99, page 584.

Temporary and proposed regulations under section 367(b) of the Code relate to transactions involving certain foreign corporations and the application of nonrecognition exchange provisions under subchapter C of the Code. A public hearing is scheduled for April 20, 2000.

T.D. 8866, page 495.

Final regulations under section 1092 of the Code relate to equity options with flexible terms and qualified covered calls.

T.D. 8868, page 491.

Final regulations under section 936 of the Code relate to the termination of the Puerto Rico and possession tax credit.

T.D. 8869, page 498.

Final regulations under section 1361 of the Code relate to the treatment of corporate subsidiaries of S corporations and interpret the rules added to the Internal Revenue Code by section 1308 of the Small Business Job Protection Act of 1996.

EMPLOYEE PLANS

Rev. Proc. 2000–16, page 518.

Administrative programs; closing agreements. This procedure consolidates and expands upon the following current employee plans programs: the Administrative Policy Regarding Self-Correction, the Walk-in Closing Agreement Program, the Closing Agreement Program, the Voluntary Compliance Resolution Program, the Standardized VCR Procedure, and the Tax-sheltered Voluntary Correction Program. Rev. Procs. 98–22, 99–13, and 99–31 modified and superseded. Rev. Proc. 2000–8 modified.

Rev. Proc. 2000–20, page 553.

Master and prototype plans. This procedure combines prior revenue procedures pertaining to master and prototype plans and regional prototype plans. It also provides that mass submitters and sponsors may apply for opinion letters that reflect current law beginning April 7, 2000, and May 8, 2000, respectively. Volume submitter practitioners may apply for current law advisory letters beginning March 8, 2000. Rev. Procs. 89–9, 89–13, 90–21, 91–66, 92–41, 93–9, 93–10, and 95–42 superseded. Rev. Procs. 2000–6 and 2000–8 modified. Announcement 99–50 modified.

Notice 2000–11, page 572.

Safe harbor explanation; certain qualified plan distributions. This notice provides a “Safe Harbor Explanation” that plan administrators may provide to recipients of eligible rollover distributions from qualified plans in order to satisfy section 402(f) of the Code. Notice 92–48 obsoleted.

(Continued on the next page)

Finding Lists begin on page ii.
Index for January begins on page iv.

Department of the Treasury
Internal Revenue Service

EMPLOYEE PLANS—continued

Announcement 2000–7, page 586.

Mortality table; retirement plans. This announcement seeks public comments with respect to the mortality table in effect under section 412(1)(7)(C) of the Code.

EXEMPT ORGANIZATIONS

Announcement 2000–8, page 586.

A list is given of organizations now classified as private foundations.

EMPLOYMENT TAX

Rev. Rul. 2000–6, page 512.

Information reporting requirements applicable to election workers. The requirements for information reporting applicable to election workers whose compensation is not subject to FICA tax are found under section 6041(a) of the Code. As a result, reporting is generally not required for election workers earning less than $600 annually. Rev. Rul. 88–36 modified.

ADMINISTRATIVE

REG–208254–90, page 577.

Proposed regulations under section 861 of the Code relate to the source of compensation for labor or personal services. A public hearing is scheduled for April 19, 2000.

REG–105089–99, page 580.

Proposed regulations under section 356 of the Code relate to the treatment of nonqualified preferred stock and other preferred stock in certain exchanges and distributions. A public hearing is scheduled for May 31, 2000.

Rev. Proc. 2000–13, page 515.

This prodedure provides guidance on the application of Articles 10(2) and 23 of the United States-United Kingdom income tax treaty after the repeal of the U.K. advance corporation tax (ACT) and reduction of the U.K. Shareholder tax credit. Rev. Proc. 80–18 modified.

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.

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

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

Section 42.—Low-Income Housing Credit

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 2000. See Rev. Rul. 2000–9, page 497.

Section 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of February 2000. See Rev. Rul, 2000–9, page 497.

Section 367.—Foreign Corporations

26 CFR 1.367(a)–3: Treatment of transfers of stock or securities to foreign corporations.

T.D. 8862

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Parts 1, 7, and 602

Stock Transfer Rules

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final regulations addressing the application of nonrecognition exchange provisions in Subchapter C of the Internal Revenue Code to transactions that involve one or more foreign corporations. These regulations provide guidance for taxpayers engaging in those transactions in order to determine the extent to which income shall be included and appropriate corresponding adjustments shall be made.

DATES: *Effective Date*. These regulations are effective as of February 23, 2000.

Applicability Dates. These regulations apply to section 367(b) exchanges that occur on or after February 23, 2000. However, taxpayers may choose to apply these regulations to section 367(b) exchanges that occur before February 23, 2000, as specified in §1.367(b)–6(a)(2).

FOR FURTHER INFORMATION CONTACT: Mark D. Harris, (202) 622-3860 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1271. Responses to these collections 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 reporting burden in these final regulations is 4 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 these collections of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

On December 27, 1977, the IRS and Treasury issued proposed and temporary regulations under section 367(b) of the Internal Revenue Code (Code). Subsequent guidance updated and amended the 1977 temporary regulations (the 1977 regulations) several times over the next 14 years. On August 26, 1991, the IRS and Treasury issued proposed regulations §§1.367(b)–1 through 1.367(b)–6 (the 1991 proposed regulations). Comments to the 1991 proposed regulations were received, and a public hearing was held on November 22, 1991. In June of 1998, the IRS and Treasury issued final regulations under sections 367(a) and (b) (the 1998 regulations). The 1998 regulations addressed transactions under section 367(b) only to the extent the transactions are also subject to the stock transfer rules of section 367(a). Thus, the 1977 regulations have remained in effect to the extent not superseded by the 1998 regulations. The preamble to the 1998 regulations stated that the IRS and Treasury would issue guidance at a later date to address the portions of the 1991 proposed regulations related to section 367(b) that were not addressed in the 1998 regulations.

After consideration of the 1977 regulations and their updates and amendments, the 1991 proposed regulations and their updates and amendments, the 1998 regulations, and all comments received with respect to such regulations, the IRS and Treasury adopt §§1.367(b)–1 through 1.367(b)–6 as final regulations under section 367(b).

Overview

A. General Policies of Section 367(b)

Section 367(b) governs corporate restructurings under sections 332, 351, 354, 355, 356, and 361 (except to the extent described in section 367(a)(1)) in which the status of a foreign corporation as a "corporation" is necessary for application of the relevant nonrecognition provisions. Section 367(b) provides that a foreign corporation that is a party to one of the enumerated nonrecognition transactions shall be respected as a corporation, and thereby the parties involved in the transaction shall obtain the benefits of the applicable nonrecognition exchange provisions and their related provisions (such as section 381) (together, the Subchapter C provisions), except to the extent provided in regulations.

The principal purpose of section 367(b) is to prevent the avoidance of U.S. tax that can arise when the Subchapter C provisions apply to transactions involving foreign corporations. The potential for tax avoidance arises because of differences between the manner in which the United States taxes foreign corporations and their shareholders and the manner in which the United States taxes domestic corporations and their U.S. shareholders.

The Subchapter C provisions generally have been drafted to apply to domestic corporations and U.S. shareholders, and thus do not fully take into account the cross-border aspects of U.S. taxation (such as deferral, foreign tax credits, and section 1248). Section 367(b) was enacted to help ensure that international tax considerations in the Code are adequately addressed when the Subchapter C provisions apply to an exchange involving a foreign corporation. Because determining the proper interaction of the Code's international and Subchapter C provisions is "necessarily highly technical," Congress granted the Secretary broad regulatory authority to provide the "necessary or appropriate" rules, rather than enacting a complex statutory regime. H.R. Rep. No. 658, 94th Cong., 1st Sess. 241 (1975).

Accordingly, as the preamble to the 1991 proposed regulations stated, the section 367(b) regulations require adjustments or inclusions in order to prevent the material distortion of income that can occur when the Subchapter C provisions apply to an exchange involving a foreign corporation. The 1991 proposed regulations simplified the 1977 regulations and were generally favorably received by taxpayers. The final regulations adopt the 1991 proposed regulations with modifications. The modifications are based on further considerations of fairness, simplicity, and administrability.

The final regulations also incorporate the section 367(b) rules contained in the 1998 regulations. The 1998 regulations finalized portions of the 1991 proposed regulations to the extent necessary to address the overlap between section 367(b) and the section 367(a) stock transfer rules. Because the scope of the final regulations is broader than that overlap, the final regulations adopt the 1998 section 367(b) provisions in a manner appropriate to their incorporation into the final regulations.

The IRS and Treasury are also issuing other guidance under section 367(b). Temporary and proposed regulations (T.D. 8862, page 466 and REG–116048–99, page 584) address the elimination of an election available to certain taxpayers under the 1977 regulations and the 1991 proposed regulations. In addition, the IRS and Treasury intend to issue other proposed regulations that provide rules regarding the combination and separation of corporate-level tax attributes in applicable section 367(b) exchanges.

B. Specific Policies in Context of Inbound Nonrecognition Transactions

Section 1.367(b)–3 addresses transactions in which a foreign corporation transfers assets to a domestic corporation pursuant to a Subchapter C provision. These transactions include a section 332 liquidation of a foreign corporation into a domestic parent corporation and an asset reorganization, such as a C, D or F reorganization, of a foreign corporation into a domestic corporation (inbound nonrecognition transactions). Section 381 generally provides rules regarding the extent to which corporate attributes carry over in such transactions.

The principal policy consideration of section 367(b) with respect to inbound nonrecognition transactions is the appropriate carryover of attributes from foreign to domestic corporations. This consideration has interrelated shareholder-level and corporate-level components. At the shareholder level, the section 367(b) regulations are concerned with the proper taxation of previously deferred earnings and profits. At the corporate level, the section 367(b) regulations are concerned with both the extent and manner in which tax attributes carry over in light of the variations between the Code's taxation of foreign and domestic corporations.

The section 367(b) regulations have historically focused on the carryover of earnings and profits and bases of assets, simultaneously addressing the shareholder and corporate level concerns by accounting for any necessary adjustments through an income inclusion by the U.S. shareholders of the foreign acquired corporation (and without limiting the extent to which the domestic acquiring corporation succeeds to the attributes). The 1991 proposed regulations required a U.S. shareholder of the foreign acquired corporation (or, in certain cases, a foreign subsidiary of the U.S. shareholder) to currently include in income the allocable portion of the foreign acquired corporation's earnings and profits accumulated during the U.S. shareholder's holding period (all earnings and profits amount). The requirement to include in income the all earnings and profits amount results in the taxation of previously unrepatriated earnings accumulated during a U.S. shareholder's (direct or indirect) holding period. This income inclusion prevents the conversion of a deferral of tax into a forgiveness of tax and generally ensures that the section 381 carryover basis reflects an after-tax amount. However, the all earnings and profits amount inclusion does not consider tax attributes that accrue during a non-U.S. person's holding period.

Commentators criticized the scope of the 1991 proposed regulations, arguing that the all earnings and profits amount should be limited to the amount that a shareholder would include in income as a deemed dividend under section 1248. The scope of the all earnings and profits amount is broader than the section 1248 amount because, for example, the all earnings and profits amount is calculated without regard to whether the foreign corporation is a CFC and without regard to a shareholder's gain in the stock. However, this view too narrowly construes the role of section 367(b) by focusing on potential shareholder-level consequences without adequately considering the section 367(b) policy of determining the appropriate carryover of corporate-level attributes in inbound nonrecognition transactions. Thus, the final regulations retain the 1991 proposed regulations' definition of all earnings and profits amount. The final regulations also generally retain (subject to a new de minimis exception) the taxation of all exchanging U.S. shareholders in inbound nonrecognition transactions.

In finalizing these regulations, the IRS and Treasury considered whether future section 367(b) regulations should limit the extent to which tax attributes carry over from foreign to domestic corporations. Such a limitation would more directly implement the section 367(b) policy related to the carryover of attributes and, as a result, reduce the class of U.S. persons required to have an income inclusion in connection with an inbound nonrecognition transaction. Such a limitation would also enable the section 367(b) regulations to address the carryover of attributes attributable to a non-U.S. person's holding period. The IRS and Treasury request comments as to the merits of an attribute carryover limitation, as well as other approaches that could address the carryover of tax attributes related to a non-U.S. person's holding period under section 367(b).

C. Specific Policies in Context of Foreign-to-Foreign Nonrecognition Transactions and Section 355 Distributions

Section 1.367(b)–4 addresses transactions in which a foreign corporation acquires the stock or assets of another foreign corporation in an exchange described in section 351 or a section 368(a)(1)(B), (C), (D), (E), (F) or (G) reorganization (foreign-to-foreign nonrecognition transactions). Section 1.367(b)–5 provides rules regarding a distribution by a foreign corporation of the stock or securities of a domestic or foreign corporation described in section 355. The historic policy objective of section 367(b) in both of these contexts has been to preserve the potential application of section 1248. Thus, the amount that would have been recharacterized as a dividend under section 1248 upon a disposition of the stock (section 1248 amount) generally must be included in income as a dividend at the time of the section 367(b) exchange to the extent such section 1248 amount would not be preserved immediately following the section 367(b) exchange.

The final regulations do not address all of the policy considerations raised by the application of the Subchapter C provisions to transactions described in §§1.367(b)–4 and 1.367(b)–5. For example, current rules regarding the carryover or separation of foreign corporations' earnings and profits do not adequately consider the international aspects of the Code, most notably the foreign tax credit. Forthcoming proposed regulations will consider these issues. Until the IRS and Treasury promulgate such regulations, taxpayers should use a reasonable method (consistent with existing law and taking proper account of the purposes of the foreign tax credit regime) to determine the carryover and separation of earnings and profits and related foreign taxes.

Explanation of Provisions

The IRS received numerous comments on the 1991 proposed regulations. The following discussion summarizes the comments and changes to the 1991 proposed regulations.

A. §1.367(b)–1(c): Notice Requirements

Section 1.367(b)–1(c) of the 1991 proposed regulations required any person that realizes income in a section 367(b) exchange to file a notice with respect to the exchange, regardless of such person's status as a U.S. person and its percentage ownership in the corporation that is a party to the section 367(b) exchange. Commentators criticized this notice requirement as overly broad. The 1998 regulations limited the notice requirement to shareholders that realize income and file a tax return under section 6012. The final regulations further revise the notice requirement and generally narrow its scope by requiring notice only with respect to persons and transactions that may be subject to an inclusion under the final regulations' operative provisions.

B. §1.367(b)–2: Definitions and Special Rules

1. §1.367(b)–2(d): All Earnings and Profits Amount

Section 1.367(b)–2(d) of the 1991 proposed regulations generally defined "all earnings and profits amount" as the allocable share of net positive earnings and profits accrued by a foreign corporation during a shareholder's holding period. The 1991 proposed regulations provided that the all earnings and profits amount is determined according to the attribution principles of section 1248. Because the section 1248 attribution rules incorporate the section 1223 holding period rules, commentators were concerned that the definition of all earnings and profits amount inappropriately included earnings and profits attributable to the holding period of non-U.S. persons by virtue of the rules of section 1223(2).

In response, the final regulations amend the definition of all earnings and profits amount to exclude amounts attributable to the holding period of non-U.S. persons. This modification applies to the extent the non-U.S. person was not directly or indirectly owned by U.S. persons with a 10 percent or greater interest when the earnings and profits accumulated. An example in the final regulations illustrates this new rule.

When applying the attribution principles of section 1248 for purposes of determining the all earnings and profits amount, the requirements of section 1248 unrelated to computing the amount of earnings and profits attributable to a shareholder's block of stock should not apply. The final regulations explicitly state this principle. The 1991 proposed regulations applied this principle, for example, when they provided that the all earnings and profits amount is calculated without regard to whether the foreign corporation is a controlled foreign corporation (CFC). The final regulations further specify that the all earnings and profits amount includes earnings attributable to an exchanging shareholder's stock, without regard to whether the exchanging shareholder owned 10 percent of the stock of the foreign acquired corporation. A new example in the final regulations illustrates these rules.

2. §1.367(b)–2(e): Treatment of Deemed Dividends

Section 1.367(b)–2(e) of the 1991 proposed regulations provided that a deemed dividend shall be treated as an actual dividend. Thus, a deemed dividend was considered as paid out of the earnings and profits of a foreign corporation and was considered as having been paid through intermediate owners (when appropriate). One commentator noted that an inclusion under the 1991 proposed regulations could yield a different result from an inclusion under section 1248 because section 1248 treats a corporation as having paid the section 1248 amount directly to an exchanging shareholder despite any intermediate owners.

A deemed dividend under section 367(b) is distinguishable from a section 1248 inclusion because a section 1248 inclusion is not treated as a dividend at the corporate level. Thus, a corporation does not reduce its earnings and profits with regard to an inclusion under section 1248. Instead, the shareholder-level inclusion is considered eligible to be treated as previously taxed earnings and profits (PTI) upon a subsequent distribution. In light of this distinction between section 367(b) and section 1248, the final regulations retain the rule in §1.367(b)–2(e) of the 1991 proposed regulations.

3. Final Regulation §1.367(b)–2(j): Sections 985 through 989

Section 1.367(b)–2(k) of the 1991 proposed regulations provided rules regarding currency exchange inclusions or adjustments that result from a section 367(b) exchange. The final regulations apply the principles of the 1991 proposed regulations, but provide the following modifications.

The 1991 proposed regulations required an acquired corporation that participates in a transaction described in section 381(a) to change its functional currency if the acquiring corporation has a different functional currency. The rule was intended to ensure that taxpayers use the correct functional currency after a section 367(b) exchange. However, functional currency is determined separately for each qualified business unit (QBU). In addition, the functional currency of a QBU of either the acquired or acquiring corporation may change as a result of a section 367(b) exchange. Accordingly, the final regulations provide that a QBU is deemed to have automatically changed its functional currency when its functional currency, as determined after a section 367(b) exchange, is different than before the exchange. Thus, the QBU is required to make appropriate adjustments under §1.985–5.

The 1991 proposed regulations provided that, if an exchanging shareholder is required to include in income either the all earnings and profits amount or the section 1248 amount, then immediately before the exchange and solely for purposes of computing exchange gain or loss under section 986(c), the shareholder is treated as receiving a distribution of PTI from the appropriate foreign corporation. The purpose of this provision was to ensure that exchange gain or loss under section 986(c) is subject to current inclusion when the earnings of the foreign corporation are no longer deferred or to the extent a taxpayer does not retain its interest in PTI.

Section 1.367(b)–2(j)(2) of the final regulations expands the rules regarding the treatment of exchange gain or loss on PTI under section 986(c). An exchanging shareholder that is a U.S. person is required to recognize its section 986(c) gain or loss to the extent that deferral has ended with respect to a foreign corporation's earnings (as can occur in the case of an inbound or foreign-to-foreign nonrecognition transaction) or the U.S. person has a diminished interest in the PTI after the exchange (as can occur in the case of a section 355 distribution by a foreign corporation). A different rule applies when a U.S. person indirectly holds (through a foreign exchanging shareholder) its interest in the foreign corporation with regard to which the PTI inclusion is measured. In that case, the indirect U.S. shareholder does not recognize section 986(c) gain or loss at the time of the section 367(b) exchange. In order to preserve such section 986(c) gain or loss for future inclusion by the indirect U.S. shareholder, the foreign exchanging shareholder is treated as having received a distribution of the PTI.

Other rules under sections 985 through 989, such as the branch termination rules, may also apply to the transaction.

C. §1.367(b)–3: Repatriation of Foreign Corporate Assets in Certain Nonrecognition Transactions

Section 1.367(b)–3 provides rules with respect to inbound nonrecognition transactions.

1. §1.367(b)–3(b): Exchanges of Stock

Section 1.367(b)–3(b) of the 1991 proposed regulations generally provided that if an exchanging shareholder is either (i) a 10 percent U.S. shareholder of the foreign acquired corporation or (ii) a foreign corporation with respect to which a U.S. person is either a section 1248 shareholder or a domestic corporation that meets the stock ownership requirements of section 902, the shareholder must include in income as a deemed dividend the all earnings and profits amount attributable to its stock in the foreign acquired corporation. The final regulations generally retain this rule. However, in order to provide greater consistency among its various ownership thresholds, the final regulations revise §1.367(b)–3(b)(ii) so that §1.367(b)–3(b) applies to a foreign corporation with respect to which there is, in general, a 10 percent U.S. shareholder.

The 1991 proposed regulations provided that the same country dividend exception in section 954(c)(3)(A)(i) does not apply to an exchanging shareholder that is a CFC. Commentators criticized this rule, stating that a deemed dividend under section 367(b) should not be treated more harshly than an actual dividend and that taxpayers can circumvent this rule by having a lower-tier foreign corporation distribute a dividend before an asset transfer. However, unlike a dividend distribution that qualifies for the same country dividend exception, an inbound asset transfer represents a current repatriation of earnings into the United States. Accordingly, the final regulations retain the rule in the 1991 proposed regulations that the same country dividend exception does not apply to an exchanging shareholder that is a CFC.

The 1991 proposed regulations generally required the recognition of exchange gain (or loss) to the extent that an exchanging shareholder's capital account in a foreign acquired corporation appreciated (or depreciated) as a result of changes in currency exchange rates. Such gain (or loss) is reflected in the basis of assets when translated at the spot rate. The preamble to the 1991 proposed regulations invited comments regarding the calculation of such exchange gain (or loss), particularly in cases when a shareholder acquired the foreign corporate stock by purchase rather than in connection with the corporation's formation. None of the comments suggested a method for determining and tracking shareholder capital accounts. Most comments focused on the potential complexity and compliance burdens created by the rule. After considering the administrability issues associated with the exchange gain (or loss) calculation, the final regulations do not adopt the provision requiring the recognition of exchange gain (or loss) on a shareholder's capital account. However, the final regulations reserve the issue for further consideration.

Sections 7.367(b)–5(b) and 7.367(b)–7(c)(2)(ii) of the 1977 regulations, and §1.367(b)–3(b)(2)(iii) of the 1991 proposed regulations provided an exchanging shareholder with an opportunity to recognize the gain (but not the loss) that it realizes in the exchange (taxable exchange election), rather than including the all earnings and profits amount in income as a deemed dividend. This taxable exchange election, however, is inconsistent with the policies of section 367(b) that apply to inbound transactions. These policies, as previously discussed, are unrelated to an exchanging shareholder's outside gain on its stock.

Moreover, when the all earnings and profits amount exceeds a shareholder's gain on its stock, merely limiting the shareholder's inclusion to its outside stock gain creates the potential for the duplication and importation of losses. See TAM 9003005 (September 28, 1989) (interpreting the 1977 regulations) (available at IRS Freedom of Information Act Reading Room, 1111 Constitution Avenue, NW., Washington, DC 20224). The 1991 proposed regulations attempted to address this aspect of the taxable exchange election by requiring various attributes of the foreign acquired corporation (such as basis in its assets) to be reduced (attribute reduction regime) to the extent the all earnings and profits amount exceeds an exchanging shareholder's stock gain.

However, the taxable exchange election in the 1991 proposed regulations had other shortcomings. The election added substantial complexity to the regulations by requiring timely coordination between electing shareholders and the acquiring corporation to carry out the required attribute reductions. In addition, the attribute reduction regime can be unfair in situations involving more than one exchanging U.S. shareholder. For example, consider an inbound C, D, or F reorganization involving two U.S. shareholders of the foreign acquired corporation, one that makes the taxable exchange election (because its gain on the stock is less than its all earnings and profits amount) and one that does not. In connection with the electing shareholder's taxable exchange election, the 1991 proposed regulations required a proportionate reduction in certain tax attributes of the foreign acquired corporation. This reduction effectively allowed the electing shareholder to transfer to the acquiring corporation the burden created by its decision not to include in income its full all earnings and profits amount and, thereby, to effectively shift a portion of this burden to the non-electing shareholder (that has already paid U.S. tax on its full share of the foreign corporation's earnings and profits).

Finally, a taxable exchange election is not required by the statute. Section 367(b) directs the Secretary to prescribe regulations that provide the necessary or appropriate tax consequences that should accompany the application of the Subchapter C provisions to transactions involving foreign corporations. Section 367(b)(2) specifically provides that the section 367(b) regulations may include the circumstances under which "gain shall be recognized currently or amounts included in gross income currently as a dividend, or both . . . ." Thus, the statute authorizes the IRS and Treasury to require an inclusion of amounts, as distinct from gain. As previously discussed, the all earnings and profits amount appropriately measures an exchanging shareholder's income inclusion in connection with an inbound nonrecognition transaction.

After balancing the above considerations against the benefits of the taxable exchange election, the final regulations do not adopt the taxable exchange election. However, in order to provide taxpayers an opportunity to comment on this change to the 1977 regulations and the 1991 proposed regulations, the IRS and Treasury are concurrently issuing temporary and proposed regulations that provide the taxable exchange election in modified form. This election permits an exchanging shareholder to elect to treat a transaction as a taxable exchange, but modifies the attribute reduction regime by limiting its application to a section 332 liquidation or to an inbound asset reorganization in which the foreign acquired corporation is wholly owned (directly or indirectly) by one U.S. person. This limited application of the attribute reduction regime eliminates the potentially unfair results that can arise when attributes are reduced in a transaction involving multiple exchanging shareholders. This also reduces (although does not eliminate) the potential for the duplication and importation of losses that can arise in the absence of attribute reduction. The temporary regulation is effective for one year from the effective date of the final regulations.

2. §1.367(b)–3(c): Exchanges of Stock by Other U.S. Persons

Section 1.367(b)–3(c) of the 1991 proposed regulations provided a special rule for U.S. persons that are not subject to the §1.367(b)–3(b) requirement to include in income the all earnings and profits amount (generally, shareholders owning less than 10 percent of the foreign acquired corporation, hereinafter small shareholders). The 1991 proposed regulations required these small shareholders to recognize the gain on their stock in the foreign acquired corporation. This rule was included because of administrative concerns, since small shareholders may not have sufficient information to calculate their all earnings and profits amounts. In addition, a foreign acquired corporation may not have adequate information about its small shareholders' inclusions to properly adjust its earnings and profits for the deemed dividends that would arise in these situations.

Commentators requested that the final regulations provide small shareholders the option of including in income the all earnings and profits amount, rather than recognizing the gain on their stock. In response, the final regulations include such an election, provided that a small shareholder has sufficient information to substantiate its all earnings and profits amount and provided that the small shareholder furnishes proper certification to the foreign acquired corporation (or its successor in interest) so that the corporation can properly reduce its earnings and profits. Electing small shareholders must also comply with the section 367(b) notice requirement. A less extensive section 367(b) notice procedure is available if the foreign acquired corporation has never had earnings and profits that would result in any shareholder having an all earnings and profits amount.

Commentators also requested an election that would permit a domestic acquiring corporation to include in income the all earnings and profits amounts on behalf of the foreign acquired corporation's small shareholders. The final regulations do not adopt this suggestion because of its substantial administrative difficulties. For example, it is unlikely that a publicly traded foreign corporation (or its domestic acquirer) could ascertain each small shareholder's correct holding period in the stock of the foreign acquired corporation, which would be necessary to properly determine such a cumulative all earnings and profits amount inclusion.

The final regulations also include a new de minimis exception, which applies to small shareholders whose stock in the foreign acquired corporation has a fair market value below $50,000 on the date of the exchange. These shareholders are not required to include gain or a deemed dividend under the section 367(b) regulations.

3. §1.367(b)-3(d): Carryover of Certain Attributes

Section 1.367(b)–3(d) of the 1991 proposed regulations clarified that a domestic acquiring corporation may succeed to foreign taxes paid or accrued by a foreign acquired corporation that are eligible for credit under section 906. A domestic acquiring corporation may not succeed to any other foreign taxes paid or accrued by a foreign acquired corporation because the earnings that carry over to a domestic acquiring corporation (other than earnings related to the taxes eligible for credit under section 906) are not subject to double taxation at the corporate level. This rule is consistent with the general policy of section 367(b) to permit the carryover of corporate tax attributes only when appropriate. The final regulations retain the rules of §1.367(b)–3(d), and add an example that illustrates their application.

D. §1.367(b)–4: Acquisition of Foreign Corporate Stock or Assets by a Foreign Corporation in Certain Nonrecognition Transactions

Section 1.367(b)–4 of the 1991 proposed regulations addressed foreign-to-foreign nonrecognition transactions. In general, if the exchange in such a transaction results in a section 1248 shareholder of the foreign acquired corporation losing its section 1248 shareholder status, §1.367(b)–4(b) required the exchanging shareholder to currently include its section 1248 amount in income as a deemed dividend. The 1991 proposed regulations generally did not require an income inclusion in circumstances when a section 1248 shareholder retains its status. In the case of a lower-tier transaction (where the exchanging shareholder is a foreign corporation), the section 1248 amount was not included as foreign personal holding company income (FPHCI) under section 954(c). This provision permitted deferral of the section 1248 amount by preserving such earnings and profits as earnings of the foreign corporation that is the exchanging shareholder. The final regulations retain these general rules.

1. §1.367(b)–4(b): Recognition of Income

Section 1.367(b)–4(b) of the 1991 proposed regulations provided an exception to its general rule if an exchanging shareholder receives stock of a domestic corporation. This provision, which the 1991 proposed regulations included in response to a criticism of the 1977 regulations, was intended to provide relief in cases when a domestic acquiring corporation issues its own stock in exchange for CFC stock and succeeds to the section 1248 amount allocable to the transferor U.S. shareholder. Because §1.367(b)–4(a) of the 1991 proposed regulations already limited the application of §1.367(b)–4 to an acquisition by a foreign corporation, such relief was unnecessary.

Moreover, the provision inadvertently did not require an inclusion of a section 1248 amount that may not be preserved immediately after the exchange. This could occur, for example, if a foreign acquiring corporation uses the stock of its domestic parent corporation to acquire the stock or assets of a foreign target corporation from a section 1248 shareholder. Accordingly, the final regulations do not adopt the 1991 proposed regulations' provision regarding receipt of stock of a domestic corporation in a transaction described in §1.367(b)–4.

2. §1.367(b)–4(d): Special Rule for Applying Section 1248 to Subsequent Exchanges

The 1998 regulations revised the rules of the 1991 proposed regulations regarding the application of section 367(b) and section 1248 to exchanges that follow a §1.367(b)–4 exchange in which an exchanging shareholder is not required to include a section 1248 amount in income. Because of the limited scope of the 1998 regulations, its rule only addressed the application of section 367(b) and section 1248 following a stock transfer by a direct U.S. shareholder. The final regulations incorporate the principles of the 1998 regulations and expand their application to the class of transactions subject to §1.367(b)–4, including asset transfers and transactions in which the exchanging shareholder is a foreign corporation. The final regulations also address the interaction of these rules with section 964(e), by providing the extent to which they apply to subsequent section 964(e) sales and exchanges. Two new examples in the final regulations, as well as an expanded restatement of the example provided in the 1998 regulations, illustrate the application of these rules.

Commentators also requested that the IRS and Treasury clarify the carryover of earnings and profits and tax accounts in transactions where an exchanging shareholder is not required to include a section 1248 amount, as well as the application of section 902 to distributions by a foreign acquiring corporation after such a section 367(b) exchange. The IRS and Treasury will address these issues in forthcoming proposed regulations.

E. §1.367(b)–5: Distributions of Stock Described in Section 355

1. §1.367(b)–5(b): Distribution by a Domestic Corporation

Section 1.367(b)–5(b) of the 1991 proposed regulations generally provided that a domestic corporation must recognize gain on a section 355 distribution of foreign stock to individuals. The final regulations retain this general rule, consistent with the recently promulgated final regulations under section 367(e) (governing a section 355 distribution by a domestic corporation of foreign stock to foreign persons).

Commentators requested that the final regulations clarify the proper method for determining whether a distributee is an individual. The same issue arises under section 367(e), and the final regulations adopt the approach of the section 367(e) regulations. Thus, a distributee is presumed to be an individual except to the extent that the distributing corporation certifies that the distributee is not an individual. However, a publicly traded distributing corporation may use a reasonable analysis with respect to distributees that are not five percent shareholders of publicly traded stock to demonstrate the number of distributees that are not individuals. A reasonable analysis includes a determination of the actual number of distributees that are not individuals or a reasonable statistical analysis of shareholder records and other relevant information. Section 1.367(b)–2(k) (§1.367(b)–2(l) of the 1991 proposed regulations) has also been amended to adopt the look-through provisions provided in §1.367(e)–1(b)(2) for purposes of determining the identity of distributees when the domestic distributing corporation stock is held by a partnership, trust or estate.

2. §1.367(b)–5(c): Pro Rata Distribution by a CFC

Section 1.367(b)–5(c) of the 1991 proposed regulations provided that, when a CFC distributes stock of a controlled corporation on a pro rata basis in a section 355 transaction, a distributee must reduce its post-distribution basis in either the distributing or controlled corporation stock to the extent its section 1248 amount attributable to such corporation is reduced as a result of the distribution. To the extent the reduction of the section 1248 amount exceeds the stock basis, the distributee must include the difference in income as a deemed dividend. The final regulations retain this general rule, subject to the following refinements.

The final regulations add new §1.367(b)–5(c)(3), which provides that the basis adjustment provided in §1.367(b)–2(e)(3)(ii) shall not apply if a deemed dividend is included in income pursuant to §1.367(b)–5(c). Under §1.367(b)–2(e)(3)(ii), a shareholder's basis is increased by the amount of a deemed dividend inclusion. In the context of a §1.367(b)–5(c) inclusion, the §1.367(b)–2(e)(3)(ii) basis increase would undermine the purpose of the section 367(b) regulations, because the basis increase would correspondingly decrease the shareholder's built-in gain, thereby reducing the section 1248 amount that is intended to be preserved after the transaction.

Furthermore, some taxpayers commented that the §1.367(b)–5(c)(2) basis reduction can lead to the creation of phantom gain; that is, it can leave a shareholder with a cumulative amount of post-distribution built-in gain in the stock of the distributing and controlled corporations that exceeds its predistribution built-in gain. As a result, commentators requested that a reduction in the basis in one of the corporations give rise to a corresponding increase in the basis of the stock of the other corporation. In response, §1.367(b)–5(c)(4) of the final regulations provides a basis redistribution rule, under which the basis of the stock of the distributing or controlled corporation (as applicable) is increased by the amount of the required decrease in basis in the other stock under §1.367(b)–5(c)(2). However, basis cannot be increased above the fair market value of the stock and also cannot be increased to the extent the increase diminishes the postdistribution section 1248 amount with respect to such stock. This basis redistribution rule also applies with regard to deemed dividend inclusions under §1.367(b)–5(c)(2). An example in the final regulations illustrates the application of these new rules.

3. §1.367(b)–5(d): Non-Pro Rata Distribution by Controlled Foreign Corporation

Section 1.367(b)–5(d) of the 1991 proposed regulations provided that, if a CFC distributes controlled corporation stock on a non-pro rata basis, each distributee must include in income the amount of any reduction in its section 1248 amount with regard to either the distributing or controlled corporation. For this purpose, the 1991 proposed regulations treated a shareholder of the distributing corporation that does not exchange stock in the distributing corporation for stock in the controlled corporation (non-participating shareholder) as a distributee. The 1991 proposed regulations provided that a non-participating shareholder may make an election (taxable distribution election), under which the distributing and controlled corporations are not treated as corporations for purposes of gain (but not loss) recognition by all persons affected by the taxable status of the transaction. The preamble to the 1991 proposed regulations invited comments as to whether the benefits of the taxable distribution election to non-participating shareholders are outweighed by the potential adverse effects on the other shareholders.

In response, commentators uniformly criticized the taxable distribution election. They argued that the election was inequitable because it enabled a non-participating shareholder (who may be a small shareholder) to unilaterally and retroactively invalidate the section 355 transaction for all parties involved. Commentators also pointed out that the taxable distribution election could distort the economic incentives in cross-border restructurings by requiring participating shareholders to consider identifying and making contractual arrangements (which could include monetary arrangements) with each non-participating shareholder in order to prevent them from electing to invalidate the section 355 transaction. Commentators thus argued in favor of not adopting the taxable distribution election in the final regulations.

The taxable distribution election is also not required by the statute. Section 367(b) directs the Secretary to prescribe regulations that provide the necessary or appropriate tax consequences that should accompany the application of the Subchapter C provisions to transactions involving foreign corporations. Section 367(b)(2) specifically provides that the section 367(b) regulations "shall include (but shall not be limited to) regulations dealing with the sale or exchange of stock or securities in a foreign corporation by a U.S. person. . . ." Accordingly, the section 367(b) regulations may address the tax consequences of a non-pro rata distribution to both participating and non-participating shareholders. In both cases, the diminution in a shareholder's potential section 1248 amount following a section 355 transaction appropriately measures the shareholder's inclusion with regard to a section 355 transaction involving a distributing corporation that is a controlled foreign corporation. Differing results depending on whether a shareholder is a participating shareholder or a non-participating shareholder can also be viewed as artificial, given that the distinction is often merely a function of alternative planning strategies.

In light of all of the above considerations, the final regulations do not adopt the taxable distribution election. As a result, all shareholders of a CFC that distributes stock on a non-pro rata basis must include in income the amount of any reduction in their section 1248 amount with respect to either the distributing or controlled corporation.

4. Final Regulation §1.367(b)–5(f): Exclusion of Deemed Dividend from FPHCI

Commentators noted that the 1991 proposed regulations did not automatically exclude a §1.367(b)–5(c) or (d) deemed dividend inclusion by an exchanging foreign corporate shareholder from FPHCI. Accordingly, the deemed dividend generally would be subpart F income and currently includible in income by a U.S. shareholder of the exchanging foreign corporation. As in the case of a lower-tier foreign-to-foreign transaction described in §1.367(b)–4, the potential application of section 1248 can be preserved by excluding the deemed dividend from FPHCI. Thus, the final regulations adopt the suggestion and provide that a §1.367(b)–5(c) or (d) deemed dividend inclusion by a foreign corporation is not included in FPHCI under section 954(c).

5. 1991 Proposed Regulation §1.367(b)–5(f): Adjustments to Earnings and Profits

Section 1.367(b)–5(f) of the 1991 proposed regulations provided rules regarding the allocation of earnings and profits of a foreign transferor corporation in connection with a section 355 distribution. After further consideration, the IRS and Treasury have not included §1.367(b)–5(f) of the 1991 proposed regulations in the final regulations. Forthcoming proposed regulations will more fully consider the allocation of earnings and profits in section 355 distributions where either (or both) the distributing or controlled corporation is a foreign corporation.

F. §1.367(b)–6: Effective Date

The final regulations apply to section 367(b) exchanges that occur on or after February 23, 2000. The preamble to the 1991 proposed regulations solicited comments on whether the final regulations should provide an election to apply the regulations retroactively to exchanges that occur on or after August 26, 1991 (the date the 1991 proposed regulations were published in the **Federal Register**). Given the length of time that has elapsed since the issuance of the 1991 proposed regulations, the IRS and Treasury do not believe that such an election would be appropriate. This determination is consistent with the 1998 revision to §1.367(b)–2(d) of the 1991 proposed regulations, which deleted the proposed special retroactive effective date for the definition of the all earnings and profits amount. A taxpayer may, however, elect to apply the final regulations to section 367(b) exchanges that occur (or occurred) before February 23, 2000, if the due date for the taxpayer's timely filed Federal tax return (including extensions) for the taxable year in which the section 367(b) exchange occurs (or occurred) is after February 23, 2000.

Removed Provisions

These regulations finalize substantially all of the 1991 proposed regulations. In connection with the finalization of these regulations, the 1977 regulations (other than §7.367(b)–12) and the section 367(b) provisions contained in the 1998 regulations are removed. Section 7.367(b)–12 is retained to address distributions with respect to (or a disposition of) stock that was subject to certain provisions of the 1977 regulations in effect prior to February 23, 2000.

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 the notice of proposed rulemaking preceding the regulations was issued prior to March 29, 1996, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply.

Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on the impact of the proposed regulations on small business.

Drafting Information

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

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1, 7, and 602 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by revising the entry for §1.367(b)–2 and by adding entries in numerical order to read in part as follows:

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

Section 1.367(b)–2 also issued under 26 U.S.C. 367(a) and (b).

Section 1.367(b)–3 also issued under 26 U.S.C. 367(a) and (b). * * *

Section 1.367(b)–5 also issued under 26 U.S.C. 367(a) and (b).

Section 1.367(b)–6 also issued under 26 U.S.C. 367(a) and (b). * * *

Par. 2. Section 1.367(a)–3 is amended as follows:

1. Paragraph (d)(3) *Example 11*, paragraph (ii), the third sentence, the reference "§7.367(b)–7(c)(1)(i) of this chapter" is removed and "§1.367(b)–4(b)" is added in its place.

2. Paragraph (d)(3) *Example 11A*, paragraph (ii), the second, third and fourth sentences are removed and a sentence is added in their place.

3. Paragraph (e)(2), in the third, fourth, and fifth sentences, the parenthetical "(as in effect before February 23, 2000, see 26 CFR part 1 revised as of April 1, 1999)" is added immediately after "§7.367(b)–7 of this chapter" each place it appears.

4. Paragraph (g)(2)(iv), the parenthetical "(as in effect before February 23, 2000, see 26 CFR part 1 revised as of April 1, 1999)" is added immediately after "7.367(b)–2(b) of this chapter."

The revisions read as follows:

§1.367(a)–3 Treatment of transfers of stock or securities to foreign corporations.

* * * * *

(d) * * *

(3) * * *

Example 11A. * * *

(ii) *Result*. * * * Assuming §1.367(b)–4(b) does not apply, there is no income inclusion under section 367(b), and the amount of the gain recognition agreement is $50.

Par. 3. Section 1.367(b)–0 is added to read as follows:

§1.367(b)–0 Table of contents.

This section lists the paragraphs contained in §§1.367(b)–0 through 1.367(b)–6.

§1.367(b)–1 Other transfers.
(a) Scope.
(b) General rules.
(1) Rules.
(2) Example.
(c) Notice required.
(1) In general.
(2) Persons subject to section 367(b) notice.
(3) Time and manner for filing notice.
(i) United States persons described in §1.367(b)–1(c)(2).
(ii) Foreign corporations described in §1.367(b)–1(c)(2).
(4) Information required.
(5) Abbreviated notice provision.
(6) Supplemental published guidance.

§1.367(b)–2 Definitions and special rules.

(a) Controlled foreign corporation.
(b) Section 1248 shareholder.
(c) Section 1248 amount.
(1) Rule.
(2) Examples.
(d) All earnings and profits amount.
(1) General rule.
(2) Rules for determining earnings and profits.
(i) Domestic rules generally applicable.
(ii) Certain adjustments to earnings and profits.
(iii)Effect of section 332 liquidating distribution.
(3) Amount attributable to a block of stock.
(i) Application of section 1248 principles.
(A) In general.
(*1*) Rule.
(*2*) Example.
(B) Foreign shareholders.
(ii) Limitation on amounts attributable to holding periods determined under section 1223.
(A) Rule.
(B) Example.
(iii)Exclusion of lower-tier earnings.
(e) Treatment of deemed dividends.
(1) In general.
(2) Consequences of dividend characterization.
(3) Ordering rules.
(4) Examples.
(f) Deemed asset transfer and closing of taxable year in certain section 368(a)(1)(F) reorganizations.
(1) Scope.
(2) Deemed asset transfer.
(3) Other applicable rules.
(4) Closing of taxable year.
(g) Stapled stock under section 269B.
(h) Section 953(d) domestication elections.
(1) Effect of election.
(2) Post-election exchanges.
(i) Section 1504(d) elections.
(j) Sections 985 through 989.
(1) Change in functional currency of a qualified business unit.
(i) Rule.
(ii) Example.
(2) Previously taxed earnings and profits.
(i) Exchanging shareholder that is a United States person.
(ii) Exchanging shareholder that is a foreign corporation.
(3) Other rules.
(k) Partnerships, trusts and estates.

§1.367(b)–3 Repatriation of foreign corporate assets in certain nonrecognition transactions.

(a) Scope.
(b) Exchange of stock owned directly by a United States shareholder or by certain foreign corporate shareholders.
(1) Scope.
(2) United States shareholder.
(3) Income inclusion.
(i) Inclusion of all earnings and profits amount.
(ii) Examples.
(iii) Recognition of exchange gain or loss with respect to capital [reserved].
(4) [Reserved].
(c) Exchange of stock owned by a United States person that is not a United States shareholder.
(1) Scope.
(2) Requirement to recognize gain.
(3) Election to include all earnings and profits amount.
(4) De minimis exception.
(5) Examples.
(d) Carryover of certain foreign taxes.
(1) Rule.
(2) Example.

§1.367(b)–4 Acquisition of foreign corporate stock or assets by a foreign corporation in certain nonrecognition transactions.

(a) Scope.
(b) Income inclusion.
(1) Exchange that results in loss of status as section 1248 shareholder.
(i) Rule.
(ii) Examples.
(2) Receipt by exchanging shareholder of preferred or other stock in certain instances.
(i) Rule.
(ii) Examples.
(3) Certain recapitalizations.
(c) Exclusion of deemed dividend from foreign personal holding company income.
(1) Rule.
(2) Example.
(d) Rules for subsequent exchanges.
(1) In general.
(2) Subsequent dispositions by a foreign acquiring corporation.
(3) Examples.

§1.367(b)–5 Distributions of stock described in section 355.

(a) In general.
(1) Scope.
(2) Treatment of distributees as exchanging shareholders.
(b) Distribution by a domestic corporation.
(1) General rule.
(2) Section 367(e) transactions.
(3) Determining whether distributees are individuals.
(4) Applicable cross-references.
(c) Pro rata distribution by a controlled foreign corporation.
(1) Scope.
(2) Adjustment to basis in stock and income inclusion.
(3) Interaction with §1.367(b)–2(e)(3)(ii).
(4) Basis redistribution.
(d) Non-pro rata distribution by a controlled foreign corporation.
(1) Scope.
(2) Treatment of certain shareholders as distributees.
(3) Inclusion of excess section 1248 amount by exchanging shareholder.
(4) Interaction with §1.367(b)–2(e)(3)(ii).
(i) Limited application.
(ii) Interaction with predistribution amount.
(e) Definitions.
(1) Predistribution amount.
(2) Postdistribution amount.
(f) Exclusion of deemed dividend from foreign personal holding company income.
(g) Examples.

§ 1.367(b)–6 Effective dates and coordination rules.

(a) Effective date.
(1) In general.
(2) Exception.
(b) Certain recapitalizations described in §1.367(b)–4(b)(3).
(c) Use of reasonable method to comply with prior published guidance.
(1) Prior exchanges.
(2) Future exchanges.
(d) Effect of removal of attribution rules.

Par. 4. Sections 1.367(b)–1 and 1.367(b)–2 are revised to read as follows:

§1.367(b)–1 Other transfers.

(a) *Scope*. The regulations promulgated under section 367(b) (the section 367(b) regulations) set forth rules regarding the proper inclusions and adjustments that must be made as a result of an exchange described in section 367(b) (a section 367(b) exchange). A section 367(b) exchange is any exchange described in section 332, 351, 354, 355, 356 or 361, with respect to which the status of a foreign corporation as a corporation is relevant for determining the extent to which income shall be recognized or for determining the effect of the transaction on earnings and profits, basis of stock or securities, basis of assets, or other relevant tax attributes. Notwithstanding the preceding sentence, a section 367(b) exchange does not include a transfer to the extent the foreign corporation fails to be treated as a corporation by reason of section 367(a)(1). See §1.367(a)–3(b)(2)(ii) for an illustration of the interaction of section 367(a) and (b).

(b) *General rules*—(1) *Rules*. The following general rules apply under the section 367(b) regulations—

(i) A foreign corporation in a section 367(b) exchange is considered to be a corporation and, as a result, all of the related provisions (e.g., section 381) shall apply, except to the extent provided in the section 367(b) regulations; and

(ii) Nothing in the section 367(b) regulations shall permit—

(A) The nonrecognition of income that would otherwise be required to be recognized under another provision of the Internal Revenue Code or the regulations thereunder; or

(B) The recognition of a loss or deduction that would otherwise not be recognized under another provision of the Internal Revenue Code or the regulations thereunder.

(2) *Example*. The following example illustrates the rules of this paragraph (b):

Example—(i) *Facts*. DC, a domestic corporation, owns 90 percent of P, a partnership. The remaining 10 percent of P is owned by a person unrelated to DC. P owns all of the outstanding stock of FC, a controlled foreign corporation. FC liquidates into P.

(ii) *Result*. FC's liquidation is not a transaction described in section 332. Nothing in the section 367(b) regulations, including §1.367(b)–2(k), permits FC's liquidation to qualify as a liquidation described in section 332.

(c) *Notice Required*—(1) *In general*. A notice under this paragraph (c) (section 367(b) notice) must be filed with regard to any person described in paragraph (c)(2) of this section. A section 367(b) notice must be filed in the time and manner described in paragraph (c)(3) of this section and must include the information described in paragraph (c)(4) of this section.

(2) *Persons subject to section 367(b) notice*. The following persons are described in this paragraph (c)(2)—

(i) A shareholder described in §1.367(b)–3(b)(1) that realizes income in a transaction described in §1.367(b)–3(a);

(ii) A shareholder that makes the election described in §1.367(b)–3(c)(3);

(iii) A shareholder described in §1.367(b)–4(b)(1)(i)(A)(*1*) or (*2*) that realizes income in a transaction described in §1.367(b)–4(a); and

(iv) A shareholder that realizes income in a transaction described in §1.367(b)–5(c) or 1.367(b)–5(d) and that is either–

(A) A section 1248 shareholder of the distributing or controlled corporation; or

(B) A foreign corporation with one or more shareholders that are described in paragraph (c)(2)(iv)(A) of this section.

(3) *Time and manner for filing notice*—(i) *United States persons described in §1.367(b)–1(c)(2)*. A United States person described in paragraph (c)(2) of this section must file a section 367(b) notice attached to a timely filed Federal tax return (including extensions) for the person's taxable year in which income is realized in the section 367(b) exchange. In the case of a shareholder that makes the election described in §1.367(b)–3(c)(3), notification of such election must be sent to the foreign acquired corporation (or its successor in interest) on or before the date the section 367(b) notice is filed, so that appropriate corresponding adjustments can be made in accordance with the rules of §1.367(b)–2(e).

(ii) *Foreign corporations described in §1.367(b)–1(c)(2)*. Each United States person listed in this paragraph (c)(3)(ii) must file a section 367(b) notice with regard to a foreign corporation described in paragraph (c)(2) of this section. Such notice must be attached to a timely filed Federal tax return (including extensions) for the United States person's taxable year in which income is realized in the section 367(b) exchange and, if the United States person is required to file a Form 5471 (Information Return of U.S. Persons With Respect To Certain Foreign Corporations), the section 367(b) notice must be attached to the Form 5471. The following persons are listed in this paragraph (c)(3)(ii)—

(A) United States shareholders (as defined in §1.367(b)–3(b)(2)) of foreign corporations described in paragraph (c)(2)(i) of this section; and

(B) Section 1248 shareholders of foreign corporations described in paragraph (c)(2)(iii) or (iv) of this section.

(4) *Information required*. Except as provided in paragraph (c)(5) of this section, a section 367(b) notice shall include the following information—

(i) A statement that the exchange is a section 367(b) exchange;

(ii) A complete description of the exchange;

(iii) A description of any stock, securities or other consideration transferred or received in the exchange;

(iv) A statement that describes any amount required, under the section 367(b) regulations, to be taken into account as income or loss or as an adjustment to basis, earnings and profits, or other tax attributes as a result of the exchange;

(v) Any information that is or would be required to be furnished with a Federal income tax return pursuant to regulations under section 332, 351, 354, 355, 356, 361 or 368 (whether or not a Federal income tax return is required to be filed), if such information has not otherwise been provided by the person filing the section 367(b) notice;

(vi) Any information required to be furnished with respect to the exchange under sections 6038, 6038A, 6038B, 6038C or 6046, or the regulations under those sections, if such information has not otherwise been provided by the person filing the section 367(b) notice; and

(vii) If applicable, a statement that the shareholder is making the election described in §1.367(b)–3(c)(3). This statement must include—

(A) A copy of the information the shareholder received from the foreign acquired corporation (or its successor in interest) establishing and substantiating the shareholder's all earnings and profits amount with respect to the shareholder's stock in the foreign acquired corporation; and

(B) A representation that the shareholder has notified the foreign acquired corporation (or its successor in interest) that the shareholder is making the election described in §1.367(b)–3(c)(3).

(5) *Abbreviated notice provision*. In the case of a foreign acquired corporation that has never had earnings and profits that would result in any shareholder having an all earnings and profits amount, a shareholder making the election described in §1.367(b)–3(c)(3) may satisfy the information requirements of paragraph (c)(4) of this section by filing a section 367(b) notice that includes–

(i) A statement from the foreign acquired corporation (or its successor in interest) that the foreign acquired corporation has never had any earnings and profits that would result in any shareholder having an all earnings and profits amount; and

(ii) The information described in paragraphs (c)(4)(i) through (iii) of this section.

(6) *Supplemental published guidance*. The section 367(b) notice requirements may be updated or amended by revenue procedure or other published guidance.

§1.367(b)–2 Definitions and special rules.

(a) *Controlled foreign corporation*. The term *controlled foreign corporation* means a controlled foreign corporation as defined in section 957 (taking into account section 953(c)).

(b) *Section 1248 shareholder*. The term *section 1248 shareholder means any* United States person that satisfies the ownership requirements of section 1248(a)(2) or (c)(2) with respect to a foreign corporation.

(c) *Section 1248 amount*—(1) *Rule*. The term *section 1248 amount* with respect to stock in a foreign corporation means the net positive earnings and profits (if any) that would have been attributable to such stock and includible in income as a dividend under section 1248 and the regulations thereunder if the stock were sold by the shareholder. In the case of a transaction in which the shareholder is a foreign corporation (foreign shareholder), the following additional rules shall apply–

(i) The foreign shareholder shall be deemed to be a United States person for purposes of this paragraph (c), except that the foreign shareholder shall not be considered a United States person for purposes of determining whether the stock owned by the foreign shareholder is stock of a controlled foreign corporation, and

(ii) The foreign shareholder's holding period in the stock of the foreign corporation shall be determined by reference to the period that the foreign shareholder's section 1248 shareholders held (directly or indirectly) an interest in the foreign corporation. This paragraph (c)(1)(ii) applies in addition to the section 1248 regulations' incorporation of section 1223 holding periods, as modified by §1.367(b)–4(d) (as applicable).

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

Example 1—(i) *Facts*. DC, a domestic corporation, owns all of the outstanding stock of FC1, a controlled foreign corporation (CFC). FC1 owns all of the outstanding stock of FC2, a CFC. DC has always owned all of the stock of FC1, and FC1 has always owned all of the stock of FC2.

(ii) *Result*. Under this paragraph (c), DC's section 1248 amount with respect to its FC1 stock is computed by reference to all of FC1's and FC2's earnings and profits. See section 1248(c)(2). Because FC1's section 1248 shareholder (DC) always indirectly held all of the stock of FC2, FC1's section 1248 amount with respect to its FC2 stock is computed by reference to all of FC2's earnings and profits.

Example 2—(i) *Facts*. DC, a domestic corporation, owns 40 percent of the outstanding stock of FC1, a foreign corporation. The other 60 percent of FC1 stock is owned (directly and indirectly) by foreign persons that are unrelated to DC. FC1 owns all of the outstanding stock of FC2, a foreign corporation. On January 1, 2001, DC purchases the remaining 60 percent of FC1 stock.

(ii) *Result*. Under this paragraph (c), DC's section 1248 amount with respect to its FC1 stock is computed by reference to FC1's and FC2's earnings and profits that accumulated on or after January 1, 2001, the date FC1 and FC2 became controlled foreign corporations (CFCs). See section 1248(a). Because FC1 is not considered a United States person for purposes of determining whether FC2 is a CFC, FC1's section 1248 amount with respect to its FC2 stock is computed by reference to FC2's earnings and profits that accumulated on or after January 1, 2001, the date FC2 became an actual CFC.

Example 3—(i) *Facts*. FC1, a foreign corporation, owns all of the outstanding stock of FC2, a foreign corporation. DC is a domestic corporation that is unrelated to FC1, FC2, and their direct and indirect owners. On January 1, 2001, DC purchases all of the outstanding stock of FC1.

(ii) *Result*. Under this paragraph (c), DC's section 1248 amount with respect to its FC1 stock is computed by reference to FC1's and FC2's earnings and profits that accumulated on or after January 1, 2001, the first day DC held the stock of FC1. See section 1248(a). FC1's section 1248 amount with respect to its FC2 stock is computed by reference to FC2's earnings and profits that accumulated on or after January 1, 2001, the first day FC1's section 1248 shareholder (DC) indirectly held the stock of FC2.

Example 4—(i) *Facts*. DC, a domestic corporation, directly owns all of the outstanding stock of FC1 and FC2, controlled foreign corporations. DC has always owned all of the stock of FC1 and FC2. On January 1, 2001, DC contributes all of the stock of FC2 to FC1 in a nonrecognition exchange that does not require an income inclusion under the section 367(a) or 367(b) regulations. See §§1.367(a)–8 and 1.367(b)–4.

(ii) *Result*. Under this paragraph (c), DC's section 1248 amount with respect to its FC1 stock is computed by reference to all of FC1's and FC2's earnings and profits. See section 1248(c)(2). Because FC1's section 1248 shareholder (DC) always held (directly or indirectly) all of the stock of FC2, FC1's section 1248 amount with respect to its FC2 stock is computed by reference to all of FC2's earnings and profits

(d) *All earnings and profits amount*—(1) *General rule*. The term *all earnings and profits amount* with respect to stock in a foreign corporation means the net positive earnings and profits (if any) determined as provided under paragraph (d)(2) of this section and attributable to such stock as provided under paragraph (d)(3) of this section. The all earnings and profits amount shall be determined without regard to the amount of gain that would be realized on a sale or exchange of the stock of the foreign corporation.

(2) *Rules for determining earnings and profits*—(i) *Domestic rules generally applicable*. For purposes of this paragraph (d), except as provided in sections 312(k)(4) and (n)(8), 964 and 986, the earnings and profits of a foreign corporation for any taxable year shall be determined according to principles substantially similar to those applicable to domestic corporations.

(ii) *Certain adjustments to earnings and profits*. Notwithstanding paragraph (d)(2)(i) of this section, for purposes of this paragraph (d), the earnings and profits of a foreign corporation for any taxable year shall not include the amounts specified in section 1248(d). In the case of amounts specified in section 1248(d)(4), the preceding sentence requires that the earnings and profits for any taxable year be decreased by the net positive amount (if any) of earnings and profits attributable to activities described in section 1248(d)(4), and increased by the net reduction (if any) in earnings and profits attributable to activities described in section 1248(d)(4).

(iii) *Effect of section 332 liquidating distribution*. The all earnings and profits amount with respect to stock of a corporation that distributes all of its property in a liquidation described in section 332 shall be determined without regard to the adjustments prescribed by section 312(a) and (b) resulting from the distribution of such property in liquidation, except that gain or loss realized by the corporation on the distribution shall be taken into account to the extent provided in section 312(f)(1). See §1.367(b)–3(b)(3)(ii) *Example 3*.

(3) *Amount attributable to a block of stock*—(i) *Application of section 1248 principles*—(A) *In general*—(*1*) *Rule*. The all earnings and profits amount with respect to stock of a foreign corporation is determined according to the attribution principles of section 1248 and the regulations thereunder. The attribution principles of section 1248 shall apply without regard to the requirements of section 1248 that are not relevant to the determination of a shareholder's pro rata portion of earnings and profits. Thus, for example, the all earnings and profits amount is determined without regard to whether the foreign corporation was a controlled foreign corporation at any time during the five years preceding the section 367(b) exchange in question, without regard to whether the shareholder owned a 10 percent or greater interest in the stock, and without regard to whether the earnings and profits of the foreign corporation were accumulated in post-1962 taxable years or while the corporation was a controlled foreign corporation.

(*2*) *Example*. The following example illustrates the rules of this paragraph (d)(3)(i)(A):

Example—(i) *Facts*. On January 1, 2001, DC, a domestic corporation, purchases 9 percent of the outstanding stock of FC, a foreign corporation. On January 1, 2002, DC purchases an additional 1 percent of FC stock. On January 1, 2003, DC exchanges its stock in FC in a section 367(b) exchange in which DC is required to include the all earnings and profits amount in income. FC was not a controlled foreign corporation during the entire period DC held its FC stock.

(ii) *Result*. The all earnings and profits amount with respect to DC's stock in FC is computed by reference to 9 percent of FC's earnings and profits from January 1, 2001, through December 31, 2001, and by reference to 10 percent of FC's earnings and profits from January 1, 2002, through January 1, 2003.

(B) *Foreign shareholders*. In the case of a transaction in which the exchanging shareholder is a foreign corporation (foreign shareholder), the following additional rules shall apply–

(*1*) The attribution principles of section 1248 shall apply without regard to whether the person directly owning the stock is a United States person; and

(*2*) The foreign shareholder's holding period in the stock of the foreign acquired corporation shall be determined by reference to the period that the foreign shareholder's United States shareholders (as defined in §1.367(b)–3(b)(2)) held (directly or indirectly) an interest in the foreign acquired corporation. This paragraph (d)(3)(i)(B)(*2*) applies in addition to the section 1248 regulations' incorporation of section 1223 holding periods, as modified by paragraph (d)(3)(ii) of this section and §1.367(b)–4(d) (as applicable).

(ii) *Limitation on amounts attributable to holding periods determined under section 1223*—(A) *Rule*. In applying the attribution principles of section 1248 and the regulations thereunder to determine the all earnings and profits amount with respect to the stock of a foreign corporation, earnings and profits attributable to a section 1223(2) holding period that relates to a period of direct ownership of the stock of the foreign corporation by a non-United States person shall not be included, except to the extent of earnings and profits attributable to a period when the stock of the foreign corporation was indirectly owned by United States shareholders (as defined in §1.367(b)–3(b)(2)).

(B) *Example*. The following example illustrates the rules of this paragraph (d)(3)(ii):

Example—(i) *Facts*. (A) FC1 is a foreign corporation. The outstanding stock of FC1 is directly owned by the following unrelated persons: 20 percent by DP, a domestic partnership; 20 percent by DC, a domestic corporation; 20 percent by FC, a foreign corporation that is directly and indirectly owned by foreign persons; 20 percent by FP, a foreign partnership that is equally owned by 2 partners, DI, a United States citizen, and FI, a nonresident alien; and 20 percent by a variety of minority shareholders, none of whom owns, applying the ownership rules of section 958, 10 percent or more of the outstanding stock of FC (the small shareholders).

(B) FC1 owns all of the outstanding stock of FC2, a foreign corporation that is not a controlled foreign corporation subject to the rules of section 953(c). FC2 has net positive earnings and profits. In a reorganization described in section 368(a)(1)(B), DA, a domestic corporation, acquires all of the stock of FC2 from FC1 in exchange for DA voting stock.

(ii) *Result*. (A) Under section 1223(2), DA holds the stock of FC2 with a holding period that includes the period that FC2 was held by FC1. As a result, the rules of this paragraph (d)(3)(ii) apply for purposes of computing DA's all earnings and profits amount.

(B) In applying the attribution principles of section 1248, earnings and profits attributable to a section 1223(2) holding period that refers to a period of direct ownership of the stock of a foreign corporation by a non-United States person are not included, except to the extent the stock of the foreign corporation was indirectly owned by United States shareholders as defined in §1.367(b)–3(b)(2). Accordingly, DA's all earnings and profits amount does not include the FC2 earnings and profits attributable to FC, FI, and the small shareholders. DA's all earnings and profits amount does include the FC2 earnings and profits attributable to DP, DC, and DI. See §1.367(b)–2(k) for rules concerning the treatment of partnerships under the section 367(b) regulations.

(iii) *Exclusion of lower-tier earnings*. In applying the attribution principles of section 1248 and the regulations thereunder to determine the all earnings and profits amount with respect to stock of a foreign corporation, the earnings and profits of subsidiaries of the foreign corporation shall not be taken into account notwithstanding section 1248(c)(2).

(e) *Treatment of deemed dividends*—(1) *In general*. In certain circumstances these regulations provide that an exchanging shareholder shall include an amount in income as a deemed dividend. This paragraph provides rules for the treatment of the deemed dividend.

(2) *Consequences of dividend characterization*. A deemed dividend described in paragraph (e)(1) of this section shall be treated as a dividend for purposes of the Internal Revenue Code. The deemed dividend shall be considered as paid out of

the earnings and profits with respect to which the amount of the deemed dividend was determined. Thus, for example, a deemed dividend that is determined by reference to the all earnings and profits amount or the section 1248 amount will never be considered as paid out of (and therefore will never reduce) earnings and profits specified in section 1248(d), because such earnings and profits are excluded in computing the all earnings and profits amount (under paragraph (d)(2)(ii) of this section) and the section 1248 amount (under section 1248(d) and paragraph (c)(1) of this section). If the deemed dividend is determined by reference to the earnings and profits of a foreign corporation that is owned indirectly (i.e., through one or more tiers of intermediate owners) by the person that is required to include the deemed dividend in income, the deemed dividend shall be considered as having been paid by such corporation to such person through the intermediate owners, rather than directly to such person.

(3) *Ordering rules*. In the case of an exchange of stock in which the exchanging shareholder is treated as receiving a deemed dividend from a foreign corporation, the following ordering rules concerning the timing, treatment, and effect of such a deemed dividend shall apply. See also paragraph (j)(2) of this section.

(i) For purposes of the section 367(b) regulations, the gain realized by an exchanging shareholder shall be determined before increasing (as provided in paragraph (e)(3)(ii) of this section) the basis in the stock of the foreign corporation by the amount of the deemed dividend.

(ii) Except as provided in paragraph (e)(3)(i) of this section, the deemed dividend shall be considered to be received immediately before the exchanging shareholder's receipt of consideration for its stock in the foreign corporation, and the shareholder's basis in the stock exchanged shall be increased by the amount of the deemed dividend. Such basis increase shall be taken into account before determining the gain otherwise recognized on the exchange (for example, under section 356), the basis that the exchanging shareholder takes in the property that it receives in the exchange (under section 358(a)(1)), and the basis that the transferee otherwise takes in the transferred stock (under section 362).

(iii) Except as provided in paragraph (e)(3)(i) of this section, the earnings and profits of the appropriate foreign corporation shall be reduced by the deemed dividend amount before determining the consequences of the recognition of gain in excess of the deemed dividend amount (for example, under section 356(a)(2) or sections 356(a)(1) and 1248).

(4) *Examples*. The following examples illustrate the rules of this paragraph (e):

Example 1. DC, a domestic corporation, exchanges stock in FC, a foreign corporation, in a section 367(b) exchange in which DC includes the all earnings and profits amount in income as a deemed dividend. Under paragraph (e)(2) of this section, a deemed dividend is treated as a dividend for purposes of the Internal Revenue Code. As a result, if the requirements of section 902 are met, DC may qualify for a deemed paid foreign tax credit with respect to the deemed dividend that it receives from FC.

Example 2. DC, a domestic corporation, exchanges stock in FC1, a foreign corporation that is a controlled foreign corporation, in a transaction in which DC is required to include the section 1248 amount in income as a deemed dividend. A portion of the section 1248 amount is determined by reference to the earnings and profits of FC1 (the upper-tier portion of the section 1248 amount), and the remainder of the section 1248 amount is determined by reference to the earnings and profits of FC2, which is a wholly owned foreign subsidiary of FC1 (the lower-tier portion of the section 1248 amount). Under paragraph (e)(2) of this section, DC computes its deemed paid foreign tax credit as if the lower-tier portion of the section 1248 amount were distributed as a dividend by FC2 to FC1, and as if such portion and the upper-tier portion of the section 1248 amount were then distributed as a dividend by FC1 to DC.

Example 3. DC, a domestic corporation, exchanges stock in FC, a foreign corporation that is a controlled foreign corporation, in a transaction in which DC realizes gain of $100 (prior to the application of the section 367(b) regulations). In connection with the transaction, DC is required to include $40 in income as a deemed dividend under the section 367(b) regulations. In addition to receiving property permitted to be received under section 354 without the recognition of gain, DC also receives cash in the amount of $70. Under paragraph (e)(3) of this section, the $40 deemed dividend increases DC's basis in its FC stock before determining the gain to be recognized under section 356. Thus, in applying section 356, DC is considered to realize $60 of gain on the exchange, all of which is recognized under section 356(a)(1).

(f) *Deemed asset transfer and closing of taxable year in certain section 368(a)(1)(F) reorganizations*—(1) *Scope*. This paragraph applies to a reorganization described in section 368(a)(1)(F) in which the transferor corporation is a foreign corporation.

(2) *Deemed asset transfer*. In a reorganization described in paragraph (f)(1) of this section, there is considered to exist—

(i) A transfer of assets by the foreign transferor corporation to the acquiring corporation in exchange for stock (or stock and securities) of the acquiring corporation and the assumption by the acquiring corporation of the foreign transferor corporation's liabilities;

(ii) A distribution of such stock (or stock and securities) by the foreign transferor corporation to its shareholders (or shareholders and security holders); and

(iii) An exchange by the foreign transferor corporation's shareholders (or shareholders and security holders) of their stock (or stock and securities) for stock (or stock and securities) of the acquiring corporation.

(3) *Other applicable rules*. For purposes of this paragraph (f), it is immaterial that the applicable foreign or domestic law treats the acquiring corporation as a continuation of the foreign transferor corporation.

(4) *Closing of taxable year.* In a reorganization described in paragraph (f)(1) of this section, the taxable year of the foreign transferor corporation shall end with the close of the date of the transfer and the taxable year of the acquiring corporation shall end with the close of the date on which the transferor's taxable year would have ended but for the occurrence of the reorganization if–

(i) The acquiring corporation is a domestic corporation; or

(ii) The foreign transferor corporation has effectively connected earnings and profits (as defined in section 884(d)) or accumulated effectively connected earnings and profits (as defined in section 884(b)(2)(B)(ii)).

(g) *Stapled stock under section 269B.* For rules treating a foreign corporation as a domestic corporation if it and a domestic corporation are stapled entities, see section 269B. The deemed conversion of a foreign corporation to a domestic corporation under section 269B is treated as a reorganization under section 368(a)(1)(F).

(h) *Section 953(d) domestication elections*—(1) *Effect of election*. A foreign corporation that elects under section 953(d) to be treated as a domestic corporation shall be treated for purposes of section 367(b) as transferring, as of the first day of the first taxable year for which the election is effective, all of its assets to a domestic corporation in a reorganization described in section 368(a)(1)(F). Notwithstanding paragraph (d) of this section, for purposes of determining the consequences of the reorganization under §1.367(b)–3, the all earnings and profits amount shall not be considered to include earnings and profits accumulated in taxable years beginning before January 1, 1988.

(2) *Post-election exchanges*. For purposes of applying section 367(b) to post-election exchanges with respect to a corporation that has made a valid election under section 953(d) to be treated as a domestic corporation, such corporation shall be treated as a domestic corporation as to earnings and profits that were taken into account at the time of the section 953(d) election or which accrue after such election, and shall be treated as a foreign corporation as to earnings and profits accumulated in taxable years beginning before January 1, 1988. Thus, for example, if the section 953(d) corporation subsequently transfers its assets to a domestic corporation (other than another section 953(d) corporation) in a transaction described in section 381(a), the rules of §1.367(b)–3 shall apply to such transaction to the extent of the section 953(d) corporation's earnings and profits accumulated in taxable years beginning before January 1, 1988.

(i) *Section 1504(d) elections*. An election under section 1504(d), which permits certain foreign corporations to be treated as domestic corporations, is treated as a transfer of property to a domestic corporation and will generally constitute a reorganization described in section 368(a)(1)(F). However, if an election under section 1504(d) is made with respect to a foreign corporation from the first day of the foreign corporation's existence, then the foreign corporation shall be treated as a domestic corporation, and the section 367(b) regulations will not apply.

(j) *Sections 985 through 989*—(1) *Change in functional currency of a qualified business unit*—(i) *Rule*. If, as a result of a transaction described in section 381(a), a qualified business unit (as defined in section 989(a)) (QBU) has a different functional currency determined under the rules of section 985(b) than it used prior to the transaction, then the QBU shall be deemed to have automatically changed its functional currency immediately prior to the transaction. A QBU that is deemed to change its functional currency pursuant to this paragraph (j) must make the adjustments described in §1.985–5.

(ii) *Example*. The following example illustrates the rule of this paragraph (j)(1):

Example—(i) *Facts*. DC, a domestic corporation, owns 100 percent of FC1, a foreign corporation. FC1 owns and operates a qualified business unit (QBU) (B1) in France, whose functional currency is the euro. FC2, an unrelated foreign corporation, owns and operates a QBU (B2) in France, whose functional currency is the dollar. FC2 acquires FC1's assets (including B1) in a reorganization described in section 368(a)(1)(C). As a part of the reorganization, B1 and B2 combine their operations into one QBU. Applying the rules of section 985(b), the functional currency of the combined operations of B1 and B2 is the euro.

(ii) *Result*. FC2's acquisition of FC1's assets is a section 367(b) exchange that is described in section 381(a). Because the functional currency of the combined operations of B1 and B2 after the exchange is the euro, B2 is deemed to have automatically changed its functional currency to the euro immediately prior to the section 367(b) exchange. B2 must make the adjustments described in §1.985–5.

(2) *Previously taxed earnings and profits*—(i) *Exchanging shareholder that is a United States person*. If an exchanging shareholder that is a United States person is required to include in income either the all earnings and profits amount or the section 1248 amount under the provisions of §1.367(b)–3 or 1.367(b)–4, then immediately prior to the exchange, and solely for the purpose of computing exchange gain or loss under section 986(c), the exchanging shareholder shall be treated as receiving a distribution of previously taxed earnings and profits from the appropriate foreign corporation that is attributable (under the principles of section 1248) to the exchanged stock. If an exchanging shareholder that is a United States person is a distributee in an exchange described in §1.367(b)–5(c) or (d), then immediately prior to the exchange, and solely for the purpose of computing exchange gain or loss under section 986(c), the exchanging shareholder shall be treated as receiving a distribution of previously taxed earnings and profits from the appropriate foreign corporation to the extent such shareholder has a diminished interest in such previously taxed earnings and profits after the exchange. The exchange gain or loss recognized under this paragraph (j)(2)(i) will increase or decrease the exchanging shareholder's adjusted basis in the stock of the foreign corporation for purposes of computing gain or loss realized with respect to the stock on the transaction. The exchanging shareholder's dollar basis with respect to each account of previously taxed income shall be increased or decreased by the exchange gain or loss recognized.

(ii) *Exchanging shareholder that is a foreign corporation*. If an exchanging shareholder that is a foreign corporation is required to include in income either the all earnings and profits amount or the section 1248 amount under the provisions of §1.367(b)–3 or 1.367(b)–4, then, immediately prior to the exchange, the exchanging shareholder shall be treated as receiving a distribution of previously taxed earnings and profits from the appropriate foreign corporation that is attributable (under the principles of section 1248) to the exchanged stock. If an exchanging shareholder that is a foreign corporation is a distributee in an exchange described in §1.367(b)–5(c) or (d), then the exchanging shareholder shall be treated as receiving (immediately prior to the exchange) a distribution of previously taxed earnings and profits from the appropriate foreign corporation. Such distribution shall be measured by the extent to which the exchanging shareholder's direct or indirect United States shareholders (as defined in section 951(b)) have a diminished interest in such previously taxed earnings and profits after the exchange.

(3) *Other rules*. See sections 985 through 989 for other currency rules that may apply in connection with a section 367(b) exchange.

(k) *Partnerships, trusts and estates*. In applying the section 367(b) regulations, stock of a corporation that is owned by a foreign partnership, trust or estate shall be considered as owned proportionately by its partners, owners, or beneficiaries under the principles of §1.367(e)–1(b)(2). Stock owned by an entity that is disregarded as an entity separate from its owner under §301.7701–3 is owned directly by the owner of such entity. In applying §1.367(b)–5(b), the principles of

§1.367(e)–1(b)(2) shall also apply to a domestic partnership, trust or estate.

Par. 5. Section 1.367(b)–3 is added to read as follows:

§1.367(b)–3 Repatriation of foreign corporate assets in certain nonrecognition transactions.

(a) *Scope*. This section applies to an acquisition by a domestic corporation (the domestic acquiring corporation) of the assets of a foreign corporation (the foreign acquired corporation) in a liquidation described in section 332 or an asset acquisition described in section 368(a)(1).

(b) *Exchange of stock owned directly by a United States shareholder or by certain foreign corporate shareholders*—(1) *Scope*. This paragraph (b) applies in the case of an exchanging shareholder that is either—

(i) A United States shareholder of the foreign acquired corporation; or

(ii) A foreign corporation with respect to which there are one or more United States shareholders.

(2) *United States shareholder*. For purposes of this section (and for purposes of the other section 367(b) regulation provisions that specifically refer to this paragraph (b)(2)), the term *United States shareholder* means any shareholder described in section 951(b) (without regard to whether the foreign corporation is a controlled foreign corporation), and also any shareholder described in section 953(c)(1)(A) (but only if the foreign corporation is a controlled foreign corporation subject to the rules of section 953(c)).

(3) *Income inclusion*—(i) *Inclusion of all earnings and profits amount*. An exchanging shareholder shall include in income as a deemed dividend the all earnings and profits amount with respect to its stock in the foreign acquired corporation. For the consequences of the deemed dividend, see §1.367(b)–2(e). Notwithstanding §1.367(b)–2(e), however, a deemed dividend from the foreign acquired corporation to an exchanging foreign corporate shareholder shall not qualify for the exception from foreign personal holding company income provided by section 954(c)(3)(A)(i), although it may qualify for the look-through treatment provided by section 904(d)(3) if the requirements of that section are met with respect to the deemed dividend.

(ii) *Examples*. The following examples illustrate the rules of paragraph (b)(3)(i) of this section:

Example 1—(i) *Facts*. DC, a domestic corporation, owns all of the outstanding stock of FC, a foreign corporation. The stock of FC has a value of $100, and DC has a basis of $30 in such stock. The all earnings and profits amount attributable to the FC stock owned by DC is $20, of which $15 is described in section 1248(a) and the remaining $5 is not (for example, because it accumulated prior to 1963). FC has a basis of $50 in its assets. In a liquidation described in section 332, FC distributes all of its property to DC, and the FC stock held by DC is canceled.

(ii) *Result*. Under paragraph (b)(3)(i) of this section, DC must include $20 in income as a deemed dividend from FC. Under section 337(a) FC does not recognize gain or loss in the assets that it distributes to DC, and under section 334(b), DC takes a basis of $50 in such assets. Because the requirements of section 902 are met, DC qualifies for a deemed paid foreign tax credit with respect to the deemed dividend that it receives from FC.

Example 2—(i) *Facts*. DC, a domestic corporation, owns all of the outstanding stock of FC, a foreign corporation. The stock of FC has a value of $100, and DC has a basis of $30 in such stock. The all earnings and profits amount attributable to the FC stock owned by DC is $75. FC has a basis of $50 in its assets. In a liquidation described in section 332, FC distributes all of its property to DC, and the FC stock held by DC is canceled.

(ii) *Result*. Under paragraph (b)(3)(i) of this section, DC must include $75 in income as a deemed dividend from FC. Under section 337(a) FC does not recognize gain or loss in the assets that it distributes to DC, and under section 334(b), DC takes a basis of $50 in such assets. Because the requirements of section 902 are met, DC qualifies for a deemed paid foreign tax credit with respect to the deemed dividend that it receives from FC.

Example 3—(i) *Facts*. DC, a domestic corporation, owns 80 percent of the outstanding stock of FC, a foreign corporation. DC has owned its 80 percent interest in FC since FC was incorporated. The remaining 20 percent of the outstanding stock of FC is owned by a person unrelated to DC (the minority shareholder). The stock of FC owned by DC has a value of $80, and DC has a basis of $24 in such stock. The stock of FC owned by the minority shareholder has a value of $20, and the minority shareholder has a basis of $18 in such stock. FC's only asset is land having a value of $100, and FC has a basis of $50 in the land. Gain on the land would not generate earnings and profits qualifying under section 1248(d) for an exclusion from earnings and profits for purposes of section 1248. FC has earnings and profits of $20 (determined under the rules of §1.367(b)–2(d)(2)(i) and (ii)), $16 of which is attributable to the stock owned by DC under the rules of §1.367(b)–2(d)(3). FC subdivides the land and distributes to the minority shareholder land with a value of $20 and a basis of $10. As part of the same transaction, in a liquidation described in section 332, FC distributes the remainder of its land to DC, and the FC stock held by DC and the minority shareholder is canceled.

(ii) *Result*. Under section 336, FC must recognize the $10 of gain it realizes in the land it distributes to the minority shareholder, and under section 331 the minority shareholder recognizes its gain of $2 in the stock of FC. Such gain is included in income by the minority shareholder as a dividend to the extent provided in section 1248 if the minority shareholder is a United States person that is described in section 1248(a)(2). Under §1.367(b)–2(d)(2)(iii), the $10 of gain recognized by FC increases its earnings and profits for purposes of computing the all earnings and profits amount and, as a result, $8 of such increase (80 percent of $10) is considered to be attributable to the FC stock owned by DC under §1.367(b)–2(d)(3)(i)(A)(1). DC's all earnings and profits amount with respect to its stock in FC is $24 (the $16 of initial all earnings and profits amount with respect to the FC stock held by DC, plus the $8 addition to such amount that results from FC's recognition of gain on the distribution to the minority shareholder). Under paragraph (b)(3)(i) of this section, DC must include the $24 all earnings and profits amount in income as a deemed dividend from FC.

Example 4—(i) *Facts*. DC1, a domestic corporation, owns all of the outstanding stock of DC2, a domestic corporation. DC1 also owns all of the outstanding stock of FC, a foreign corporation. The stock of FC has a value of $100, and DC1 has a basis of $30 in such stock. The assets of FC have a value of $100. The all earnings and profits amount with respect to the FC stock owned by DC1 is $20. In a reorganization described in section 368(a)(1)(D), DC2 acquires all of the assets of FC solely in exchange for DC2 stock. FC distributes the DC2 stock to DC1, and the FC stock held by DC1 is canceled.

(ii) *Result*. DC1 must include $20 in income as a deemed dividend from FC under paragraph (b)(3)(i) of this section. Under section 361, FC does not recognize gain or loss in the assets that it transfers to DC2 or in the DC2 stock that it distributes to DC1, and under section 362(b) DC2 takes a basis in the assets that it acquires from FC equal to the basis that FC had therein. Under §1.367(b)–2(e)(3)(ii) and section 358(a)(1), DC1 takes a basis of $50 (its $30 basis in the stock of FC, plus the $20 that was treated as a deemed dividend to DC1) in the stock of DC2 that it receives in exchange for the stock of FC. Under §1.367(b)–2(e)(3)(iii) and section 312(a), the earnings and profits of FC are reduced by the $20 deemed dividend.

Example 5—(i) *Facts*. DC1, a domestic corporation, owns all of the outstanding stock of DC2, a domestic corporation. DC1 also owns all of the outstanding stock of FC1, a foreign corporation. FC1 owns all of the outstanding stock of FC2, a foreign corporation. The all earnings and profits amount with respect to the FC2 stock owned by FC1 is $20. In a reorganization described in section 368(a)(1)(D), DC2 acquires all of the assets and liabilities of FC2 in exchange for DC2 stock. FC2 distributes the DC2 stock to FC1, and the FC2 stock held by FC1 is canceled.

(ii) *Result*. FC1 must include $20 in income as a deemed dividend from FC2 under paragraph (b)(3)(i) of this section. The deemed dividend is treated as a dividend for purposes of the Internal Revenue Code as provided in §1.367(b)–2(e)(2); however, under paragraph (b)(3)(i) of this section the deemed dividend cannot qualify for the exception from foreign personal holding company income provided by section 954(c)(3)(A)(i), even if the provisions of that section would otherwise have been met in the case of an actual dividend.

Example 6—(i) *Facts*. DC1, a domestic corporation, owns 99 percent of USP, a domestic partnership. The remaining 1 percent of USP is owned by a person unrelated to DC1. DC1 and USP each directly own 9 percent of the outstanding stock of FC, a foreign corporation that is not a controlled foreign corporation subject to the rule of section 953(c). In a reorganization described in section 368(a)(1)(C), DC2, a domestic corporation, acquires all of the assets and liabilities of FC in exchange for DC2 stock. FC distributes to its shareholders DC2 stock, and the FC stock held by its shareholders is canceled.

(ii) *Result*. (A) DC1 and USP are United States persons that are exchanging shareholders in a transaction described in paragraph (a) of this section. As a result, DC1 and USP are subject to the rules of paragraph (b) of this section if they qualify as United States shareholders as defined in paragraph (b)(2) of this section. Alternatively, if they do not qualify as United States shareholders as defined in paragraph (b)(2) of this section, DC1 and USP are subject to the rules of paragraph (c) of this section. Paragraph (b)(2) of this section defines the term United States shareholder to include any shareholder described in section 951(b) (without regard to whether the foreign corporation is a controlled foreign corporation). A shareholder described in section 951(b) is a United States person that is considered to own, applying the rules of section 958(a) and 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of a foreign corporation. Under section 958(b), the rules of section 318(a), as modified by section 958(b) and the regulations thereunder, apply so that, in general, stock owned directly or indirectly by a partnership is considered as owned proportionately by its partners, and stock owned directly or indirectly by a partner is considered as owned by the partnership. Thus, under section 958(b), DC1 is treated as owning its proportionate share of FC stock held by USP, and USP is treated as owning all of the FC stock held by DC1.

(B) Accordingly, for purposes of determining whether DC1 is a United States shareholder under paragraph (b)(2) of this section, DC1 is considered as owning 99 percent of the 9 percent of FC stock held by USP. Because DC1 also owns 9 percent of FC stock directly, DC1 is considered as owning more than 10 percent of FC stock. DC1 is thus a United States shareholder of FC under paragraph (b)(2) of this section and, as a result, is subject to the rules of paragraph (b) of this section. However, for purposes of determining DC1's all earnings and profits amount, DC1 is not treated as owning the FC stock held by USP. Under §1.367(b)–2(d)(3), DC1's all earnings and profits amount is determined by reference to the 9 percent of FC stock that it directly owns.

(C) For purposes of determining whether USP is a United States shareholder under paragraph (b)(2) of this section, USP is considered as owning the 9 percent of FC stock held by DC1. Because USP also owns 9 percent of FC stock directly, USP is considered as owning more than 10 percent of FC stock. USP is thus a United States shareholder of FC under paragraph (b)(2) of this section and, as a result, is subject to the rules of paragraph (b) of this section. However, for purposes of determining USP's all earnings and profits amount, USP is not treated as owning the FC shares held by DC1. Under §1.367(b)–2(d)(3), USP's all earnings and profits amount is determined by reference to the 9 percent of FC stock that it directly owns.

(iii) *Recognition of exchange gain or loss with respect to capital*. [Reserved]

(4) *Reserved*. For further guidance concerning section 367(b) exchanges occurring before February 24, 2001, see §1.367(b)–3T(b)(4).

(c) *Exchange of stock owned by a United States person that is not a United States shareholder*—(1) *Scope*. This paragraph (c) applies in the case of an exchanging shareholder that is a United States person not described in paragraph (b)(1)(i) of this section (i.e., a United States person that is not a United States shareholder of the foreign acquired corporation).

(2) *Requirement to recognize gain*. An exchanging shareholder described in paragraph (c)(1) of this section shall recognize realized gain (but not loss) with respect to the stock of the foreign acquired corporation.

(3) *Election to include all earnings and profits amount*. In lieu of the treatment prescribed by paragraph (c)(2) of this section, an exchanging shareholder described in paragraph (c)(1) of this section may instead elect to include in income as a deemed dividend the all earnings and profits amount with respect to its stock in the foreign acquired corporation. For the consequences of a deemed dividend, see §1.367(b)–2(e). Such election may be made only if–

(i) The foreign acquired corporation (or its successor in interest) has provided the exchanging shareholder information to substantiate the exchanging shareholder's all earnings and profits amount with respect to its stock in the foreign acquired corporation; and

(ii) The exchanging shareholder complies with the section 367(b) notice requirement described in §1.367(b)–1(c), including the specific rules contained therein concerning the time and manner for electing to apply the rules of this paragraph (c)(3).

(4) *De minimis exception*. This paragraph (c) shall not apply in the case of an exchanging shareholder whose stock in the foreign acquired corporation has a fair market value of less than $50,000 on the date of the section 367(b) exchange.

(5) *Examples*. The following examples illustrate the rules of this paragraph (c):

Example 1—(i) *Facts*. DC1, a domestic corporation, owns 5 percent of the outstanding stock of FC, a foreign corporation that is not a controlled foreign corporation subject to the rule of section 953(c). Persons unrelated to DC1 own the remaining 95 percent of the outstanding stock of FC. DC1 has owned its 5 percent interest in FC since FC was incorporated. DC1's stock in FC has a basis of $40,000 and a value of $100,000. The all earnings and profits amount with respect to DC1's stock in FC is $50,000. In a reorganization described in section 368(a)(1)(C), DC2, a domestic corporation, acquires all of the assets and liabilities of FC in exchange for DC2 stock. FC distributes DC2 stock to its shareholders, and the FC stock held by its shareholders is canceled.

(ii) *Alternate result 1*. If DC1 does not make the election described in paragraph (c)(3) of this section, then the general rule of paragraph (c)(2) of this section applies and DC1 must recognize its $60,000 gain in the FC stock. Under section 358(a)(1), DC1 has a $100,000 basis (its $40,000 basis in the FC stock, plus the $60,000 recognized gain) in the DC2 stock that it receives in exchange for its FC stock. Because DC1 is not a shareholder described in section 1248(a)(2), section 1248 does not apply to recharacterize any of DC1's gain as a dividend.

(iii) *Alternate result 2*. If DC1 makes a valid election under paragraph (c)(3) of this section, then DC1 must include in income as a deemed dividend the $50,000 all earnings and profits amount with respect to its FC stock. Under §1.367(b)–2(e)(3) and section 358(a)(1), DC1 has a $90,000 basis (its $40,000 basis in the FC stock, plus the $50,000 that was treated as a deemed dividend to DC1) in the DC2 stock that it receives in exchange for its FC stock. Because DC1 owns less than 10 percent of the voting stock of FC, DC1 does not qualify for a deemed paid foreign tax credit under section 902.

Example 2—(i) *Facts*. The facts are the same as in *Example 1*, except that DC1's stock in FC has a fair market value of $48,000 on the date DC1 receives the DC2 stock.

(ii) *Result*. Because DC1's stock in FC has a fair market value of less than $50,000 on the date of the section 367(b) exchange, the de minimis exception of paragraph (c)(4) of this section applies. As a result, DC1 is not subject to the gain or income inclusion requirements of this paragraph (c).

(d) *Carryover of certain foreign taxes*—(1) *Rule*. Unused foreign tax credits allowable to the foreign acquired corporation under section 906 shall carry over to the domestic acquiring corporation and become allowable under section 901, subject to the limitations prescribed by the Internal Revenue Code (for example, sections 383, 904 and 907). The domestic acquiring corporation shall not succeed to any other foreign taxes paid or incurred by the foreign acquired corporation.

(2) *Example*. The following example

illustrates the rules of this paragraph (d):

Example—(i) *Facts*. DC, a domestic corporation owns 100 percent of the outstanding stock of FC, a foreign corporation. FC has net positive earnings and profits, none of which are attributable to DC's FC stock under §1.367(b)–2(d)(3). FC has paid foreign taxes that are not eligible for credit under section 906. In a liquidation described in section 332, FC distributes all of its property to DC, and the FC stock held by DC is canceled.

(ii) *Result*. The liquidation of FC into DC is a section 367(b) exchange. Thus, DC is subject to the section 367(b) regulations, and must file a section 367(b) notice pursuant to §1.367(b)–1(c). Pursuant to the provisions of paragraph (d)(1) of this section, the foreign taxes paid by FC do not carryover to DC because FC's foreign taxes are not eligible for credit under section 906.

Par. 6. Section 1.367(b)–4 is revised to read as follows:

§1.367(b)–4 Acquisition of foreign corporate stock or assets by a foreign corporation in certain nonrecognition transactions.

(a) *Scope*. This section applies to an acquisition by a foreign corporation (the foreign acquiring corporation) of the stock or assets of another foreign corporation (the foreign acquired corporation) in an exchange described in section 351 or a reorganization described in section 368(a)(1)(B), (C), (D), (E), (F) or (G). See §1.367(a)–3(b)(2) for additional rules that may apply.

(b) *Income inclusion*. If an exchange is described in paragraph (b)(1)(i), (2)(i) or (3) of this section, the exchanging shareholder shall include in income as a deemed dividend the section 1248 amount attributable to the stock that it exchanges.

(1) *Exchange that results in loss of status as section 1248 shareholder*—(i) *Rule*. An exchange is described in this paragraph (b)(1)(i) if–

(A) Immediately before the exchange, the exchanging shareholder is—

(*1*) A United States person that is a section 1248 shareholder with respect to the foreign acquired corporation; or

(*2*) A foreign corporation, and a United States person is a section 1248 shareholder with respect to such foreign corporation and with respect to the foreign acquired corporation; and

(B) Either of the following conditions is satisfied—

(*1*) Immediately after the exchange, the stock received in the exchange is not stock in a corporation that is a controlled foreign corporation as to which the United States person described in paragraph (b)(1)(i)(A) of this section is a section 1248 shareholder; or

(*2*) Immediately after the exchange, the foreign acquiring corporation (or, in the case of a reorganization described in section 368(a)(1)(B), the foreign acquired corporation) is not a controlled foreign corporation as to which the United States person described in paragraph (b)(1)(i)(A) of this section is a section 1248 shareholder.

(ii) *Examples*. The following examples illustrate the rules of this paragraph (b)(1):

Example 1—(i) *Facts*. FC1 is a foreign corporation that is owned, directly and indirectly (applying the ownership rules of section 958), solely by foreign persons. DC is a domestic corporation that is unrelated to FC1. DC owns all of the outstanding stock of FC2, a foreign corporation. Thus, under §1.367(b)–2(a) and (b), DC is a section 1248 shareholder with respect to FC2, and FC2 is a controlled foreign corporation. Under §1.367(b)–2(c)(1), the section 1248 amount attributable to the stock of FC2 held by DC is $20. In a reorganization described in section 368(a)(1)(C), FC1 acquires all of the assets and assumes all of the liabilities of FC2 in exchange for FC1 voting stock. The FC1 voting stock received does not represent more than 50 percent of the voting power or value of FC1's stock. FC2 distributes the FC1 stock to DC, and the FC2 stock held by DC is canceled.

(ii) *Result*. FC1 is not a controlled foreign corporation immediately after the exchange. As a result, the exchange is described in paragraph (b)(1)(i) of this section. Under paragraph (b) of this section, DC must include in income, as a deemed dividend from FC2, the section 1248 amount ($20) attributable to the FC2 stock that DC exchanged.

Example 2—(i) *Facts*. The facts are the same as in *Example 1*, except that the voting stock of FC1, which is received by FC2 in exchange for its assets and distributed by FC2 to DC, represents more than 50 percent of the voting power of FC1's stock under the rules of section 957(a).

(ii) *Result*. Paragraph (b)(1)(i) of this section does not apply to require inclusion in income of the section 1248 amount, because FC1 is a controlled foreign corporation as to which DC is a section 1248 shareholder immediately after the exchange.

Example 3—(i) *Facts.* The facts are the same as in *Example 1*, except that FC2 receives and distributes voting stock of FP, a foreign corporation that is in control (within the meaning of section 368(c)) of FC1, instead of receiving and distributing voting stock of FC1.

(ii) *Result*. For purposes of section 367(a), the transfer is an indirect stock transfer subject to section 367(a). See §1.367(a)–3(d)(1)(iv). Accordingly, DC's exchange of FC2 stock for FP stock under section 354 will be taxable under section 367(a) (and section 1248 will be applicable) if DC fails to enter into a gain recognition agreement in accordance with §1.367(a)–8. Under §1.367(a)–3(b)(2), if DC enters into a gain recognition agreement, the exchange will be subject to the provisions of section 367(b) and the regulations thereunder, as well as section 367(a). If FP and FC1 are controlled foreign corporations as to which DC is a (direct or indirect) section 1248 shareholder immediately after the reorganization, then the section 367(b) result is the same as in *Example 2*— that is, paragraph (b)(1)(i) of this section does not apply to require inclusion in income of the section 1248 amount. Under these circumstances, the amount of the gain recognition agreement would equal the amount of the gain realized on the indirect stock transfer. If FP or FC1 is not a controlled foreign corporation as to which DC is a (direct or indirect) section 1248 shareholder immediately after the exchange, then the section 367(b) result is the same as in *Example 1*— that is, DC must include in income, as a deemed dividend from FC2, the section 1248 amount ($20) attributable to the FC2 stock that DC exchanged. Under these circumstances, the amount of the gain recognition agreement would equal the amount of the gain realized on the indirect stock transfer, less the $20 section 1248 amount inclusion.

Example 4—(i) *Facts*. DC1, a domestic corporation, owns all of the outstanding stock of DC2, a domestic corporation. DC2 owns various assets including all of the outstanding stock of FC2, a foreign corporation. The stock of FC2 has a value of $100, and DC2 has a basis of $30 in such stock. The section 1248 amount attributable to the FC2 stock held by DC2 is $20. DC2 does not own any other stock in a foreign corporation. FC1 is a foreign corporation that is unrelated to DC1, DC2 and FC2. In a reorganization described in section 368(a)(1)(C), FC1 acquires all of the assets and liabilities of DC2 in exchange for FC1 voting stock that represents 20 percent of the outstanding voting stock of FC1. DC2 distributes the FC1 stock to DC1, and the DC2 stock held by DC1 is canceled. DC1 properly files a gain recognition agreement under §1.367(a)–8 to qualify for nonrecognition treatment under section 367(a) with respect to DC2's transfer of the FC2 stock to FC1. See §1.367(a)–8(f)(2).

(ii) *Result*. Pursuant to paragraph (b)(1)(i)(A) of this section, DC2 is the exchanging shareholder that is a section 1248 shareholder with respect to FC2, the foreign acquired corporation. Immediately after the exchange, DC2 is not a section 1248 shareholder with respect to FC1, the corporation whose stock is received in the exchange (because the DC2 stock is canceled). Thus, paragraph (b)(1)(i)(B) of this section is satisfied and, as a result, paragraph (b)(1)(i) of this section applies to DC2's section 361 exchange of FC2 stock. Accordingly, under paragraph (b) of this section, DC2 must include in income, as a deemed dividend from FC2, the section 1248 amount ($20) attributable to the FC2 stock that DC2 exchanges. This result arises without regard to whether FC1 and FC2 are controlled foreign corporations immediately after the exchange. For the tax treatment of DC2's transfer of assets (other than stock) to FC1, see sections 367(a)(1) and (a)(3), and the regulations thereunder. Because the exchange is also described in section 361(a) or (b), see section 367(a)(5) and any regulations thereunder. If any of the assets transferred are intangible assets, see section 367(d) and the regulations thereunder.

(2) *Receipt by exchanging shareholder of preferred or other stock in certain instances*—(i) *Rule*. An exchange is described in this paragraph (b)(2)(i) if–

(A) Immediately before the exchange, the foreign acquired corporation and the foreign acquiring corporations are not members of the same affiliated group (within the meaning of section 1504(a), but without regard to the exceptions set forth in section 1504(b), and substituting the words "more than 50" in place of the words "at least 80" in sections 1504(a)(2)(A) and (B));

(B) Immediately after the exchange, a domestic corporation meets the ownership threshold specified by section 902(a) or (b) such that it may qualify for a deemed paid foreign tax credit if it receives a distribution from the foreign acquiring corporation (directly or through tiers); and

(C) The exchanging shareholder receives preferred stock (other than preferred stock that is fully participating with respect to dividends, redemptions and corporate growth) in consideration for common stock or preferred stock that is fully participating with respect to dividends, redemptions and corporate growth, or, in the discretion of the Commissioner or the Commissioner's delegate (and without regard to whether the stock exchanged is common stock or preferred stock), receives stock that entitles it to participate (through dividends, redemption payments or otherwise) disproportionately in the earnings generated by particular assets of the foreign acquired corporation or foreign acquiring corporation.

(ii) *Examples*. The following examples illustrate the rules of this paragraph (b)(2):

Example 1—(i) *Facts*. FC1 is a foreign corporation. DC is a domestic corporation that is unrelated to FC1. DC owns all of the outstanding stock of FC2, a foreign corporation, and FC2 has no outstanding preferred stock. The value of FC2 is $100 and DC has a basis of $50 in the stock of FC2. Under §1.367(b)–2(c)(1), the section 1248 amount attributable to the stock of FC2 held by DC is $20. In a reorganization described in section 368(a)(1)(B), FC1 acquires all of the stock of FC2 and, in exchange, DC receives FC1 voting preferred stock that constitutes 10 percent of the voting stock of FC1 for purposes of section 902(a). Immediately after the exchange, FC1 and FC2 are controlled foreign corporations and DC is a section 1248 shareholder of FC1 and FC2, so paragraph (b)(1)(i) of this section does not require inclusion in income of the section 1248 amount.

(ii) *Result*. Pursuant to §1.367(a)–3(b)(2), the transfer is subject to both section 367(a) and section 367(b). Under §1.367(a)–3(b)(1), DC will not be subject to tax under section 367(a)(1) if it enters into a gain recognition agreement in accordance with §1.367(a)–8. Even though paragraph (b)(1)(i) of this section does not apply to require inclusion in income by DC of the section 1248 amount, DC must nevertheless include the $20 section 1248 amount in income as a deemed dividend from FC2 under paragraph (b)(2)(i) of this section. Thus, if DC enters into a gain recognition agreement, the amount is $30 (the $50 gain realized less the $20 recognized under section 367(b)). If DC fails to enter into a gain recognition agreement, it must include in income under section 367(a)(1) the $50 of gain realized ($20 of which is treated as a dividend under section 1248). Section 367(b) does not apply in such case.

Example 2—(i) *Facts*. The facts are the same as in *Example 1*, except that DC owns all of the outstanding stock of FC1 immediately before the transaction.

(ii) *Result*. Both section 367(a) and section 367(b) apply to the transfer. Paragraph (b)(2)(i) of this section does not apply to require inclusion of the section 1248 amount. Under paragraph (b)(2)(i)(A) of this section, the transaction is outside the scope of paragraph (b)(2)(i) of this section because FC1 and FC2 are, immediately before the transaction, members of the same affiliated group (within the meaning of such paragraph). Thus, if DC enters into a gain recognition agreement in accordance with §1.367(a)–8, the amount of such agreement is $50. As in *Example 1*, if DC fails to enter into a gain recognition agreement, it must include in income $50, $20 of which will be treated as a dividend under section 1248.

Example 3—(i) *Facts*. FC1 is a foreign corporation. DC is a domestic corporation that is unrelated to FC1. DC owns all of the outstanding stock of FC2, a foreign corporation. The section 1248 amount attributable to the stock of FC2 held by DC is $20. In a reorganization described in section 368(a)(1)(B), FC1 acquires all of the stock of FC2 in exchange for FC1 voting stock that constitutes 10 percent of the voting stock of FC1 for purposes of section 902(a). The FC1 voting stock received by DC in the exchange carries voting rights in FC1, but by agreement of the parties the shares entitle the holder to dividends, amounts to be paid on redemption, and amounts to be paid on liquidation, that are to be determined by reference to the earnings or value of FC2 as of the date of such event, and that are affected by the earnings or value of FC1 only if FC1 becomes insolvent or has insufficient capital surplus to pay dividends.

(ii) *Result*. Under §1.367(a)–3(b)(1), DC will not be subject to tax under section 367(a)(1) if it enters into a gain recognition agreement with respect to the transfer of FC2 stock to FC1. Under §1.367(a)–3(b)(2), the exchange will be subject to the provisions of section 367(b) and the regulations thereunder to the extent that it is not subject to tax under section 367(a)(1). Furthermore, even if DC would not otherwise be required to recognize income under this section, the Commissioner or the Commissioner's delegate may nevertheless require that DC include the $20 section 1248 amount in income as a deemed dividend from FC2 under paragraph (b)(2)(i) of this section.

(3) *Certain recapitalizations*. An exchange pursuant to a recapitalization under section 368(a)(1)(E) shall be deemed to be an exchange described in this paragraph (b)(3) if the following conditions are satisfied—

(i) During the 24-month period immediately preceding or following the date of the recapitalization, the corporation that undergoes the recapitalization (or a predecessor of, or successor to, such corporation) also engages in a transaction that would be described in paragraph (b)(2)(i) of this section but for paragraph (b)(2)(i)(C) of this section, either as the foreign acquired corporation or the foreign acquiring corporation; and

(ii) The exchange in the recapitalization is described in paragraph (b)(2)(i)(C) of this section.

(c) *Exclusion of deemed dividend from foreign personal holding company income*—(1) *Rule*. In the event the section 1248 amount is included in income as a deemed dividend by a foreign corporation under paragraph (b) of this section, such deemed dividend shall not be included as foreign personal holding company income under section 954(c).

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

Example—(i) *Facts*. FC1 is a foreign corporation that is owned, directly and indirectly (applying the ownership rules of section 958), solely by foreign persons. DC is a domestic corporation that is unrelated to FC1. DC owns all of the outstanding stock of FC2, a foreign corporation. FC2 owns all of the outstanding stock of FC3, a foreign corporation. Under §1.367(b)–2(c)(1), the section 1248 amount attributable to the stock of FC3 held by FC2 is $20. In a reorganization described in section 368(a)(1)(B), FC1 acquires from FC2 all of the stock of FC3 in exchange for FC1 voting stock. The FC1 voting stock received by FC2 does not represent more than 50 percent of the voting power or value of FC1's stock.

(ii) *Result*. FC1 is not a controlled foreign corporation immediately after the exchange. Under paragraph (b)(1) of this section, FC2 must include in income, as a deemed dividend from FC3, the section 1248 amount ($20) attributable to the FC3 stock that FC2 exchanged. The deemed dividend is treated as a dividend for purposes of the Internal Revenue Code as provided in §1.367(b)–2(e)(2); however, under this paragraph (c) the deemed dividend is not foreign personal holding company income to FC2.

(d) *Rules for subsequent exchanges*—(1) *In general*. If income is not required to be included under paragraph (b) of this section in a section 367(b) exchange described in paragraph (a) of this section (non-inclusion exchange) then, for purposes of applying section 367(b) or 1248 to subsequent exchanges, the determination of the earnings and profits attributable to an exchanging shareholder's stock received in the non-inclusion exchange shall include a computation that refers to the exchanging shareholder's pro rata interest in the earnings and profits of the foreign acquiring corporation (and, in the case of a stock transfer, the foreign acquired corporation) that accumulate after the non-inclusion exchange, as well as its pro rata interest in the earnings and profits of the foreign acquired corporation that accumulated before the non-inclusion exchange. See also section 1248(c)(2)(D)(ii). The earnings and profits attributable to the stock received by an exchanging shareholder in the non-inclusion exchange shall not include any earnings and profits of the foreign acquiring corporation that accumulated before the non-inclusion exchange. In the case of a non-inclusion exchange in which the exchanging shareholder is a foreign corporation, this paragraph (d)(1) shall also apply for purposes of determining the earnings and profits attributable to the exchanging foreign corporation's shareholders, as well as for purposes of determining the earnings and profits attributable to the exchanging foreign corporation when applying section 964(e) to subsequent sales or exchanges of the stock of the foreign acquiring corporation.

(2) *Subsequent dispositions by a foreign acquiring corporation.* In the case of an exchange by a foreign acquiring corporation that is subject to section 367(b) or 964(e) and that follows a non-inclusion exchange (as defined in paragraph (d)(1) of this section), the rules of paragraph (d)(1) of this section shall not apply. However, as a result of such a subsequent exchange, proportionate reductions shall be made to the earnings and profits that accumulated before the non-inclusion exchange and that were attributed under paragraph (d)(1) of this section. Such reductions shall be made without regard to whether gain is recognized on the subsequent sale or exchange.

(3) *Examples.* The following examples illustrate the rules of this section:

Example 1—(i) *Facts.* DC1, a domestic corporation, owns all of the outstanding stock of FC1, a foreign corporation. DC1 has owned all of the stock of FC1 since FC1's formation. FC1 has $20 of earnings and profits, all of which is eligible for inclusion in the section 1248 amount attributable to DC1's stock in FC1. DC2, a domestic corporation, owns all of the outstanding stock of FC2, a foreign corporation. DC2 has owned all of the stock of FC2 since FC2's formation. FC2 has $40 of earnings and profits, all of which is eligible for inclusion in the section 1248 amount attributable to DC2's stock in FC2. DC1 and DC2 are unrelated. In a reorganization described in section 368(a)(1)(B), DC1 transfers all of the stock of FC1 to FC2 in exchange for 40 percent of FC2 stock. DC1 enters into a five-year gain recognition agreement under the provisions of §§1.367(a)–3(b) and 1.367(a)–8 with respect to its transfer of FC1 stock to FC2.

(ii) *Result.* (A) DC1's transfer of FC1 to FC2 is not described in paragraph (b)(1)(i), (2)(i), or (3) of this section. As a result, DC1 is not required to include in income the section 1248 amount attributable to its FC1 stock and the rules of paragraph (d)(1) of this section apply. Thus, for purposes of applying section 367(b) or 1248 to subsequent exchanges of FC2 stock, the determination of the earnings and profits attributable to DC1's stock in FC2 will include a computation that refers to 40 percent of the post-reorganization earnings and profits of FC1 and FC2, and that refers to 100 percent of the $20 of pre-reorganization earnings and profits of FC1. The earnings and profits attributable to DC1's stock in FC2 will not include any of the $40 of earnings and profits accumulated by FC2 prior to the transaction. Those earnings and profits are attributable to DC2 under section 1248. However, paragraph (d)(1) of this section does not apply for purposes of applying section 367(b) or 964(e) to subsequent exchanges of FC1 stock by FC2. For these purposes, the determination of the earnings and profits attributable to FC2's stock in FC1 is made under the principles of section 1248 and, as a result, includes a computation that refers to the $20 of earnings and profits attributable to FC2's section 1223(2) holding period in the FC1 stock.

(B) In the event FC2 exchanges FC1 stock in a transaction that is subject to section 367(b) or 964(e), a proportionate reduction must be made to the $20 of earnings and profits that was previously attributed under paragraph (d)(1) of this section to DC1's stock in FC2. Thus, for example, if FC2 sells 50 percent of its FC1 stock (at a time when there have been no other reductions that affect the $20 of FC1 earnings and profits), paragraph (d)(2) of this section requires DC1 to proportionately reduce the $20 of earnings and profits that was previously attributed to its FC2 stock (to $10). This reduction occurs without regard to whether FC2 recognizes gain on its sale of FC1 stock.

Example 2—(i) *Facts.* The facts are the same as in *Example 1*, except that in a reorganization described in section 368(a)(1)(C), FC1 transfers all of its assets to FC2 in exchange for 40 percent of FC2 stock. FC1 then distributes the stock of FC2 to DC1, and the FC1 stock held by DC1 is canceled. None of FC1's assets include stock.

(ii) *Result.* FC2's acquisition of FC1 is not described in paragraph (b)(1)(i), (2)(i), or (3) of this section. As a result, DC1 is not required to include in income the section 1248 amount attributable to its FC1 stock and the rules of paragraph (d)(1) of this section apply. Thus, for purposes of applying section 367(b) or 1248 to subsequent exchanges, the determination of the earnings and profits attributable to DC1's stock in FC2 will include a computation that refers to 40 percent of the post-reorganization earnings and profits of FC2, and that refers to 100 percent of the pre-reorganization earnings and profits of FC1. The earnings and profits attributable to DC1's stock in FC2 will not include any of the $40 of earnings and profits accumulated by FC2 prior to the transaction. Those earnings and profits are attributable to DC2 under section 1248.

Example 3—(i) *Facts.* DC1, a domestic corporation, owns all of the outstanding stock of FC1, a foreign corporation. FC1 owns all of the outstanding stock of FC3, a foreign corporation. DC1 has owned all of the stock of FC1 since FC1's formation, and FC1 has owned all of the stock of FC3 since FC3's formation. FC3 has $20 of earnings and profits, all of which is eligible for inclusion in the section 1248 amount attributable to DC1's stock in FC1 and in the section 1248 amount attributable to FC1's stock in FC3. Such earnings and profits are similarly eligible for inclusion as a dividend attributable to FC1's stock in FC3 under section 964(e). DC2, a domestic corporation, owns all of the outstanding stock of FC2, a foreign corporation. DC2 has owned all of the stock of FC2 since FC2's formation. FC2 has $40 of earnings and profits, all of which is eligible for inclusion in the section 1248 amount attributable to DC2's stock in FC2. DC1 and DC2 are unrelated. In a reorganization described in section 368(a)(1)(B), FC1 transfers all of the stock of FC3 to FC2 in exchange for 40 percent of FC2 stock.

(ii) *Result.* (A) FC1's transfer of FC3 to FC2 is not described in paragraph (b)(1)(i), (2)(i), or (3) of this section. As a result, FC1 is not required to include in income the section 1248 amount attributable to its FC3 stock and the rules of paragraph (d)(1) of this section apply. Thus, for purposes of applying section 367(b) or 1248 to subsequent exchanges of FC1 stock, the determination of the earnings and profits attributable to DC1's stock in FC1 will include a computation that refers to 40 percent of the post-reorganization earnings and profits of FC2 and FC3, and that refers to 100 percent of the $20 of pre-reorganization earnings and profits of FC3. The earnings and profits attributable to FC1's stock in FC2 will not include any of the $40 of earnings and profits accumulated by FC2 prior to the transaction. Those earnings and profits are attributable to DC2 under section 1248. For purposes of applying section 367(b) or 964(e) to subsequent exchanges of FC2 stock, the determination of the earnings and profits attributable to FC1's stock in FC2 will include a computation that refers to 40 percent of the post-reorganization earnings and profits of FC2 and FC3, and that refers to 100 percent of the $20 of pre-reorganization earnings and profits of FC3. The earnings and profits attributable to FC1's interest in FC2 do not include any of the $40 of earnings and profits accumulated by FC2 prior to the transaction. However, paragraph (d)(1) of this section does not apply for purposes of applying section 367(b) or 964(e) to subsequent exchanges of FC3 stock by FC2. For these purposes, the determination of the earnings and profits attributable to FC2's stock in FC3 is made under the principles of section 1248 and, as a result, includes a computation that refers to the $20 of earnings and profits attributable to FC2's section 1223(2) holding period in the FC3 stock.

(B) In the event FC2 exchanges FC3 stock in a transaction that is subject to section 367(b) or 964(e), a proportionate reduction must be made to the $20 of earnings and profits that was previously attributed under paragraph (d)(1) of this section to DC1's stock in FC1 (for purposes of subsequent application of section 367(b) or 1248) as well as to FC1's stock in FC2 (for purposes of subsequent application of section 367(b) or 964(e)). Thus, for example, if FC2 sells 50 percent of its FC3 stock (at a time when there have been no other reductions that affect the $20 of FC3 earnings and profits), paragraph (d)(2) of this section requires DC1 and FC1 to proportionately reduce the $20 of earnings and profits that was previously attributed to their FC1 and FC2 stock, respectively (to $10). These reductions occur without regard to whether FC2 recognizes gain on its sale of FC3 stock.

Par. 7. Sections 1.367(b)–5 and 1.367(b)–6 are added to read as follows:

§1.367(b)–5 Distributions of stock described in section 355.

(a) *In general*—(1) *Scope*. This section provides rules relating to a distribution described in section 355 and to which section 367(b) applies. For purposes of this section, the terms *distributing corporation*, *controlled corporation*, and *distributee* have the same meaning as used in section 355 and the regulations thereunder.

(2) *Treatment of distributees as exchanging shareholders*. For purposes of the section 367(b) regulations, all distributees in a transaction described in paragraph (b), (c), or (d) of this section shall be treated as exchanging shareholders that realize income in a section 367(b) exchange.

(b) *Distribution by a domestic corporation*—(1) *General rule*. In a distribution described in section 355, if the distributing corporation is a domestic corporation and the controlled corporation is a foreign corporation, the following general rules shall apply–

(i) If the distributee is a corporation, then the controlled corporation shall be considered to be a corporation; and

(ii) If the distributee is an individual, then, solely for purposes of determining the gain recognized by the distributing corporation, the controlled corporation shall not be considered to be a corporation, and the distributing corporation shall recognize any gain (but not loss) realized on the distribution.

(2) *Section 367(e) transactions*. The rules of paragraph (b)(1) of this section shall not apply to a foreign distributee to the extent gain is recognized under section 367(e)(1) and the regulations thereunder.

(3) *Determining whether distributees are individuals*. All distributees in a distribution described in paragraph (b)(1) of this section are presumed to be individuals. However, the shareholder identification principles of §1.367(e)–1(d) (including the reporting procedures in §1.367(e)–1(d)(2) and (3)) shall apply for purposes of rebutting this presumption.

(4) *Applicable cross-references*. For rules with respect to a distributee that is a partnership, trust or estate, see §1.367(b)–2(k). For additional rules relating to a distribution of stock of a foreign corporation by a domestic corporation, see section 1248(f) and the regulations thereunder. For additional rules relating to a distribution described in section 355 by a domestic corporation to a foreign distributee, see section 367(e)(1) and the regulations thereunder.

(c) *Pro rata distribution by a controlled foreign corporation*—(1) *Scope*. This paragraph (c) applies to a distribution described in section 355 in which the distributing corporation is a controlled foreign corporation and in which the stock of the controlled corporation is distributed pro rata to each of the distributing corporation's shareholders.

(2) *Adjustment to basis in stock and income inclusion*. If the distributee's postdistribution amount (as defined in paragraph (e)(2) of this section) with respect to the distributing or controlled corporation is less than the distributee's predistribution amount (as defined in paragraph (e)(1) of this section) with respect to such corporation, then the distributee's basis in such stock immediately after the distribution (determined under the normal principles of section 358) shall be reduced by the amount of the difference. However, the distributee's basis in such stock shall not be reduced below zero, and to the extent the foregoing reduction would have reduced basis below zero, the distributee shall instead include such amount in income as a deemed dividend from such corporation.

(3) *Interaction with §1.367(b)–2(e)(3)(ii)*. The basis increase provided in §1.367(b)–2(e)(3)(ii) shall not apply to a deemed dividend that is included in income pursuant to paragraph (c)(2) of this section.

(4) *Basis redistribution*. If a distributee reduces the basis in the stock of the distributing or controlled corporation (or has an inclusion with respect to such stock) under paragraph (c)(2) of this section, the distributee shall increase its basis in the stock of the other corporation by the amount of the basis decrease (or deemed dividend inclusion) required by paragraph (c)(2) of this section. However, the distributee's basis in such stock shall not be increased above the fair market value of such stock and shall not be increased to the extent the increase diminishes the distributee's postdistribution amount with respect to such corporation.

(d) *Non-pro rata distribution by a controlled foreign corporation*—(1) *Scope*. This paragraph (d) applies to a distribution described in section 355 in which the distributing corporation is a controlled foreign corporation and in which the stock of the controlled corporation is not distributed pro rata to each of the distributing corporation's shareholders.

(2) *Treatment of certain shareholders as distributees*. For purposes of the section 367(b) regulations, all persons owning stock of the distributing corporation immediately after a transaction described in paragraph (d)(1) of this section shall be treated as distributees of such stock. For other applicable rules, see paragraph (a)(2) of this section.

(3) *Inclusion of excess section 1248 amount by exchanging shareholder*. If the distributee's postdistribution amount (as defined in paragraph (e)(2) of this section) with respect to the distributing or controlled corporation is less than the distributee's predistribution amount (as defined in paragraph (e)(1) of this section) with respect to such corporation, then the distributee shall include in income as a deemed dividend the amount of the difference. For purposes of this paragraph (d)(3), if a distributee owns no stock in the distributing or controlled corporation immediately after the distribution, the distributee's postdistribution amount with respect to such corporation shall be zero.

(4) *Interaction with §1.367(b)–2(e)(3)(ii)*—(i) *Limited application*. The basis increase provided in §1.367(b)–2(e)(3)(ii) shall apply to a deemed dividend that is included in income pursuant to paragraph (d)(3) of this section only to the extent that such basis increase does not increase the distributee's basis above

the fair market value of such stock and does not diminish the distributee's postdistribution amount with respect to such corporation.

(ii) *Interaction with predistribution amount*. For purposes of this paragraph (d), the distributee's predistribution amount (as defined in paragraph (e)(1) of this section) shall be determined without regard to any basis increase permitted under paragraph (d)(4)(i) of this section.

(e) *Definitions*—(1) *Predistribution amount*. For purposes of this section, the predistribution amount with respect to a distributing or controlled corporation is the distributee's section 1248 amount (as defined in §1.367(b)–2(c)(1)) computed immediately before the distribution (and after any section 368(a)(1)(D) transfer connected with the section 355 distribution), but only to the extent that such amount is attributable to the distributing corporation and any corporations controlled by it immediately before the distribution (the distributing group) or the controlled corporation and any corporations controlled by it immediately before the distribution (the controlled group), as the case may be, under the principles of §§1.1248–1(d)(3), 1.1248–2 and 1.1248–3. However, the predistribution amount with regard to the distributing group shall be computed without taking into account the distributee's predistribution amount with respect to the controlled group.

(2) *Postdistribution amount*. For purposes of this section, the postdistribution amount with respect to a distributing or controlled corporation is the distributee's section 1248 amount (as defined in §1.367(b)–2(c)(1)) with respect to such stock, computed immediately after the distribution (but without regard to paragraph (c) or (d) of this section (whichever is applicable)). The postdistribution amount under this paragraph (e)(2) shall be computed before taking into account the effect (if any) of any inclusion under section 356(a) or (b).

(f) *Exclusion of deemed dividend from foreign personal holding company income*. In the event an amount is included in income as a deemed dividend by a foreign corporation under paragraph (c) or (d) of this section, such deemed dividend shall not be included as foreign personal holding company income under section 954(c).

(g) *Examples*. The following examples illustrate the rules of this section:

Example 1—(i) *Facts*. USS, a domestic corporation, owns 40 percent of the outstanding stock of FD, a controlled foreign corporation (CFC). USS has owned the stock since FD was incorporated, and FD has always been a CFC. USS has a basis of $80 in its FD stock, which has a fair market value of $200. FD owns 100 percent of the outstanding stock of FC, a foreign corporation. FD has owned the stock since FC was incorporated. Neither FD nor FC own stock in any other corporation. FD has earnings and profits of $0 and a fair market value of $250 (not considering its ownership of FC). FC has earnings and profits of $300, none of which is described in section 1248(d), and a fair market value of $250. In a pro rata distribution described in section 355, FD distributes to USS stock in FC worth $100; thereafter, USS's FD stock is worth $100 as well.

(ii) *Result*—(A) FD's distribution is a transaction described in paragraph (c)(1) of this section. Under paragraph (c)(2) of this section, USS must compare its predistribution amounts with respect to FD and FC to its respective postdistribution amounts. Under paragraph (e)(1) of this section, USS's predistribution amount with respect to FD or FC is its section 1248 amount computed immediately before the distribution, but only to the extent such amount is attributable to FD or FC. Under §1.367(b)–2(c)(1), USS's section 1248 amount computed immediately before the distribution is $120, all of which is attributable to FC. Thus, USS's predistribution amount with respect to FD is $0, and its predistribution amount with respect to FC is $120. These amounts are computed as follows: If USS had sold its FD stock immediately before the transaction, it would have recognized $120 of gain ($200 fair market value å $80 basis). All of the gain would have been treated as a dividend under section 1248, and all of the section 1248 amount would have been attributable to FC (based on USS's pro rata share of FC's earnings and profits (40 percent x $300)).

(B) Under paragraph (e)(2) of this section, USS's postdistribution amount with respect to FD or FC is its section 1248 amount with respect to such corporation, computed immediately after the distribution (but without regard to paragraph (c) of this section). Under §1.367(b)–2(c)(1), USS's section 1248 amounts computed immediately after the distribution with respect to FD and FC are $60 and $0, respectively. These amounts, which are USS's postdistribution amounts, are computed as follows: Under the normal principles of section 358, USS allocates its $80 predistribution basis in FD between FD and FC according to the stock blocks' relative values, yielding a $40 basis in each block. If USS sold its FD stock immediately after the distribution, none of the resulting gain would be treated as a dividend under section 1248. If USS sold its FC stock immediately after the distribution, it would have a $60 gain ($100 fair market value å $40 basis), all of which would be treated as a dividend under section 1248.

(C) The basis adjustment and income inclusion rules of paragraph (c)(2) of this section apply to the extent of any difference between USS's postdistribution and predistribution amounts. In the case of FD, there is no difference between the two amounts and, as a result, no adjustment or income inclusion is required. In the case of FC, USS's postdistribution amount is $60 less than its predistribution amount. Accordingly, under paragraph (c)(2) of this section, USS is required to reduce its basis in its FC stock from $40 to $0 and include $20 in income as a deemed dividend from FC. Under paragraph (c)(3) of this section, the basis increase provided in §1.367(b)–2(e)(3)(ii) does not apply with regard to the $20 deemed dividend. Under the rules of paragraph (c)(4) of this section, USS increases its basis in FD by the amount by which it decreased its basis in FC, as well as by the amount of its deemed dividend inclusion ($40 + $40 + $20 = $100).

Example 2—(i) *Facts*. USS1 and USS2, domestic corporations, each own 50 percent of the outstanding stock of FD, a controlled foreign corporation (CFC). USS1 and USS2 have owned their FD stock since it was incorporated, and FD has always been a CFC. USS1 and USS2 each have a basis of $500 in their FD stock, and the fair market value of each block of FD stock is $750. FD owns 100 percent of the outstanding stock of FC, a foreign corporation. FD owned the stock since FC was incorporated. Neither FD nor FC own stock in any other corporation. FD has earnings and profits of $0 and a fair market value of $750 (not considering its ownership of FC). FC has earnings and profits of $500, none of which is described in section 1248(d), and a fair market value of $750. In a non-pro rata distribution described in section 355, FD distributes all of the stock of FC to USS2 in exchange for USS2's FD stock.

(ii) *Result*—(A) FD's distribution is a transaction described in paragraph (d)(1) of this section. Under paragraph (d)(2) of this section, USS1 is considered a distributee of FD stock. Under paragraph (d)(3) of this section, USS1 and USS2 must compare their predistribution amounts with respect to FD and FC stock to their respective postdistribution amounts. Under paragraph (e)(1) of this section, USS1's predistribution amount with respect to FD or FC is USS1's section 1248 amount computed immediately before the distribution, but only to the extent such amount is attributable to FD or FC. USS2's predistribution amount is determined in the same manner. Under §1.367(b)–2(c)(1), USS1 and USS2 each have a section 1248 amount computed immediately before the distribution of $250, all of which is attributable to FC. Thus, USS1 and USS2 each have a predistribution amount with respect to FD of $0, and each have a predistribution amount with respect to FC of $250. These amounts are computed as follows: If either USS1 or USS2 had sold its FD stock immediately before the transaction, it would have recognized $250 of gain ($750 fair market value å $500 basis). All of the gain would have been treated as a dividend under section 1248, and all of the section 1248 amount would have been attributable to FC (based on USS1's and USS2's pro rata shares of FC's earnings and profits (50 percent x $500)).

(B) Under paragraph (d)(3) of this section, a distributee that owns no stock in the distributing or controlled corporation immediately after the distribution has a postdistribution amount with regard to that stock of zero. Accordingly, USS2 has a postdistribution amount of $0 with respect to FD and USS1 has a postdistribution amount of $0 with respect to FC. Under paragraph (e)(2) of this section, USS1's postdistribution amount with respect to FD is its section 1248 amount with respect to such corporation, computed immediately after the distribution (but without regard to paragraph (d) of this section). USS2's postdistribution amount with respect to FC is determined in the same manner. Under §1.367(b)–2(c)(1), USS1's section 1248 amount computed immediately after the distribution with respect to FD is $0 and USS2's section 1248 amount computed immediately after the distribution with respect to FC is $250. These amounts, which are USS1's and USS2's postdistribution amounts, are computed as follows: After the non-pro rata distribution, USS1 owns all the stock of FD and USS2 owns all the stock of FC. If USS1 sold its FD stock immediately after the distribution, none of the resulting $250 gain ($750 fair market value å $500 basis) would be treated as a dividend under section 1248. If USS2 sold its FC stock immediately after the distribution, it would have a $250 gain ($750 fair market value å $500 basis), all of which would be treated as a dividend under section 1248.

(C) The income inclusion rule of paragraph (d)(3) of this section applies to the extent of any difference between USS1's and USS2's postdistribution and predistribution amounts. In the case of USS2, there is no difference between the two amounts with respect to either FD or FC and, as a result, no income inclusion is required. In the case of USS1, there is no difference between the two amounts with respect to its FD stock. However, USS1's postdistribution amount with respect to FC is $250 less than its predistribution amount. Accordingly, under paragraph (d)(3) of this section, USS1 is required to include $250 in income as a deemed dividend. Under §1.367(b)–2(e)(2), the $250 deemed dividend is considered as having been paid by FC to FD, and by FD to USS1, immediately prior to the distribution. This deemed dividend increases USS1's basis in FD ($500 + $250 = $750).

§1.367(b)–6 Effective dates and coordination rules.

(a) *Effective date*—(1) *In general*. Sections 1.367(b)–1 through 1.367(b)–5, and this section, apply to section 367(b) exchanges that occur on or after February 23, 2000.

(2) *Exception*. A taxpayer may, however, elect to have §§1.367(b)–1 through 1.367(b)–5, and this section, apply to section 367(b) exchanges that occur (or occurred) before February 23, 2000, if the due date for the taxpayer's timely filed Federal tax return (including extensions) for the taxable year in which the section 367(b) exchange occurs (or occurred) is after February 23, 2000. The election under this paragraph (a)(2) will be valid only if–

(i) The electing taxpayer makes the election on a timely filed section 367(b) notice;

(ii) In the case of an exchanging shareholder that is a foreign corporation, the election is made on the section 367(b) notice that is filed by each of its shareholders listed in §1.367(b)–1(c)(3)(ii); and

(iii) The electing taxpayer provides notice of the election to all corporations (or their successors in interest) whose earnings and profits are affected by the election on or before the date the section 367(b) notice is filed.

(b) *Certain recapitalizations described in §1.367(b)–4(b)(3)*. In the case of a recapitalization described in §1.367(b)–4(b)(3) that occurred prior to July 20, 1998, the exchanging shareholder shall include the section 1248 amount on its tax return for the taxable year that includes the exchange described in §1.367(b)–4(b)(3)(i) (and not in the taxable year of the recapitalization), except that no inclusion is required if both the recapitalization and the exchange described in §1.367(b)–4(b)(3)(i) occurred prior to July 20, 1998.

(c) *Use of reasonable method to comply with prior published guidance*—(1) *Prior exchanges*. The taxpayer may use a reasonable method to comply with the following prior published guidance to the extent such guidance relates to section 367(b): Notice 88–71 (1988–2 C.B. 374); Notice 89–30 (1989–1 C.B. 670); and Notice 89–79 (1989–2 C.B. 392) (see §601.601(d)(2) of this chapter). This rule applies to section 367(b) exchanges that occur (or occurred) before February 23, 2000, or, if a taxpayer makes the election described in paragraph (a)(2) of this section, for section 367(b) exchanges that occur (or occurred) before the date described in paragraph (a)(2) of this section. This rule also applies to section 367(b) exchanges and distributions described in paragraph (d) of this section.

(2) *Future exchanges*. Section 367(b) exchanges that occur on or after February 23, 2000, (or, if a taxpayer makes the election described in paragraph (a)(2) of this section, for section 367(b) exchanges that occur on or after the date described in paragraph (a)(2) of this section) are governed by the section 367(b) regulations and, as a result, paragraph (c)(1) of this section shall not apply.

(d) *Effect of removal of attribution rules*. To the extent that the rules under §§7.367(b)–9 and 7.367(b)–10(h) of this chapter, as in effect prior to February 23, 2000 (see 26 CFR part 1 revised as of April 1, 1999), attributed earnings and profits to the stock of a foreign corporation in connection with an exchange described in section 351, 354, 355, or 356 before February 23, 2000, the foreign corporation shall continue to be subject to the rules of §7.367(b)–12 of this chapter in the event of any subsequent exchanges and distributions with respect to such stock, notwithstanding the fact that such subsequent exchange or distribution occurs on or after the effective date described in paragraph (a) of this section.

§§1.367(b)–7 through 1.367(b)–9 [Removed]

Par. 8. Sections 1.367(b)–7 through 1.367(b)–9 are removed.

Par. 9. Section 1.381(b)–1, paragraph (a)(1), the second sentence is amended by removing the reference "7.367(b)–1(e)" and adding "1.367(b)–2(f)" in its place.

PART 7—TEMPORARY INCOME TAX REGULATIONS UNDER THE TAX REFORM ACT OF 1976

Par. 10. The authority citation for part 7 is amended by removing the entries for §§7.367(b)–1, 7.367(b)–2, 7.367(b)–3, 7.367(b)–4, 7.367(b)–5, 7.367(b)–6, 7.367(b)–7, 7.367(b)–8, 7.367(b)–9, 7.367(b)–10, 7.367(b)–11, and 7.367(b)–13; and continues to read in part as follows:

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

Par. 11. Sections 7.367(b)–1 through 7.367(b)–11 and 7.367(b)–13 are removed as of February 23, 2000.

Par. 12. Section 7.367(b)–12 is amended by revising paragraph (a) to read as follows:

§7.367(b)–12 Subsequent treatment of amounts attributed or included in income (temporary).

(a) *Application*. This section applies to distributions with respect to, or a disposition of, stock–

(1) To which, in connection with an exchange occurring before February 23, 2000, an amount has been attributed pursuant to §7.367(b)–9 or 7.367(b)–10 (as in effect prior to February 23, 2000, see 26 CFR part 1 revised as of April 1, 1999); or

(2) In respect of which, before February 23, 2000, an amount has been included in income or added to earnings and profits pursuant to §7.367(b)–7 or 7.367(b)–10 (as in effect prior to February 23, 2000, see 26 CFR part 1 revised as of April 1, 1999).

* * * * *

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 13. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 14. In §602.101, paragraph (b) is amended in the table by adding an entry in numerical order to read as follows:

§602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.367(b)–1	1545-1271
* * * * *	

John M. Dalrymple,
Acting 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 21, 2000, 8:45 a.m., and published in the issue of the Federal Register for January 24, 2000, 65 F.R. 3589)

Section 367.—Foreign Corporations

26 CFR 1.367(b)–3T: Repatriation of foreign corporate assets in certain nonrecognition transactions (temporary).

T.D. 8863

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

Stock Transfer Rules: Supplemental Rules

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations that provide an election for certain taxpayers engaged in certain exchanges described in section 367(b). These regulations provide guidance for taxpayers that make the specified election in order to determine the extent to which income must be included and certain corresponding adjustments must be made. The text of the temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in REG–116048–99 on page 584.

DATES: *Effective Date*. These regulations are effective as of February 23, 2000.

Applicability Date. These regulations apply to section 367(b) exchanges that occur on or after February 23, 2000.

FOR FURTHER INFORMATION CONTACT: Mark D. Harris, (202) 622-3860 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

These regulations are being issued without prior notice and public procedure pursuant to the Administrative Procedure Act (5 U.S.C. 553). For this reason, the collection of information contained in these regulations has been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget under control number 1545-1666. Responses to this collection of information is 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 OMB control number.

For further information concerning this collection of information, and where to submit comments on the collection of information and the accuracy of the estimated burden, and suggestions for reducing this burden, please refer to REG–116048–99, page 584, the preamble to the cross-referencing notice of proposed rulemaking published in the Proposed Rules section of this issue of the **Federal Register**.

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 December 27, 1977, the IRS and Treasury issued proposed and temporary regulations under section 367(b) of the Internal Revenue Code (Code). Subsequent guidance updated and amended the 1977 temporary regulations (the 1977 regulations) several times over the next 14 years. On August 26, 1991, the IRS and Treasury issued proposed regulations §§1.367(b)–1 through 1.367(b)–6 (the 1991 proposed regulations). Comments to the 1991 proposed regulations were received, and a public hearing was held on November 22, 1991. In June of 1998, the IRS and Treasury issued final regulations under sections 367(a) and (b) (the 1998 regulations). The 1998 regulations addressed transactions under section 367(b) only to the extent the transactions are also subject to the stock transfer rules of section 367(a). Thus, the 1977 regulations have remained in effect to the extent not superseded by the 1998 regulations. The preamble to the 1998 regulations stated that the IRS and Treasury would issue guidance at a later date to address the portions of the 1991 proposed regulations related to section 367(b) that were not addressed in the 1998 regulations.

The IRS and Treasury adopted §§1.367(b)–1 through 1.367(b)–6 as final regulations under section 367(b) (see T.D. 8862, page 466). These temporary regulations relate to certain provisions of the 1991 proposed regulations not adopted in the final section 367(b) regulations T.D. 8862.

General Purpose

These temporary regulations address the elimination of an election available to certain taxpayers under the 1991 proposed regulations that was not adopted in the final section 367(b) regulations T.D. 8862.

Specific Provisions

A. §1.367(b)–3T(b)(4): Election of taxable exchange treatment

Section 1.367(b)–3 of the 1991 proposed regulations addressed transactions in which a foreign corporation transfers assets to a domestic corporation pursuant to a Subchapter C nonrecognition provision. These transactions include a section 332 liquidation of a foreign corporation into a domestic parent corporation and an asset reorganization, such as a C, D or F reorganization, of a foreign corporation into a domestic corporation. The 1991 proposed regulations required a U.S. shareholder of a foreign acquired corporation (or, in certain cases, a foreign subsidiary of the U.S. shareholder) to currently include in income the allocable portion of the foreign acquired corporation's earnings and profits accumulated during the U.S. shareholder's holding period (all earnings and profits amount). The final section 367(b) regulations T.D. 8862 adopted this general rule.

Sections 7.367(b)–5(b) and 7.367(b)–7(c)(2)(ii) of the 1977 regulations and §1.367(b)–3(b)(2)(iii) of the 1991 proposed regulations provided an exception to this rule, which permitted an exchanging shareholder to elect to recognize the gain (but not the loss) that it realizes in the exchange (taxable exchange election), rather than include the all earnings and profits amount in income. To the extent the all earnings and profits amount exceeds a shareholder's stock gain, the 1991 proposed regulations further required the foreign acquired corporation to reduce various tax attributes that would otherwise carryover to the domestic acquiring corporation (attribute reduction regime). The final regulations T.D. 8862 did not adopt the taxable exchange election.

In order to provide taxpayers an opportunity to comment on this change, these temporary regulations provide the taxable exchange election in modified form. The modified election permits an exchanging shareholder to elect to treat a transaction as a taxable exchange, but limits application of the attribute reduction regime to a section 332 liquidation or to an inbound asset reorganization in which the foreign acquired corporation is wholly owned (directly or indirectly) by one U.S. person. These temporary regulations apply to section 367(b) exchanges that occur between February 23, 2000, and February 24, 2001.

Further Explanation

For a more detailed discussion regarding section 367(b), see T.D. 8862.

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 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. Further it is hereby certified pursuant to sections 603(a) and 605(b) of the Regulatory Flexibility Act that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that the number of section 367(b) exchanges that require reporting under these regulations is estimated to be only 20 per year. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required.

Pursuant to section 7805(f) of the Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact.

Drafting Information

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

* * * * *

Adoption of Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Section 1.367(b)–3T also issued under 26 U.S.C. 367(a) and (b). * * *

Par. 2. Section 1.367(b)–3T is added to read as follows:

§1.367(b)–3T Repatriation of foreign corporate assets in certain nonrecognition transactions (temporary).

(a) through (b)(3). [Reserved]. For further guidance, see §1.367(b)–3(a) through (b)(3).

(4) *Election of taxable exchange treatment*—(i) *Rules*—(A) *In general*. In lieu of the treatment prescribed by §1.367(b)–3(b)(3)(i), an exchanging shareholder described in §1.367(b)–3(b)(1) may instead elect to recognize the gain (but not loss) that it realizes in the exchange (taxable exchange election). To make a taxable exchange election, the following requirements must be satisfied–

(*1*) The exchanging shareholder (and its direct or indirect owners that would be affected by the election, in the case of an exchanging shareholder that is a foreign corporation) reports the exchange in a manner consistent therewith (see, e.g., sections 954(c)(1)(B)(i), 1001 and 1248);

(*2*) The notification requirements of paragraph (b)(4)(i)(C) of this section are satisfied; and

(*3*) The adjustments described in paragraph (b)(4)(i)(B) of this section are made when the following circumstances are present–

(*i*) The transaction is described in section 332 or is an asset acquisition described in section 368(a)(1), with regard to which one U.S. person owns (directly or indirectly) 100 percent of the foreign acquired corporation; and

(*ii*) The all earnings and profits amount described in §1.367(b)–3(b)(3)(i) with respect to the exchange exceeds the gain recognized by the exchanging shareholder.

(B) *Attribute reduction*—(*1*) *Reduction of NOL carryovers*. The amount by which the all earnings and profits amount exceeds the gain recognized by the exchanging shareholder (the excess earnings and profits amount) shall be applied to reduce the net operating loss carryovers (if any) of the foreign acquired corporation to which the domestic acquiring corporation would otherwise succeed under section 381(a) and (c)(1). See also Rev. Rul. 72–421 (1972–2 C.B. 166) (see §601.601(d)(2) of this chapter).

(*2*) *Reduction of capital loss carryovers*. After the application of paragraph (b)(4)(i)(B)(*1*) of this section, any remaining excess earnings and profits amount shall be applied to reduce the capital loss carryovers (if any) of the foreign acquired corporation to which the domestic acquiring corporation would otherwise succeed under section 381(a) and (c)(3).

(*3*) *Reduction of basis*. After the application of paragraph (b)(4)(i)(B)(2) of this section, any remaining excess earnings and profits amount shall be applied to reduce (but not below zero) the basis of the assets (other than dollar-denominated money) of the foreign acquired corporation that are acquired by the domestic acquiring corporation. Such remaining excess earnings and profits amount shall be applied to reduce the basis of such assets in the following order: first, tangible depreciable or depletable assets, according to their class lives (beginning with those assets with the shortest class life); second, other non-inventory tangible assets; third, intangible assets that are amortizable; and finally, the remaining assets of the foreign acquired corporation that are acquired by the domestic acquiring corporation. Within each of these categories, if the total basis of all assets in the category is greater than the excess earnings and profits amount to be applied against such basis, the taxpayer may choose to which specific assets in the category the basis reduction first applies.

(C) *Notification*. The exchanging shareholder shall elect to apply the rules of this paragraph (b)(4)(i) by attaching a statement of its election to its section 367(b) notice. See §1.367(b)–1(c) for the rules concerning filing a section 367(b) notice.

(D) *Example*. The following example illustrates the rules of this paragraph (b)(4)(i):

Example—(i) *Facts*. DC, a domestic corporation, owns all of the outstanding stock of FC, a foreign corporation. The stock of FC has a value of $100, and DC has a basis of $80 in such stock. The assets of FC are one parcel of land with a value of $60 and a basis of $30, and tangible depreciable assets with a value of $40 and a basis of $80. FC has no net operating loss carryovers or capital loss carryovers. The all earnings and profits amount with respect to the FC stock owned by DC is $30, of which $19 is described in section 1248(a) and the remaining $11 is not (for example, because it was earned prior to 1963). In a liquidation described in section 332, FC distributes all of its property to DC, and the FC stock held by DC is canceled. Rather than including in income as a deemed dividend the all earnings and profits amount of $30 as provided in §1.367(b)–3(b)(3)(i), DC instead elects taxable exchange treatment under paragraph (b)(4)(i)(A) of this section.

(ii) *Result*. DC recognizes the $20 of gain it realizes on its stock in FC. Of this $20 amount, $19 is included in income by DC as a dividend pursuant to section 1248(a). (For the source of the remaining $1 of gain recognized by DC, see section 865. For the treatment of the $1 for purposes of the foreign tax credit limitation, see generally section 904(d)(2)(A)(i).) Because the transaction is described in section 332 and because the all earnings and profits amount with respect to the FC stock held by DC ($30) exceeds by $10 the income recognized by DC ($20), the attribute reduction rules of paragraph (b)(4)(i)(B) of this section apply. Accordingly, the $10 excess earnings and profits amount is applied to reduce the basis of the tangible depreciable assets of FC, beginning with those assets with the shortest class lives. Under section 337(a) FC does not recognize gain or loss in the assets that it distributes to DC, and under section 334(b) (which is applied taking into account the basis reduction prescribed by paragraph (b)(4)(i)(A)(*3*) of this section) DC takes a basis of $30 in the land and $70 in the tangible depreciable assets that it receives from FC.

(ii) *Effective date*. This paragraph (b)(4) applies for section 367(b) exchanges that occur between February 23, 2000, and February 24, 2001**.**

(c) and (d) [Reserved]. For further guidance, see §1.367(b)–3(c) through (d).

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 as follows:

1. Removing the following entries from the table:

§602.101 OMB Control numbers.

* * * * *

(b) * * *

2. Adding the following entry in numerical order to the table to read as follows:

CFR part or section where identified and described	Current OMB control No.
* * * * *	
7.367(b)–1	1545-0026
7.367(b)–3	1545-0026
7.367(b)–7	1545-0026
7.367(b)–9	1545-0026
7.367(b)–10	1545-0026
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§602.101 OMB Control numbers.

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(b) * * *

John M. Dalrymple,
Acting 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 21, 2000, 8:45 a.m., and published in the issue of the Federal Register for January 24, 2000, 65 F.R. 3586)

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.367(b)–3T	1545-1666
* * * * *	

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

The adjusted applicable federal long-term rate is set forth for the month of February 2000. See Rev. Rul. 2000–9, page 497.

Section 412.—Minimum Funding Standards

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 2000. See Rev. Rul. 2000–9, page 497.

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

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 2000. See Rev. Rul. 2000–9, page 497.

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

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 2000. See Rev. Rul. 2000–9, page 497.

Section 482.—Allocation of Income and Deductions Among Taxpayers

Federal short-term, mid-term, and long-term rates are set forth for the month of February 2000. See Rev. Rul. 2000–9, page 497.

Section 483.—Interest on Certain Deferred Payments

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 2000. See Rev. Rul. 2000–9, page 497.

Section 642.—Special Rules for Credits and Deductions

Federal short-term, mid-term, and long-term rates are set forth for the month of February 2000. See Rev. Rul. 2000–9, page 497.

Section 807.—Rules for Certain Reserves

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 2000. See Rev. Rul. 2000–9, page 497.

Section 846.—Discounted Unpaid Lossed Defined

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 2000. See Rev. Rul. 2000–9, page 497.

Section 936.—Puerto Rico and Possessions Tax Credit

26 CFR 1.936–11: New lines of business prohibited.

T.D. 8868

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Termination of Puerto Rico and Possession Tax Credit; New Lines of Business Prohibited

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document amends the Income Tax Regulations by removing temporary regulations that provide guidance regarding the addition of a substantial new line of business by a possessions corporation that is an existing credit claimant and adding final regulations. These regulations are necessary to implement changes made by the Small Business Job Protection Act of 1996.

DATES: *Effective Date*. These regulations are effective January 25, 2000.

FOR FURTHER INFORMATION CONTACT: Daniel S. Karen, (202) 874-1490, or Jacob Feldman, (202) 622-3830 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Section 1601(a) of the Small Business Job Protection Act of 1996, Public Law 104-188, 110 Stat. 1755 (1996), amended the Internal Revenue Code by adding section 936(j). Section 936(j) generally repeals the Puerto Rico and possession tax credit for taxable years beginning after December 31, 1995. However, the section provides grandfather rules under which a corporation that is an existing credit claimant would be eligible to claim credits for a transition period. The Puerto

Rico and possession tax credit and the Puerto Rico economic activity credit phase out for these existing credit claimants ending with the last taxable year beginning before January 1, 2006.

For taxable years beginning after December 31, 1995 and before January 1, 2006, the Puerto Rico and possession tax credit and the Puerto Rico economic activity credit apply only to a corporation that qualifies as an existing credit claimant (as defined in section 936(j)(9)(A)). The determination of whether a corporation is an existing credit claimant is made separately for each possession. A possessions corporation that adds a substantial new line of business (other than in a qualifying acquisition of all the assets of a trade or business of an existing credit claimant) after October 13, 1995, ceases to be an existing credit claimant as of the beginning of the taxable year during which such new line of business is added. Therefore, a possessions corporation that ceases to be an existing credit claimant either because it has added a substantial new line of business, or because a new line of business becomes substantial, during a taxable year may not claim the Puerto Rico and possession tax credit or the Puerto Rico economic activity credit for that taxable year or any subsequent taxable year.

On August 19, 1998, T.D. 8778, 1998–36 I.R.B. 4 were published in the **Federal Register** (63 FR 44387). A cross referenced Notice of Proposed Rulemaking was also published in the **Federal Register,** REG–115446–97 (1998–36 I.R.B. 23 [63 FR 44416]) on the same date. Three comments were received with respect to the Notice. No hearing was requested and none was held. The temporary regulations are, therefore, adopted as proposed with the following changes, as explained, below.

Explanation of Revisions and Summary of Comments

Minor and conforming changes were made in these final regulations. Several changes were also made in the final regulations with regard to the three comments that were received on the Notice of Proposed Rulemaking.

The first comment received addressed the issue as to whether the leasing of some of the assets of an existing credit claimant would result in a new line of business under section 936(j)(9)(B) with respect to the leasing activity. In response to the comment, the final regulations provide that the leasing out of assets by an existing credit claimant (and the employees necessary to operate the leased assets) will not be treated as a new line of business provided that (1) the existing credit claimant used the leased assets in an active trade or business for at least five years, (2) the existing credit claimant does not through its own officers or staff of employees perform management or operational functions (but not including operational functions performed through leased employees) with respect to the leased assets, and (3) the existing credit claimant does not perform marketing functions with respect to the leasing of the assets. The income from the leasing of assets will not be income from the active conduct of a trade or business, and therefore, the existing credit claimant may not receive a possession tax credit with respect to such income.

A second comment asked for clarification as to whether a taxpayer seeking to be treated as an existing credit claimant through the acquisition of the assets of an existing credit claimant pursuant to section 936(j)(9)(A)(ii) must acquire all the assets of the acquired corporation even in cases in which the existing credit claimant has more than one trade or business. The final regulations have been clarified to conform to the language of section 936(j)(9)(A)(ii) and provide that an acquiring corporation need only acquire all the assets of a single trade or business to be treated as an existing credit claimant.

The third comment asked for clarification as to when the assets of a trade or business are measured for purposes of satisfying the requirement that all the assets of a trade or business must be acquired from an existing credit claimant in order to satisfy section 936(j)(9)(A)(ii). Specifically, the comment expressed concern that assets of an existing credit claimant may be sold or otherwise disposed of between October 13, 1995, the date on which existing credit claimant status is established, and the date of acquisition. In response to the comment, the final regulations provide that the assets of a trade or business of an existing credit claimant are determined on the date of acquisition provided that the transferee actively conducts a trade or business in the possession with the acquired assets.

Special Analyses

It has been determined that this final regulation 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 this regulation, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the preceding notice of proposed rulemaking was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its effect on small business.

Drafting Information

The principal author of this regulation is Daniel S. Karen of the Office of the Associate Chief Counsel (International), within the office of Chief Counsel, IRS. However, other personnel from the IRS and the Department of the Treasury participated in the development of this regulation.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entry for 1.936–11T and by adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *
Section 1.936–11 also issued under 26 U.S.C. 936(j). * * *

§1.936–11T [Removed]

Par. 2. Section 1.936–11T is removed.

Par. 3. Section 1.936–11 is added to read as follows:

§1.936–11 New lines of business prohibited.

(a) *In general*. A possessions corporation that is an existing credit claimant, as defined in section 936(j)(9)(A) and this section, that adds a substantial new line of business during a taxable year, or that has a new line of business that becomes substantial during the taxable year, loses its status as an existing credit claimant for that year and all years subsequent.

(b) *New line of business*—(1) *In general*. A new line of business is any business activity of the possessions corporation that is not closely related to a pre-existing business of the possessions corporation. The term *closely related* is defined in paragraph (b)(2) of this section. The term *pre-existing business* is defined in paragraph (b)(3) of this section.

(2) *Closely related*. To determine whether a new activity is closely related to a pre-existing business of the possessions corporation all the facts and circumstances must be considered, including those set forth in paragraphs(b)(2)(i)(A) through (G) of this section.

(i) *Factors*. The following factors will help to establish that a new activity is closely related to a pre-existing business activity of the possessions corporation—

(A) The new activity provides products or services very similar to the products or services provided by the pre-existing business;

(B) The new activity markets products and services to the same class of customers;

(C) The new activity is of a type that is normally conducted in the same business location;

(D) The new activity requires the use of similar operating assets;

(E) The new activity's economic success depends on the success of the pre-existing business;

(F) The new activity is of a type that would normally be treated as a unit with the pre-existing business in the business' accounting records; and

(G) The new activity and the pre-existing business are regulated or licensed by the same or similar governmental authority.

(ii) *Safe harbors*. An activity is not a new line of business if—

(A) If the activity is within the same six-digit North American Industry Classification System (NAICS) code (or four-digit Standard Industrial Classification (SIC) code). The similarity of the NAICS or SIC codes may not be relied upon to determine whether the activity is closely related to a pre-existing business where the code indicates a miscellaneous category;

(B) If the new activity is within the same five-digit NAICS code (or three-digit SIC code) and the facts relating to the new activity also satisfy at least three of the factors listed in paragraphs (b)(2)(i)(A) through (G) of this section; or

(C) If the pre-existing business is making a component product or end-product form, as defined in §1.936–5(a)(1),Q&A1, and the new business activity is making an integrated product, or an end-product form with fewer excluded components, that is not within the same six-digit NAICS code (or four-digit SIC code) as the pre-existing business solely because the component product and the integrated product (or two end-product forms) have different end-uses.

(3) *Pre-existing business*—(i) *In general*. Except as provided in paragraph (b)(3)(ii) of this section, a business activity is a pre-existing business of the existing credit claimant if—

(A) The existing credit claimant was actively engaged in the activity within the possession on or before October 13, 1995; and

(B) The existing credit claimant had elected the benefits of the Puerto Rico and possession tax credit pursuant to an election which was in effect for the taxable year that included October 13, 1995.

(ii) *Acquisition of an existing credit claimant*. (A) If all the assets of one or more trades or businesses of a corporation of an existing credit claimant are acquired by an affiliated or non-affiliated existing credit claimant which carries on the business activity of the predecessor existing credit claimant, the acquired business activity will be treated as a pre-existing business of the acquiring corporation. A non-affiliated acquiring corporation will not be bound by any section 936(h) election made by the predecessor existing credit claimant with respect to that business activity.

(B) Where all of the assets of one or more trades or businesses of a corporation of an existing credit claimant are acquired by a corporation that is not an existing credit claimant, the acquiring corporation may make a section 936(e) election for the taxable year in which the assets are acquired with the following effects—

(*1*) The acquiring corporation will be treated as an existing credit claimant for the year of acquisition;

(*2*) The activity will be considered a pre-existing business of the acquiring corporation;

(*3*) The acquiring corporation will be deemed to satisfy the rules of section 936(a)(2) for the year of acquisition; and

(*4*) After making an election under section 936(e), a non- affiliated acquiring corporation will not be bound by elections under sections 936(a)(4) and (h) made by the predecessor existing credit claimant.

(C) For purposes of this section the assets of a trade or business are determined at the time of acquisition provided that the transferee actively conducts the trade or business acquired.

(D) A mere change in the stock ownership of a possessions corporation will not affect its status as an existing credit claimant for purposes of this section.

(4) *Leasing of Assets*.—(i) The leasing of assets (and employees to operate leased assets) will not, for purposes of this section, be considered a new line of business of the existing credit claimant if—

(A) the existing credit claimant used the leased assets in an active trade or business for at least five years;

(B) the existing credit claimant does not through its own officers or staff of employees perform management or operational functions (but not including operational functions performed through leased employees) with respect to the leased assets; and

(C) the existing credit claimant does not perform marketing functions with respect to the leasing of the assets.

(ii) Any income from the leasing of assets not considered a new line of business pursuant to paragraph (b)(4)(i) of this section will not be income from the active conduct of a trade or business (and, therefore, the existing credit claimant may not receive a possession tax credit with respect to such income).

(5) *Timing rule*. The tests for a new line of business in this paragraph (whether the new activity is closely related to a pre-existing business) are applied only at the end of the taxable year during which the new activity is added.

(c) *Substantial*—(1) *In general. A new line of business* is considered to be substantial as of the earlier of—

(i) The taxable year in which the possessions corporation derives more than 15 percent of its gross income from that new line of business (gross income test); or

(ii) The taxable year in which the possessions corporation directly uses in that new line of business more than 15 percent of its assets (assets test).

(2) *Gross income test*. The denominator in the gross income test is the amount that is the gross income of the possessions corporation for the current taxable year, while the numerator is the amount that is the gross income of the new line of business for the current taxable year. The gross income test is applied at the end of each taxable year. For purposes of this test, if a new line of business is added late in the taxable year, the income is not to be annualized in that year. In the case of a new line of business acquired through the purchase of assets, the gross income of such new line of business for the taxable year of the acquiring corporation that includes the date of acquisition is determined from the date of acquisition through the end of the taxable year. In the case of a consolidated group election made pursuant to section 936(i)(5), the test applies on a company by company basis and not on a consolidated basis.

(3) *Assets test*—(i) *Computation*. The denominator is the adjusted tax basis of the total assets of the possessions corporation for the current taxable year. The numerator is the adjusted tax basis of the total assets utilized in the new line of business for the current taxable year. The assets test is computed annually using all assets including cash and receivables.

(ii) *Exception*. A new line of business of a possessions corporation will not be treated as substantial as a result of meeting the assets test if an event that is not reasonably anticipated causes assets used in the new line of business of the possessions corporation to exceed 15 percent of the adjusted tax basis of the possessions corporation's total assets. For example, an event that is not reasonably anticipated would include the destruction of plant and equipment of the pre-existing business due to a hurricane or other natural disaster, or other similar circumstances beyond the control of the possessions corporation. The expiration of a patent is not such an event and will not permit use of this exception.

(d) *Examples*. The following examples illustrate the rules described in paragraphs (a), (b), and (c) of this section. In the following examples, X Corp. is an existing credit claimant unless otherwise indicated:

Example 1. X Corp. is a pharmaceutical corporation which manufactured bulk chemicals (a component product). In March 1997, X Corp. began to also manufacture pills (e.g., finished dosages or an integrated product). The new activity provides products very similar to the products provided by the pre-existing business. The new activity is of a type that is normally conducted in the same business location as the pre-existing business. The activity's economic success depends on the success of the pre-existing business. The manufacture of bulk chemicals is in NAICS code 325411, Medicinal and Botanical Manufacturing, while the manufacture of the pills is in NAICS code 325412, Pharmaceutical Preparation Manufacturing. Although the products have a different end-use, may be marketed to a different class of customers, and may not use similar operating assets, they are within the same five-digit NAICS code and the activity also satisfies paragraphs (b)(2)(i)(A), (C), and (E) of this section. The manufacture of the pills by X Corp. will be considered closely related to the manufacture of the bulk chemicals. Therefore, X Corp. will not be considered to have added a new line of business for purposes of paragraph (b) of this section because it falls within the safe harbor rule of (b)(2)(ii)(B).

Example 2. X Corp. currently manufactures printed circuit boards in a possession. As a result of a technological breakthrough, X Corp. could produce the printed circuit boards more efficiently if it modified its existing production methods. Because demand for its products was high, X Corp. expanded when it modified its production methods. After these modifications to the facilities and production methods, the products produced through the new technology were in the same six-digit NAICS code as products produced previously by X Corp. See paragraph (b)(2)(ii)(A) of this section. Therefore, X Corp. will not be considered to have added a new line of business for purposes of paragraph (b) of this section because it falls within the safe harbor rule of (b)(2)(ii)(A).

Example 3. X Corp. has manufactured Device A in Puerto Rico for a number of years and began to manufacture Device B in Puerto Rico in 1997. Device A and Device B are both used to conduct electrical current to the heart and are both sold to cardiologists. There is no significant change in the type of activity conducted in Puerto Rico after the transfer of the manufacturing of Device B to Puerto Rico. Similar manufacturing equipment, manufacturing processes and skills are used in the manufacture of both devices. Both are regulated and licensed by the Food and Drug Administration. The economic success of Device B is dependent upon the success of Device A only to the extent that the liability and manufacturing prowess with respect to one reflects favorably on the other. Depending upon the heart abnormality, the cardiologist may choose to use Device A, Device B or both on a patient. The manufacture of Device B is treated as a unit with the manufacture of Device A in X Corp.'s accounting records. The manufacture of Device A is in the six-digit NAICS code 339112, Surgical and Medical Instrument Manufacturing. The manufacture of Device B is in the six-digit NAICS code 334510, Electromedical and electrotherapeutic Apparatus Manufacturing. (The manufacture of Device A is in the four-digit SIC code 3845, Electromedical and Electrotherapeutic Apparatus. The manufacture of Device B is in the four-digit SIC code 3841, Surgical and Medical Instruments and Apparatus.) The safe harbor of paragraph (b)(2)(ii)(B) of this section applies because the two activities are within the same three-digit SIC code and Corp. X satisfies paragraphs (b)(2)(i)(A), (B), (C), (D), (F), and (G) of this section.

Example 4. X Corp. has been manufacturing house slippers in Puerto Rico since 1990. Y Corp. is a U.S. corporation that is not affiliated with X Corp. and is not an existing credit claimant. Y Corp. has been manufacturing snack food in the United States. In 1997, X Corp. purchased the assets of Y Corp. and began to manufacture snack food in Puerto Rico. House slipper manufacturing is in the six-digit NAICS code 316212 (Four-digit SIC code 3142, House Slippers). The manufacture of snack foods falls under the six-digit NAICS code 311919, Other Snack Food Manufacturing (four-digit SIC code 2052, Cookies and Crackers (pretzels)). Because these activities are not within the same five or six digit NAICS code (or the same three or four-digit SIC code), and because snack food is not an integrated product that contains house slippers, the safe harbor of paragraph (b)(2)(ii) of this section cannot apply. Considering all the facts and circumstances, including the seven factors of paragraph (b)(2)(i) of this section, the snack food manufacturing activity is not closely related to the manufacture of house slippers, and is a new line of business, within the meaning of paragraph (b) of this section.

Example 5. X Corp., a calendar year taxpayer, is an existing credit claimant that has elected the profit-split method for computing taxable income. P Corp. was not an existing credit claimant and manufactured a product in a different five-digit NAICS code than the product manufactured by X Corp. In 1997, X Corp. acquired the stock of P Corp. and liquidated P Corp. in a tax-free liquidation under section 332, but continued the business activity of P Corp. as a new business segment. Assume that this new business segment is a new line of business within the meaning of paragraph (c) of this section. In 1997, X Corp. has gross income from the active conduct of a trade or business in a possession computed under section 936(a)(2) of $500 million and the adjusted tax basis of its assets is $200 million. The new business segment had gross income of $60 million, or 12 percent of the X Corp. gross income, and the adjusted basis of the new segment's assets was $20 million, or 10 percent of the X Corp. total assets. In 1997, X Corp. does not derive more than 15 percent of its gross income, or directly use more that 15 percent of its total assets, from the new business segment. Thus, the new line of business acquired from P Corp. is not a *substantial* new line of business within the meaning of paragraph (c) of this section, and the new activity will not cause X Corp. to lose its status as an existing credit claimant during 1997. In 1998, however, the gross income of X Corp. grew to $750 million while the gross income of the new line of business grew to $150 million, or 20% of the X Corp. 1998 gross income. Thus, in 1998, the new line of business is substantial within the meaning of paragraph (c) of this section, and X Corp. loses its status as an existing credit claimant for 1998 and all years subsequent.

(e) *Loss of status as existing credit claimant*. An existing credit claimant that adds a substantial new line of business in a taxable year, or that has a new line of business that becomes substantial in a taxable year, loses its status as an existing credit claimant for that year and all years subsequent.

(f) *Effective date*—(1) *General rule*. This section applies to taxable years of a possessions corporation beginning on or after January 25, 2000.

(2) *Election for retroactive application*. Taxpayers may elect to apply retroactively all the provisions of this section for any open taxable year beginning after December 31, 1995. Such election will be effective for the year of the election and all subsequent taxable years. This section will not apply to activities of pre-existing businesses for taxable years beginning before January 1, 1996.

David Mader,
Acting Deputy Commissioner of Internal Revenue.

Approved January 12, 2000.

Jonathan Talisman,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on January 21, 2000, 8:45 a.m., and published in the issue of the Federal Register for January 25, 2000, 65 F.R. 3814)

Section 1092.—Straddles

26 CFR 1.1092(c)–1: Equity options with flexible terms.

T.D. 8866

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Equity Options With Flexible Terms; Special Rules and Definitions

AGENCY: Internal Revenue Service (IRS), Treasury

ACTION: Final regulations.

SUMMARY: This document contains final regulations providing guidance on the application of the rules governing qualified covered calls. The new rules address concerns that were created by the introduction of new financial instruments after the enactment of the qualified covered call rules. The final regulations will provide guidance to taxpayers writing qualified covered calls.

EFFECTIVE DATE: These regulations are effective January 25, 2000.

FOR FURTHER INFORMATION CONTACT: Pamela Lew of the Office of Assistant Chief Counsel (Financial Institutions and Products), (202) 622-3950 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On June 25, 1998, the IRS published in the **Federal Register** proposed regulations REG–104641–97 (1998–29 I.R.B. 9 [63 F.R. 34616]) addressing whether strike prices available for equity options with flexible terms affect the definition of a qualified covered call (QCC) under section 1092(c)(4) for equity options with standardized terms. No requests to speak at a public hearing were received, and no public hearing was held.

Two written comments were received. These comments focused on whether equity options with flexible terms should be eligible for QCC treatment. After considering these comments, the IRS and Treasury have decided to address the eligibility of equity options with flexible terms and certain other equity options for QCC treatment in other forthcoming guidance.

One of the comments also suggested a clarifying change to the text of the proposed regulations. After revising the regulation to take into account this comment, the proposed regulations are adopted by this Treasury decision.

Explanation of Provisions

Section 1092(c) defines a straddle as offsetting positions with respect to personal property. Under section 1092(d)(3), stock is personal property if the stock is part of a straddle that involves an option on that stock or substantially identical stock or securities. Under section 1092(c)(4), however, writing a QCC option and owning the optioned stock is not treated as a straddle for purposes of section 1092.

In order to be a QCC, a call option must, among other things, be exchange-traded and not be deep in the money. An option is deep in the money if the strike price of the option is lower than the lowest qualified bench mark for the stock. This bench mark is generally the highest available strike price for an option on the stock that is less than the applicable stock price.

At the time the QCC provisions were enacted, exchange-traded options were available only at standardized maturity dates and strike price intervals. This fixed-interval system was a basic assumption of the Congressional plan for QCCs and, more specifically, was the foundation for the definition of a deep-in-the-money option.

Certain options exchanges have begun to trade equity options with flexible terms. Unlike standardized exchange-traded options, these options could have strike prices at other than fixed intervals. For this reason, there is concern that the strike prices established for equity options with flexible terms could impact the bench-mark system for standardized exchange-traded options.

The proposed regulations provide that strike prices established by equity options with flexible terms are not taken into account in determining whether options that are not equity options with flexible terms are deep in the money. Thus, the existence of strike prices established by equity options with flexible terms does not affect the lowest qualified bench mark, as determined under section 1092(c)(4)(D), for an equity option with standardized terms.

One commentator was concerned that usage of the phrase “existence of strike prices established by equity options without standardized terms” might be interpreted as requiring actual trading at a particular strike price. The commentator suggested that the regulation be modified to discuss the availability of a strike price for equity options with flexible terms rather than the existence of a strike price established by equity options with flexible terms. This suggestion has been incorporated into the final regulation.

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 the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking 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 Pamela Lew, Office of Assistant Chief Counsel (Financial Institutions and Products). 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 is amended by adding an entry in numerical order to read as follows:

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

Section 1.1092(c)–1 also issued under 26 U.S.C.
1092(c)(4)(H). * * *

Par. 2. Section 1.1092(c)–1 is added to read as follows:

§1.1092(c)–1 Equity options with flexible terms.

(a) *In general*. Section 1092(c)(4) provides an exception to the general rule that a straddle exists if a taxpayer holds stock and writes a call option on that stock. Under section 1092(c)(4), the ownership of stock and the issuance of a call option meeting certain requirements result in a qualified covered call, which is exempted from the general straddle rules of section 1092. This section addresses the consequences of the availability of equity options with flexible terms under the qualified covered call rules.

(b) *No effect on lowest qualified bench mark for standardized options*. The availability of strike prices for equity options with flexible terms does not affect the determination of the lowest qualified bench mark, as defined in section 1092(c)(4)(D), for an option that is not an equity option with flexible terms.

(c) [Reserved].

(d) *Definitions*. For purposes of this section–

(1) *Equity option with flexible terms* means an equity option—

(i) That is described in any of the following Securities Exchange Act Releases—

(A) Self-Regulatory Organizations; Order Approving Proposed Rule Changes and Notice of Filing and Order Granting Accelerated Approval of Amendments by the Chicago Board Options Exchange, Inc. and the Pacific Stock Exchange, Inc., Relating to the Listing of Flexible Equity Options on Specified Equity Securities, Securities Exchange Act Release No. 34–36841 (Feb. 21, 1996); or

(B) Self-Regulatory Organizations; Order Approving Proposed Rule Changes and Notice of Filing and Order Granting Accelerated Approval of Amendment Nos. 2 and 3 to the Proposed Rule Change by the American Stock Exchange, Inc., Relating to the Listing of Flexible Equity Options on Specified Equity Securities, Securities Exchange Act Release No. 34–37336 (June 27, 1996); or

(C) Self-Regulatory Organizations; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval of Amendment Nos. 2, 4 and 5 to the Proposed Rule Change by the Philadelphia Stock Exchange, Inc., Relating to the Listing of Flexible Exchange Traded Equity and Index Options, Securities Exchange Act Release No. 34–39549 (Jan. 23, 1998); or

(D) Any changes to the SEC releases described in paragraphs (d)(1)(i)(A) through (C) of this section that are approved by the Securities and Exchange Commission; or

(ii) That is traded on any national securities exchange which is registered with the Securities and Exchange Commission (other than those described in the SEC Releases set forth in paragraph (d)(1)(i) of this section) or other market which the Secretary determines has rules adequate to carry out the purposes of section 1092 and is—

(A) Substantially identical to the equity options described in paragraph (d)(1)(i) of this section; and

(B) Approved by the Securities and Exchange Commission in a Securities Exchange Act Release.

(2) *Securities Exchange Act Release* means a release issued by the Securities and Exchange Commission. To determine identifying information for releases referenced in paragraph (d)(1) of this section, including release titles, identification numbers, and issue dates, contact the Office of the Secretary, Securities and Exchange Commission, 450 5th Street, NW., Washington, DC 20549. To obtain a copy of a Securities Exchange Act Release, submit a written request, including the specific release identification number, title, and issue date, to Securities and Exchange Commission, Attention Public Reference, 450 5th Street, NW., Washington, DC 20549.

(e) *Effective date*. These regulations apply to equity options with flexible terms entered into on or after January 25, 2000.

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved January 17, 2000.

Jonathan Talisman,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on January 21, 2000, 8:45 a.m., and published in the issue of the Federal Register for January 25, 2000, 65 F.R. 3812)

Section 1274.—Determination of Issue Price in the Case of Certain Debt Instruments Issued for Property

(Also Sections 42, 280G, 382, 412, 467, 468, 482, 483, 642, 807, 846, 1288, 7520, 7872.)

Federal rates; adjusted federal rates; adjusted federal long-term rate, and the long-term exempt rate. For purposes of sections 1274, 1288, 382, and other sections of the Code, tables set forth the rates for February 2000.

Rev. Rul. 2000–9

This revenue ruling provides various prescribed rates for federal income tax purposes for February 2000 (the current month.) Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Finally, Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520.

REV. RUL. 2000–9 TABLE 1

Applicable Federal Rates (AFR) for February 2000

Period for Compounding

	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	6.20%	6.11%	6.06%	6.03%
110% AFR	6.83%	6.72%	6.66%	6.63%
120% AFR	7.46%	7.33%	7.26%	7.22%
130% AFR	8.10%	7.94%	7.86%	7.81%
Mid-Term				
AFR	6.56%	6.46%	6.41%	6.37%
110% AFR	7.24%	7.11%	7.05%	7.01%
120% AFR	7.90%	7.75%	7.68%	7.63%
130% AFR	8.58%	8.40%	8.31%	8.26%
150% AFR	9.92%	9.69%	9.58%	9.50%
175% AFR	11.63%	11.31%	11.15%	11.05%
Long-Term				
AFR	6.77%	6.66%	6.61%	6.57%
110% AFR	7.46%	7.33%	7.26%	7.22%
120% AFR	8.15%	7.99%	7.91%	7.86%
130% AFR	8.85%	8.66%	8.57%	8.51%

REV. RUL. 2000–9 TABLE 2

Adjusted AFR for February 2000

Period for Compounding

	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	4.19%	4.15%	4.13%	4.11%
Mid-term adjusted AFR	4.87%	4.81%	4.78%	4.76%
Long-term adjusted AFR	5.73%	5.65%	5.61%	5.58%

REV. RUL. 2000–9 TABLE 3	
Rates Under Section 382 for February 2000	
Adjusted federal long-term rate for the current month	5.73%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months.)	5.73%

REV. RUL. 2000–9 TABLE 4	
Appropriate Percentages Under Section 42(b)(2) for February 2000	
Appropriate percentage for the 70% presentvalue low-income housing credit	8.57%
Appropriate percentage for the 30% presentvalue low-income housing credit	3.67%

REV. RUL. 2000–9 TABLE 5	
Rate Under Section 7520 for February 2000	
Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest	8.0%

Section 1288.—Treatment of Original Issue Discounts on Tax Exempt Obligations

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 2000. See Rev. Rul. 2000–9, page 497.

Section 1361.—S Corporation Defined

26 CFR 1.351–2: Definitions relating to S corporation subsidiaries.

T.D. 8869

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1, 301, and 602

Subchapter S Subsidiaries

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that relate to the treatment of corporate subsidiaries of S corporations and interpret the rules added to the Internal Revenue Code by section 1308 of the Small Business Job Protection Act of 1996. These regulations provide the public with guidance needed to comply with applicable law and will affect S corporations and their shareholders.

DATES: *Effective Date*: These regulations are effective January 20, 2000.

Applicability Date: For dates of applicability, see §§1.1361–4(a)(3)(iii), 1.1361–4(a)(5)(i), 1.1361–5(c)(2), 1.1361–6, 1.1362–8(e), and 301.6109–1(i)(4).

FOR FURTHER INFORMATION CONTACT: Jeanne M. Sullivan (202)622-3050 (not a toll-free number) or David J. Sotos (202)622-3050 (Subchapter S); Michael N. Kaibni (202)622-7550 (Subchapter C) (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1590. Responses to these collections of information are required to determine the manner in which a corporate subsidiary of an S corporation will be treated under the Internal Revenue Code.

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

The estimated annual burden per respondent/recordkeeper varies from 45 minutes to 1 hour, depending on individual circumstances, with an estimated average of 57 minutes.

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 April 22, 1998, the IRS published REG–251698–96, 1998–20 I.R.B. 14 (63 FR 19864) concerning the treatment of corporate subsidiaries of S corporations. The regulations interpreted rules added to the Internal Revenue Code (Code) by section 1308 of the Small Business Job Protection Act of 1996, Public Law 104–188, 110 Stat. 1755 (the Act), as amended by section 1601 of the Taxpayer Relief Act of 1997, Public Law 105–34, 111 Stat. 788 (the 1997 Act). The Act modified section 1361 of the Code to permit an S corporation (1) to own 80 percent or more of the stock of a C corporation, and (2) to elect to treat a wholly owned subsidiary as a qualified subchapter S subsidiary (QSub). The 1997 Act made a technical correction to section 1361 to provide regulatory authority to make exceptions to the general tax treatment of an election to be a QSub.

Written comments were received in response to the notice of proposed rulemaking, and a public hearing was held on October 14, 1998. After consideration of all the comments, the proposed regulations under sections 1361, 1362, and 1374 are adopted, as revised by this Treasury decision. The comments received and the revisions are discussed below. In addition, regulations under section 6109 are adopted to provide additional guidance consistent with the QSub provisions.

On January 13, 1997, the IRS published Notice 97–4, 1997–1 C.B. 351, to provide a temporary procedure for making a QSub (formerly QSSS) election. Taxpayers should continue to follow Notice 97–4 when making a QSub election until the QSub election form is published.

Explanation of Provisions

1. *Step Transaction Doctrine*

a. QSub Election

The proposed regulations provide that, when an S corporation makes a valid QSub election with respect to a subsidiary, the subsidiary is deemed to have liquidated into the parent S corporation immediately before the QSub election is effective. The tax treatment of this liquidation, alone or in the context of any larger transaction (for example, a transaction that also includes the acquisition of the subsidiary's stock), generally is determined under all relevant provisions of the Code and general principles of tax law, including the step transaction doctrine. However, the proposed regulations include a special transition rule that applies to certain elections effective prior to the date that is 60 days after publication of final regulations in the **Federal Register**. The transition rule suspends the application of the step transaction doctrine with respect to the acquisition of stock followed by a QSub election in cases where the S corporation and the subsidiary are related (as described in section 267(b)) prior to the acquisition of the subsidiary's stock.

Commentators expressed concern over the application of the step transaction doctrine to transactions that include the deemed liquidation that occurs as the result of a QSub election. These commentators argued that applying step transaction to the acquisition of stock that precedes a QSub election can cause the transaction to be recast as an asset acquisition under section 368 with results that may be inconsistent with the expectations of some taxpayers. Under step transaction principles, for example, if, pursuant to a plan, a shareholder contributes the stock of one wholly owned S corporation (S2) to another wholly owned S corporation (S1), and makes a QSub election for S2, the transaction generally would be a reorganization under section 368(a)(1)(D), with the possibility of gain recognition under section 357(c). See generally, Rev. Rul. 67–274 (1967–2 C.B. 141). In the opinion of these commentators, the legislative history of the QSub provisions indicates that the deemed liquidation that is incident to a QSub election should be respected as an independent, tax-free liquidation under section 332, rather than recast under the principles of the step transaction doctrine.

After consideration of all of the comments, Treasury and the IRS believe that the proposed regulations are consistent with the legislative history of the QSub provisions, conform the results of the deemed liquidation to the results that would obtain if an actual liquidation occurred, and follow the approach taken in other provisions of the tax law. In T.D. 8844, (1999–50 I.R.B. 661) published on November 29, 1999 (64 FR 66580), rules for elective changes in the classification of an entity for Federal tax purposes also provide that the tax treatment of a change in the classification of an entity by election is determined under all relevant provisions of the Internal Revenue Code and general principles of tax law, including the step transaction doctrine.) Accordingly, the final regulations provide that general principles of tax law, including step transaction, apply to determine the tax consequences of the transactions that include a QSub election. The final regulations provide examples illustrating the results of applying step transaction in the context of a QSub election.

The final regulations also provide for an extended transition period during which step transaction will be suspended. During the extended transition period, it is anticipated that proposed regulations published in the Federal Register on June 14, 1999, relating to the tax treatment of partially controlled subsidiaries under section 368(a)(1)(C) (64 FR 31770), will be finalized. These regulations generally reverse the IRS's position that the acquisition of assets of a partially controlled subsidiary does not qualify as a tax-free reorganization under section 368(a)(1)(C). See *Bausch & Lomb Optical Co. v. Commissioner*, 30 T.C. 602 (1958), aff'd 267 F.2d 75 (2d Cir.), cert. denied, 361 U.S. 835 (1959); Rev. Rul. 54–396, 1954–2 C.B. 147. The regulations provide that preexisting ownership of a portion of a target corporation's stock by an acquiring corporation generally will not prevent the solely for voting stock requirement in a "C" reorganization from being satisfied. See also Notice 2000–1, 2000–2 I.R.B. 288, which provides that the proposed regulations, when finalized, will provide that the regulations generally will apply to transactions occurring after December 31, 1999, with an exception for transactions pursuant to binding agreements. The finalization of these regulations will provide additional certainty as to the tax consequences of making a QSUB election in situations where an S corporation acquires the remainder of a partially controlled subsidiary in exchange for stock of the S corporation and immediately thereafter elects QSUB status with respect to the subsidiary.

b. QSUB Termination

Section 1361(b)(3)(C) provides that, if a QSUB election terminates, the corporation is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) from the S corporation in exchange for stock of the new corporation immediately before the termination. The proposed regulations provide that the tax treatment of this transaction or of a larger transaction that includes this transaction will be determined under the Code and general principles of tax law, including the step transaction doctrine. The proposed regulations include examples illustrating the application of the step transaction doctrine in the context of the termination of a QSUB election.

Commentators recommended that step transaction not apply to the termination of a QSUB election. Those commentators argue that the application of the step transaction doctrine causes inappropriate tax results in some situations. One example cited is the sale of 21 percent of the stock of a QSUB, thereby terminating the QSUB election. Under step transaction principles, the deemed formation of a new corporation that occurs as a result of the QSub termination fails to qualify under section 351 because the S corporation parent is not in control of the new corporation as defined in section 368(c) after the disposition. As a result of the failure to qualify under section 351, gain would be recognized on all of the QSub's assets.

Treasury and the IRS believe that it is appropriate to apply the step transaction doctrine to the termination of a QSub election. Applying the step transaction principles to the control requirement of section 351 after the disposition of QSub stock is completed is consistent with the legislative history of the QSub termination provisions. S. Rep. No. 104–281, 104th Cong., 2d Sess. 52 n.59 (1996). Moreover, in many cases, application of the step transaction doctrine will provide a more taxpayer favorable result than giving separate effect to each step. This may occur, for example, if 100 percent of the stock of a QSub is sold. In that case, applying step transaction principles would result in a fair market value basis for the former QSub's assets, rather than a lower carryover basis that would result (absent a section 338 election) from treating the deemed formation of the new corporation as an independent step qualifying under section 351. In order to assist taxpayers to understand the effect of QSub terminations, the final regulations include two examples that illustrate the contrasting tax consequences of purchasing 21 percent of the stock of a QSub as opposed to the tax consequences of contributing property to the QSub in exchange for 21 percent of the former QSub's stock. The final regulations include additional examples illustrating the consequences of revoking the QSub election prior to sale of the QSub's stock and of merging a QSub into a disregarded entity prior to such sale.

2. *"F" Reorganizations During the Transition Period*.

As noted above, commentators generally oppose applying the step transaction doctrine to the acquisition of the stock of a corporation followed immediately by a QSub election. Some commentators, however, suggested that, for policy and other reasons, during the transition period, the formation of a new shell S corporation (Newco) by the shareholders of an existing S corporation, followed by the contribution of the stock of the existing S corporation to Newco, coupled with an immediate QSub election for the existing corporation, should be characterized as a reorganization under section 368(a)(1)(F) if all of the other requisites of that section are met. Treating the transaction as an "F" reorganization (as opposed to a stock acquisition followed by a section 332 liquidation) can be beneficial to taxpayers. For example, the existing S corporation's taxable year does not close if it undergoes an "F" reorganization.

In light of the underlying purpose of the transition rule as a relief provision for the benefit of taxpayers, during the extended transition period provided in the final regulations, the IRS will not challenge taxpayers who, through application of the step transaction doctrine to an acquisition of stock followed by a QSub election, obtain tax treatment similar to that applied in a valid reorganization under section 368(a)(1)(F) if, without regard to the transition rule, the transaction would properly qualify as such a reorganization.

3. *Timing of Adoption of Plan of Liquidation*

Under section 332(a), no gain or loss shall be recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation if the requirements of section 332(b) are satisfied. Those requirements include the adoption of a plan of liquidation at a time when the corporation receiving the distribution owns 80 percent or more of the stock of the liquidating corporation. A QSub election results in a constructive liquidation for Federal tax purposes. Formally adopting a plan of liquidation for the QSub, however, is potentially incompatible with the QSub provisions of the Code, which allow the state-law entity to continue to exist while liquidating only for Federal tax purposes. In order to provide tax treatment for the constructive liquidation incident to a QSub election that is compatible with the requirements of section 332, the proposed regulations include a provision that the making of a QSub election satisfies the requirement of adopting a plan of liquidation.

One commentator asked that the regulations provide a safe harbor with respect to the timing of the adoption of the plan of liquidation for purposes of section 332. The commentator argued that, where the acquisition of stock followed by the deemed liquidation does not constitute a reorganization (after appropriate application of step-transaction principles), the regulations should provide that, for purposes of applying section 332 to the liquidation incident to a QSub election, the S corporation will be deemed to adopt a plan of liquidation for its subsidiary as of the effective date of the election, which should not precede the acquisition by the S corporation of 100 percent of the stock of the subsidiary.

The timing of the adoption of the plan of liquidation is important in the context of section 332 because only liquidating distributions to a corporation that owns 80 percent or more of the stock of the subsidiary when the plan is adopted qualify for tax-free treatment. A QSub election cannot be effective until the parent S corporation owns 100 percent of the subsidiary. Thus, the constructive liquidation incident to a QSub election cannot commence before that level of ownership is attained. Furthermore, providing certainty with respect to the deemed timing of the adoption of the plan of liquidation facilitates the efficient administration and use of the QSub provisions. Accordingly, to provide tax treatment of a QSub election that is compatible with the requirements of section 332, the final regulations provide that, for purposes of satisfying the requirement of section 332(b) that the parent corporation own stock in the subsidiary meeting the requirements of section 1504(a)(2) on the date of adoption of the plan of liquidation of the subsidiary, the plan of liquidation is deemed adopted immediately before the deemed liquidation incident to a QSub election unless a formal plan of liquidation that contemplates the filing of the QSub election is adopted on an earlier date. (Although no similar rule is contained in the rules for elective changes in the classification of an entity for Federal tax purposes, Treasury and the IRS intend to amend those regulations to include such a rule.) However, if as a result of the application of general tax principles the transactions that include the QSub election are treated as an asset acquisition, section 332 is not applicable and this rule has no relevance.

4. *Insolvent Subsidiaries*

In general, section 332 does not apply to the liquidation of an insolvent corporation, because the parent corporation does not receive at least partial payment for the stock of its subsidiary. See, e.g., §1.332–2(b) and Rev. Rul. 68–602 (1968–2 C.B. 135). One commentator recommended that a QSub election made for an insolvent subsidiary be eligible for tax-free treatment under section 332. The commentator argued that the legislative history of the QSub provisions makes it clear that a QSub election should qualify as a liquidation under section 332 unless regulations provide otherwise and that taxpayers may be unaware of the harsh results of making a QSub election for an insolvent corporation.

Treasury and the IRS do not agree that the legislative history indicates that section 332 applies to the liquidation of an insolvent corporation. In order to assist taxpayers, an example illustrates the effect of a QSub election for an insolvent corporation.

5. *Definition of Stock of the QSub*

Commentators recommended that, for purposes of determining whether a subsidiary is wholly owned by the parent S corporation, arrangements that are not considered to be stock under the one-class-of-stock rules of §1.1361–1(l) should be disregarded. The commentators noted that applying the principles of these regulations would provide certainty with respect to the subsidiary's eligibility to be a QSub and avoid difficult debt/equity determinations.

The final regulations adopt the position recommended by the commentators. The final regulations provide that, for purposes of determining whether the deemed liquidation of the subsidiary qualifies under section 332, the deemed exercise of an option under §1.1504–4 and any instrument, obligation, or arrangement that would not be considered stock under the one-class-of-stock rules of §1.1361–1(l) are disregarded in determining if the stock ownership requirements of section 332(b) are met. For example, an option that would not be treated as stock under §1.1361–1, but that would be treated as exercised under §1.1504–4, is disregarded. Similarly, if a QSub election terminates, in determining the applicability of section 351, the determination of whether stock ownership of the newly formed corporation satisfies the control requirement of section 368(c) is made without regard to instruments, obligations, or other arrangements that are not treated as stock for purposes of the 100 percent stock ownership requirement for the election.

The rule regarding options under §1.1504–4 is included for purposes of applying section 332 because section 332 explicitly incorporates the affiliation rules of section 1504. See §1.1504–4(a)(1) (the option rules apply to all provisions under the Code and the regulations to which affiliation within the meaning of section 1504(a) is relevant). The affiliation rules are not relevant for purposes of applying the rules regarding the 100 percent stock ownership requirement in section 1361(b)(3)(B)(i). Accordingly, the rule concerning the treatment of stock in applying the 100 percent stock ownership requirement does not refer to the option rules under §1.1504–4.

6. *Section 1374 and Excess Loss Accounts*

Commentary on the proposed regulations identified certain discrepancies in the treatment of tiered groups of corporations when QSub elections are made for some or all of the members of the group and certain unintended implications of the sentence added to §1.1374–8(b) in the proposed regulations.

a. Section 1374

Section 1374(d)(8) and §1.1374–8(a) generally provide that, if an S corporation acquires assets in a transaction in which the S corporation's basis in the assets is determined (in whole or in part) by reference to a C corporation's basis in the assets (or any other property) (a section 1374(d)(8) transaction), section 1374 applies to the net recognized built-in gain attributable to the assets acquired in such a transaction. Section 1.1374–8(b) provides that, for purposes of the tax imposed under section 1374(d)(8), a separate determination of tax is made with respect to the assets the S corporation acquires in one section 1374(d)(8) transaction from the assets the S corporation acquires in another section 1374(d)(8) transaction and from the assets the corporation held when it became an S corporation.

A corporation's section 1374 attributes (loss carryforwards, credits, and credit carryforwards as provided in §1.1374–1(c)) may be used only to reduce the section 1374 tax imposed on the disposition of assets held by the S corporation at the time it converted from C status. Likewise, section 1374 attributes acquired in one section 1374(d)(8) transaction may be used only to reduce tax on the disposition of assets acquired in that transaction. This results in separate section 1374 pools for purposes of calculating the tax imposed by section 1374.

One commentator noted that §1.1374–8(b) of the proposed regulations implies that a QSub election for two or more corporations results in a section 1374(d)(8) transaction for each subsidiary and that this implication is contrary to the general timing rules of §1.1361–4(b)(1). Those general timing rules provide that the deemed liquidation of a tiered group of C corporations that elect S and QSub status effective on the same day occurs at the close of the day before the effective date of the elections, while the parent is a C corporation. As a result of the operation of the general timing rules, there is a single section 1374 pool when the parent corporation's S election is effective. Moreover, the commentator noted that a literal reading of §1.1374–8(b) of the proposed regulations may cause the assets of an S corporation that is acquired by a C corporation to become subject to section 1374 when the acquiring C corporation immediately makes an S election for itself and a QSub election for the acquired S corporation. Finally, the commentator requested that the final regulations provide that when an S corporation acquires a tiered group of corporations and makes QSub elections effective on the same date for some or all of the corporations, the assets deemed acquired by the S corporation will be treated as acquired in a single section 1374(d)(8) transaction, consistent with the apparent intent of the general timing rules of §1.1361–4(b)(1) of the proposed regulations.

b. Excess loss accounts

Section 1.1502–19 of the Income Tax Regulations provides rules requiring, in certain instances, a member (X) of a consolidated group of corporations to include in income its excess loss account (ELA) in the stock of another member (Y) of the group. An ELA reflects X's negative adjustments with respect to Y's stock to the extent the negative adjustments exceed X's basis in the stock. An ELA must be included in X's income if X is treated as disposing of Y's stock. See §1.1502–19(b)(1). A merger or liquidation of X into an S corporation or an S election by X is treated as a disposition that triggers income recognition with respect to an ELA in Y stock. In contrast, X's income or gain in certain cases is subject to any nonrecognition or deferral rules applicable, including section 332. As a result, if Y liquidates into X in a transaction subject to section 332, there is no income recognition with respect to an ELA in Y's stock. See §1.1502–19(b)(2)(i).

Under the general timing rules of §1.1361–4(b)(1), if the common parent elects S status, the deemed liquidations of the subsidiary members of the consolidated group for which QSub elections are made (effective on the same date as the S election) occur as of the close of the day before the QSub elections are effective, while the S electing parent corporation is still a C corporation. As a result, there is no triggering of income with respect to ELAs in the stock of the subsidiary corporations if the liquidations qualify under section 332. In contrast, if a consolidated group of corporations is acquired by an S corporation and the acquiring S corporation makes QSub elections for the parent and members of the consolidated group, a deemed liquidation of the parent prior to the deemed liquidation of other members of the consolidated group may be a disposition that triggers income recognition with respect to ELAs in the subsidiaries' stock.

c. Modifications adopted in the final regulations

The final regulations remove the proposed amendment to §1.1374–8(b). Furthermore, an amendment to the general timing rules under §1.1361–4(b)(1) for acquired S corporations clarifies that an acquired S corporation liquidates into an acquiring corporation as of the beginning of the day of acquisition, after the parent's S election, if any, is effective. There is no section 1374(d)(8) transaction when an S corporation acquires assets from another S corporation, if the acquired S corporation has no C corporation history. The modification to the timing rule also clarifies that there is no period during which an acquired S corporation is a C corporation if the QSub election is made effective as of the time of the acquisition.

As noted in the commentary, the order of the deemed liquidations for a tiered group of corporations for which QSub elections are made (effective on the same date) is significant for purposes of section 1374 and under §1.1502–19. In many situations, it is preferable to have the deemed liquidations occur in order from the lowest tier subsidiary to the highest tier subsidiary, a bottom-up liquidation order. As a result of that ordering, the final liquidation of the highest tier subsidiary results in a single section 1374 pool for the group. In addition, in the case of a consolidated group of corporations, because the deemed liquidation of the common parent follows the deemed liquidation of its subsidiaries, there is no deconsolidation for purposes of §1.1502–19 and no triggering of ELAs. In other circumstances, however, a top to bottom liquidation of a tiered group of subsidiaries may be preferable. Therefore, the final regulations allow the S corporation to specify the order of the deemed liquidations when QSub elections are made (effective on the same day) for a tiered group of subsidiaries. In default of an election, the deemed liquidations occur in succession on the effective date of the election, beginning with the lowest tier subsidiary.

7. *Timing*

One commentator noted a potential lack of coordination in the regulations that determine the timing of the termination of the S election of an acquired S corporation and the deemed liquidation incident to a QSub election for that S corporation. The commentator acknowledged that the intent of the proposed regulations is to provide that an acquired S corporation for which a QSub election is made effective immediately on acquisition should have no intervening C period.

Other timing issues can arise with respect to the termination of a QSub election. The regulations provide rules that govern the timing of the deemed liquidation incident to a QSub election and of the termination of a QSub election. The regulations also provide examples illustrating those rules. The regulations generally are intended to provide that a corporation may move between S and QSub status without an intervening C period, if the appropriate election is made effective as of the termination of the previous S or QSub election. The regulations are coordinated with provisions under section 338 and §§1.1362–2 and 1.1502–76 that have differing timing provisions.

8. *Inadvertent QSub Election and Inadvertent Termination Relief*

One commentator requested that the regulations provide inadvertent invalid QSub election relief similar to the relief that is available under section 1362(f) for inadvertent invalid S elections and inadvertent S terminations. The proposed regulations include a provision indicating that inadvertent QSub termination relief may be available under standards established by the Commissioner for inadvertent termination of an S election under §1.1362–4.

The QSub provisions include no section analogous to section 1362(f) that allows the IRS to determine that a corporation is a QSub during a period when the corporation does not satisfy the requirement of section 1361(b)(3)(B)(i). For example, if the parent corporation inadvertently transfers one share of QSub stock to another person, the QSub election terminates. The subsidiary is not eligible to have a QSub election in effect for the period during which the parent does not own 100 percent of its stock. If the QSub election terminates because of the inadvertent termination of the parent's S election, however, relief may be available under section 1362(f). A favorable determination under that section causes the subsidiary to continue to satisfy the requirements of section 1361(b)(3)(B)(ii) during the period when the parent is accorded relief for inadvertent termination of its S election. Moreover, if the parent fails to make a timely QSub election, relief may be available under the procedures applicable under §301.9100–1 and §301.9100–3.

The final regulations do not include the provision relating to the inadvertent termination of a QSub election. The removal of that provision is not intended to suggest that relief under section 1362(f) is not available in appropriate circumstances (such as those discussed above), but is intended to avoid confusion with respect to the scope of the IRS's statutory authority under section 1362(f).

9. *Ordering Rule for Termination of QSub Elections*

Commentators requested that the final regulations provide an ordering rule for the simultaneous termination of QSub elections as the result of the termination of an upper-tier subsidiary's QSub election. The final regulations provide that the terminations occur in succession, beginning with the upper-tier subsidiary, and include examples to illustrate the effect of simultaneous QSub terminations.

10. *Banking Provisions*

Consistent with the proposed regulations, the final regulations provide that any special rules applicable to banks under the Code continue to apply separately to banks as if the deemed liquidation incident to a QSub election had not occurred (the banking provisions). Commentators requested that the banking provisions be retroactive to the effective date of the Act, by election. As authorized by section 1601 of the 1997 Act, and as first announced in Notice 97–5 (1997–1 C.B. 352), the final regulations provide that the banking provisions apply to taxable years beginning after December 31, 1996. This rule applies to all taxpayers and is not subject to an election. The banking provisions also include a reference to other published guidance for section 265(b); see Rev. Rul. 90–44 (1990–1 C.B. 54, 57).

11. *Taxpayer Identifying Numbers*

The regulations provide clarification regarding employer identification numbers (EINs) for QSubs. The regulations restate the general rules that (1) when an entity's classification changes as a result of an election, it retains its EIN; and (2) unless regulations or published guidance provide otherwise, a disregarded entity (including a QSub) must use its owner's EIN for Federal tax purposes.

Notice 99–6 (1999–3 I.R.B. 12) provides guidance that, under limited circumstances, a disregarded entity may use its own EIN. If a QSub wishes to use its own EIN in accordance with Notice 99–6 but did not have an EIN prior to becoming a QSub, it must apply for a new EIN.

If a subsidiary's QSub election terminates, the new corporation formed as a result of that termination must use its own EIN for Federal tax purposes. If the new corporation had an EIN before the effective date of its QSub election or during its QSub status, it should use that EIN. Otherwise, the new corporation must apply for a new EIN.

12. *Effective Date and Transition rules*

The regulations generally apply to taxable years that begin on or after January 20, 2000; however, taxpayers may elect to apply the regulations in whole, but not in part (aside from those sections with special dates of applicability), for taxable years beginning on or after January 1, 2000**,** provided the corporation and all affected taxpayers apply the regulations in a consistent manner. To make the election, the corporation and all affected taxpayers must file a return or an amended return that is consistent with these rules for the taxable year for which the election is made. For purposes of this section, affected taxpayers means all taxpayers whose returns are affected by the election to apply the regulations. The rules relating to the treatment of banks apply to all taxable years beginning after December 31, 1996; see §1.1361–4(a)(3)(iii). The provision relating to transitional relief from the step transaction applies to certain QSub elections effective on or before the end of calendar year 2000; see §1.1361–4(a)(5)(i). Section 1.1361– 5(c)(2), relating to automatic consent for an S or QSub election made for a corporation whose QSub election has terminated within the five-year period described in section 1361(b)(3)(D), applies to certain QSub elections effective after December 31, 1996. Section 301.6109–1(i), relating to EINs, applies on or after January 20, 2000.

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 has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant impact on a substantial number of small businesses. This certification is based upon the fact that the economic burden imposed on taxpayers by the collection of information and recordkeeping requirements of these regulations is insignificant. For example, the estimated average annual burden per respondent is less than one hour. Furthermore, most taxpayers will only have to respond to the requests for information contained in §§1.1361–3 and 1.1361–5 one time in the life of the corporation. Therefore, a Regulatory Flexibility Analysis is not required under the Regulatory Flexibility Act (5 U.S.C. chapter 6). 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 authors of these regulations are Jeanne M. Sullivan and David J. Sotos of the Office of the Assistant Chief Counsel (Passthroughs & Special Industries); and Michael N. Kaibni of the Office of the Assistant Chief Counsel (Corporate). 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, 301, and 602 are amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. Amend §1.1361–0 as follows:

1.Revise the introductory text.

2.Remove the entry for §1.1361–1(d)(3).

3.Add entries for §§1.1361–2, 1.1361–3, 1.1361–4, 1.1361–5, and 1.1361–6.

The revisions and additions read as follows:

§1.1361–0 Table of contents.

This section lists captions contained in §§1.1361–1, 1.1361–2, 1.1361–3, 1.1361–4, 1.1361–5, and 1.1361–6.

* * * * *

§1.1361–2 Definitions relating to S corporation subsidiaries.

(a) In general.
(b) Stock treated as held by S corporation.
(c) Straight debt safe harbor.
(d) Examples.

§1.1361–3 QSub election.

(a) Time and manner of making election.
(1) In general.
(2) Manner of making election.
(3) Time of making election.
(4) Effective date of election.
(5) Example.
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(b) Revocation of QSub election.
(1) Manner of revoking QSub election.
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§1.1361–4 Effect of QSub election.

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(1) In general.
(2) Liquidation of subsidiary.
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(ii) Special rules for acquired S corporations.
(4) Coordination with section 338 election.
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§1.1361–5 Termination of QSub election.

(a) In general.
(1) Effective date.
(2) Information to be provided upon termination of QSub election by failure to qualify as a QSub.
(3) QSub joins a consolidated group.
(4) Examples.
(b) Effect of termination of QSub election.
(1) Formation of new corporation.
(i) In general.
(ii) Termination for tiered QSubs.
(2) Carryover of disallowed losses and deductions.
(3) Examples.
(c) Election after QSub termination.
(1) In general.
(2) Exception.
(3) Examples.

§1.1361–6 Effective date.

Par. 3. Amend §1.1361–1 as follows:

1. Revise paragraph (b)(1)(i).

2. Remove paragraph (d)(1)(i).

3. Redesignate paragraphs (d)(1)(ii), (d)(1)(iii), (d)(1)(iv), and (d)(1)(v) as paragraphs (d)(1)(i), (d)(1)(ii), (d)(1)(iii), and (d)(1)(iv), respectively.

4. Revise newly designated paragraph (d)(1)(i).

5. Remove paragraph (d)(3).

6. Revise the first sentence of paragraph (e)(1).

The revisions read as follows:

§1.1361–1 S corporation defined.

* * * * *

(b) * * *

(1) * * *

(i) More than 75 shareholders (35 for taxable years beginning before January 1, 1997);

* * * * *

(d) * * *

(1) * * *

(i) For taxable years beginning on or after January 1, 1997, a financial institution that uses the reserve method of accounting for bad debts described in section 585 (for taxable years beginning prior to January 1, 1997, a financial institution to which section 585 applies (or would apply but for section 585(c)) or to which section 593 applies);

* * * * *

(e) * * *

(1) *General rule*. A corporation does not qualify as a small business corporation if it has more than 75 shareholders (35 for taxable years beginning prior to January 1, 1997). * * *

* * * * *

Par. 4. Add §§1.1361–2, 1.1361–3, 1.1361–4, 1.1361–5, and 1.1361–6 to read as follows:

§1.1361–2 Definitions relating to S corporation subsidiaries.

(a) *In general*. The term *qualified subchapter S subsidiary* (QSub) means any domestic corporation that is not an ineligible corporation (as defined in section 1361(b)(2) and the regulations thereunder), if—

(1) 100 percent of the stock of such corporation is held by an S corporation; and

(2) The S corporation properly elects to treat the subsidiary as a QSub under §1.1361–3.

(b) *Stock treated as held by S corporation*. For purposes of satisfying the 100 percent stock ownership requirement in section 1361(b)(3)(B)(i) and paragraph (a)(1) of this section—

(1) Stock of a corporation is treated as held by an S corporation if the S corporation is the owner of that stock for Federal income tax purposes; and

(2) Any outstanding instruments, obligations, or arrangements of the corporation which would not be considered stock for purposes of section 1361(b)(1)(D) if the corporation were an S corporation are not treated as outstanding stock of the QSub.

(c) *Straight debt safe harbor*. Section 1.1361–1(l)(5)(iv) and (v) apply to an obligation of a corporation for which a QSub election is made if that obligation would satisfy the definition of straight debt in §1.1361–1(l)(5) if issued by the S corporation.

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

Example 1. X, an S corporation, owns 100 percent of Y, a corporation for which a valid QSub election is in effect for the taxable year. Y owns 100 percent of Z, a corporation otherwise eligible for QSub status. X may elect to treat Z as a QSub under section 1361(b)(3)(B)(ii).

Example 2. Assume the same facts as in *Example 1*, except that Y is a business entity that is disregarded as an entity separate from its owner under §301.7701–2(c)(2) of this chapter. X may elect to treat Z as a QSub.

Example 3. Assume the same facts as in *Example 1*, except that Y owns 50 percent of Z, and X owns the other 50 percent. X may elect to treat Z as a QSub.

Example 4. Assume the same facts as in *Example 1*, except that Y is a C corporation. Although Y is a domestic corporation that is otherwise eligible to be a QSub, no QSub election has been made for Y. Thus, X is not treated as holding the stock of Z. Consequently, X may not elect to treat Z as a QSub.

Example 5. Individuals A and B own 100 percent of the stock of corporation X, an S corporation, and, except for C's interest (described below), X owns 100 percent of corporation Y, a C corporation. Individual C holds an instrument issued by Y that is considered to be equity under general principles of tax law but would satisfy the definition of straight debt under §1.1361–1(l)(5) if Y were an S corporation. In determining whether X owns 100 percent of Y for purposes of making the QSub election, the instrument held by C is not considered outstanding stock. In addition, under §1.1361–1(l)(5)(v), the QSub election is not treated as an exchange of debt for stock with respect to such instrument, and §1.1361–1(l)(5)(iv) applies to determine the tax treatment of payments on the instrument while Y's QSub election is in effect.

§1.1361–3 QSub election.

(a) *Time and manner of making election*—(1) *In general*. The corporation for which the QSub election is made must meet all the requirements of section 1361(b)(3)(B) at the time the election is made and for all periods for which the election is to be effective.

(2) *Manner of making election*. Except as provided in section 1361(b)(3)(D) and §1.1361–5(c) (five-year prohibition on re-election), an S corporation may elect to treat an eligible subsidiary as a QSub by filing a completed form to be prescribed by the IRS. The election form must be signed by a person authorized to sign the S corporation's return required to be filed under section 6037. Unless the election form provides otherwise, the election must be submitted to the service center where the subsidiary filed its most recent tax return (if applicable), and, if an S corporation forms a subsidiary and makes a valid QSub election (effective upon the date of the subsidiary's formation) for the subsidiary, the election should be submitted to the service center where the S corporation filed its most recent return.

(3) *Time of making election*. A QSub election may be made by the S corporation parent at any time during the taxable year.

(4) *Effective date of election*. A QSub election will be effective on the date specified on the election form or on the date the election form is filed if no date is specified. The effective date specified on the form cannot be more than two months and 15 days prior to the date of filing and cannot be more than 12 months after the date of filing. For this purpose, the definition of the term *month* found in §1.1362–6(a)(2)(ii)(C) applies. If an election form specifies an effective date more than two months and 15 days prior to the date on which the election form is filed, it will be effective two months and 15 days prior to the date it is filed. If an election form specifies an effective date more than 12 months after the date on which the election is filed, it will be effective 12 months after the date it is filed.

(5) *Example*. The following example illustrates the application of paragraph (a)(4) of this section:

Example. X has been a calendar year S corporation engaged in a trade or business for several years. X acquires the stock of Y, a calendar year C corporation, on April 1, 2002. On August 10, 2002, X makes an election to treat Y as a QSub. Unless otherwise specified on the election form, the election will be effective as of August 10, 2002. If specified on the election form, the election may be effective on some other date that is not more than two months and 15 days prior to August 10, 2002, and not more than 12 months after August 10, 2002.

(6) *Extension of time for making a QSub election*. An extension of time to make a QSub election may be available under the procedures applicable under §§301.9100–1 and 301.9100–3 of this chapter.

(b) *Revocation of QSub election*—(1) *Manner of revoking QSub election.* An S corporation may revoke a QSub election under section 1361 by filing a statement with the service center where the S corporation's most recent tax return was properly filed. The revocation statement must include the names, addresses, and taxpayer identification numbers of both the parent S corporation and the QSub, if any. The statement must be signed by a person authorized to sign the S corporation's return required to be filed under section 6037.

(2) *Effective date of revocation*. The revocation of a QSub election is effective on the date specified on the revocation statement or on the date the revocation statement is filed if no date is specified. The effective date specified on the revocation statement cannot be more than two months and 15 days prior to the date on which the revocation statement is filed and cannot be more than 12 months after the date on which the revocation statement is filed. If a revocation statement specifies an effective date more than two months and 15 days prior to the date on which the statement is filed, it will be effective two months and 15 days prior to the date it is filed. If a revocation statement specifies an effective date more than 12 months after the date on which the statement is filed, it will be effective 12 months after the date it is filed.

(3) *Revocation after termination*. A revocation may not be made after the occurrence of an event that renders the subsidiary ineligible for QSub status under section 1361(b)(3)(B).

(4) *Revocation before QSub election effective*. For purposes of Section 1361(b)(3)(D) and §1.1361–5(c) (five-year prohibition on re-election), a revocation effective on the first day the QSub election was to be effective will not be treated as a termination of a QSub election.

§1.1361–4 Effect of QSub election.

(a) *Separate existence ignored*—(1) *In general*. Except as otherwise provided in paragraph (a)(3) of this section, for Federal tax purposes—

(i) A corporation which is a QSub shall not be treated as a separate corporation; and

(ii) All assets, liabilities, and items of income, deduction, and credit of a QSub shall be treated as assets, liabilities, and items of income, deduction, and credit of the S corporation.

(2) *Liquidation of subsidiary*—(i) *In general*. If an S corporation makes a valid QSub election with respect to a subsidiary, the subsidiary is deemed to have liquidated into the S corporation. Except as provided in paragraph (a)(5) of this section, the tax treatment of the liquidation or of a larger transaction that includes

the liquidation will be determined under the Internal Revenue Code and general principles of tax law, including the step transaction doctrine. Thus, for example, if an S corporation forms a subsidiary and makes a valid QSub election (effective upon the date of the subsidiary's formation) for the subsidiary, the transfer of assets to the subsidiary and the deemed liquidation are disregarded, and the corporation will be deemed to be a QSub from its inception.

(ii) *Examples*. The following examples illustrate the application of this paragraph (a)(2)(i) of this section:

Example 1. Corporation X acquires all of the outstanding stock of solvent corporation Y from an unrelated individual for cash and short-term notes. Thereafter, as part of the same plan, X immediately makes an S election and a QSub election for Y. Because X acquired all of the stock of Y in a qualified stock purchase within the meaning of section 338(d)(3), the liquidation described in paragraph (a)(2) of this section is respected as an independent step separate from the stock acquisition, and the tax consequences of the liquidation are determined under sections 332 and 337.

Example 2. Corporation X, pursuant to a plan, acquires all of the outstanding stock of corporation Y from the shareholders of Y solely in exchange for 10 percent of the voting stock of X. Prior to the transaction, Y and its shareholders are unrelated to X. Thereafter, as part of the same plan, X immediately makes an S election and a QSub election for Y. The transaction is a reorganization described in section 368(a)(1)(C), assuming the other conditions for reorganization treatment (e.g., continuity of business enterprise) are satisfied.

Example 3. After the expiration of the transition period provided in paragraph (a)(5)(i) of this section, individual A, pursuant to a plan, contributes all of the outstanding stock of Y to his wholly owned S corporation, X, and immediately causes X to make a QSub election for Y. The transaction is a reorganization under section 368(a)(1)(D), assuming the other conditions for reorganization treatment (e.g., continuity of business enterprise) are satisfied. If the sum of the amount of liabilities of Y treated as assumed by X exceeds the total of the adjusted basis of the property of Y, then section 357(c) applies and such excess is considered as gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be.

(iii) *Adoption of plan of liquidation*. For purposes of satisfying the requirement of adoption of a plan of liquidation under section 332, unless a formal plan of liquidation that contemplates the QSub election is adopted on an earlier date, the making of the QSub election is considered to be the adoption of a plan of liquidation immediately before the deemed liquidation described in paragraph (a)(2)(i) of this section.

(iv) *Example*. The following example illustrates the application of paragraph (a)(2)(iii) of this section:

Example. Corporation X owns 75 percent of a solvent corporation Y, and individual A owns the remaining 25 percent of Y. As part of a plan to make a QSub election for Y, X causes Y to redeem A's 25 percent interest on June 1 for cash and makes a QSub election for Y effective on June 3. The making of the QSub election is considered to be the adoption of a plan of liquidation immediately before the deemed liquidation. The deemed liquidation satisfies the requirements of section 332.

(v) *Stock ownership requirements of section 332*. The deemed exercise of an option under §1.1504–4 and any instruments, obligations, or arrangements that are not considered stock under §1.1361–2(b)(2) are disregarded in determining if the stock ownership requirements of section 332(b) are met with respect to the deemed liquidation provided in paragraph (a)(2)(i) of this section.

(3) *Treatment of banks*—(i) *In general*. If an S corporation is a bank, or if an S corporation makes a valid QSub election for a subsidiary that is a bank, any special rules applicable to banks under the Internal Revenue Code continue to apply separately to the bank parent or bank subsidiary as if the deemed liquidation of any QSub under paragraph (a)(2) of this section had not occurred (except as other published guidance may apply section 265(b) and section 291(a)(3) and (e)(1)(B) not only to the bank parent or bank subsidiary but also to any QSub deemed to have liquidated under paragraph (a)(2) of this section). For any QSub that is a bank, however, all assets, liabilities, and items of income, deduction, and credit of the QSub, as determined in accordance with the special bank rules, are treated as assets, liabilities, and items of income, deduction, and credit of the S corporation. For purposes of this paragraph (a)(3)(i), the term *bank* has the same meaning as in section 581.

(ii) *Examples*. The following examples illustrate the application of this paragraph (a)(3):

Example 1. X, an S corporation, is a bank as defined in section 581. X owns 100 percent of Y and Z, corporations for which valid QSub elections are in effect. Y is a bank as defined in section 581, and Z is not a financial institution. Pursuant to paragraph (a)(3)(i) of this section, any special rules applicable to banks under the Internal Revenue Code continue to apply separately to X and Y and do not apply to Z. Thus, for example, section 265(b), which provides special rules for interest expense deductions of banks, applies separately to X and Y. That is, X and Y each must make a separate determination under section 265(b) of interest expense allocable to tax-exempt interest, and no deduction is allowed for that interest expense. Section 265(b) does not apply to Z except as published guidance may provide otherwise.

Example 2. X, an S corporation, is a bank holding company and thus is not a bank as defined in section 581. X owns 100 percent of Y, a corporation for which a valid QSub election is in effect. Y is a bank as defined in section 581. Pursuant to paragraph (a)(3)(i) of this section, any special rules applicable to banks under the Internal Revenue Code continue to apply to Y and do not apply to X. However, all of Y's assets, liabilities, and items of income, deduction, and credit, as determined in accordance with the special bank rules, are treated as those of X. Thus, for example, section 582(c), which provides special rules for sales and exchanges of debt by banks, applies only to sales and exchanges by Y. However, any gain or loss on such a transaction by Y that is considered ordinary income or ordinary loss pursuant to section 582(c) is treated as ordinary income or ordinary loss of X.

(iii) *Effective date*. This paragraph (a)(3) applies to taxable years beginning after December 31, 1996.

(4) *Treatment of stock of QSub*. Except for purposes of section 1361(b)(3)(B)(i) and §1.1361–2(a)(1), the stock of a QSub shall be disregarded for all Federal tax purposes.

(5) *Transitional relief*—(i) *General rule*. If an S corporation and another corporation (the related corporation) are persons specified in section 267(b) prior to an acquisition by the S corporation of some or all of the stock of the related corporation followed by a QSub election for the related corporation, the step transaction doctrine will not apply to determine the tax consequences of the acquisition. This paragraph (a)(5) shall apply to QSub elections effective before January 1, 2001.

(ii) *Examples*. The following examples illustrate the application of this paragraph (a)(5):

Example 1. Individual A owns 100 percent of the stock of X, an S corporation. X owns 79 percent of the stock of Y, a solvent corporation, and A owns the remaining 21 percent. On May 4, 1998, A contributes its Y stock to X in exchange for X stock. X makes a QSub election with respect to Y effective immediately following the transfer. The liquidation described in paragraph (a)(2) of this section is respected as an independent step separate from the stock acquisition, and the tax consequences of the liquidation are determined under sections 332 and 337. The contribution by A of the Y stock qualifies under section 351, and no gain or loss is recognized by A, X, or Y.

Example 2. Individual A owns 100 percent of the stock of two solvent S corporations, X and Y. On May 4, 1998, A contributes the stock of Y to X. X makes a QSub election with respect to Y immediately following the transfer. The liquidation described in paragraph (a)(2) of this section is respected as an independent step separate from the stock acquisition, and the tax consequences of the liquidation are determined under sections 332 and 337. The contribution by A of the Y stock to X qualifies under section 351, and no gain or loss is recognized by A, X, or Y. Y is not treated as a C corporation for any period solely because of the transfer of its stock to X, an ineligible shareholder. Compare *Example 3* of §1.1361–4(a)(2)(ii).

(b) *Timing of the liquidation*—(1) *In general*. Except as otherwise provided in paragraph (b)(3) or (4) of this section, the liquidation described in paragraph (a)(2) of this section occurs at the close of the day before the QSub election is effective. Thus, for example, if a C corporation elects to be treated as an S corporation and makes a QSub election (effective the same date as the S election) with respect to a subsidiary, the liquidation occurs immediately before the S election becomes effective, while the S electing parent is still a C corporation.

(2) *Application to elections in tiered situations*. When QSub elections for a tiered group of subsidiaries are effective on the same date, the S corporation may specify the order of the liquidations. If no order is specified, the liquidations that are deemed to occur as a result of the QSub elections will be treated as occurring first for the lowest tier entity and proceed successively upward until all of the liquidations under paragraph (a)(2) of this section have occurred. For example, S, an S corporation, owns 100 percent of C, the common parent of an affiliated group of corporations that includes X and Y. C owns all of the stock of X and X owns all of the stock of Y. S elects under §1.1361–3 to treat C, X and Y as QSubs effective on the same date. If no order is specified for the elections, the following liquidations are deemed to occur as a result of the elections, with each successive liquidation occuring on the same day immediately after the preceding liquidation: Y is treated as liquidating into X, then X is treated as liquidating into C, and finally C is treated as liquidating into S.

(3) *Acquisitions*. (i) *In general*. If an S corporation does not own 100 percent of the stock of the subsidiary on the day before the QSub election is effective, the liquidation described in paragraph (a)(2) of this section occurs immediately after the time at which the S corporation first owns 100 percent of the stock.

(ii) *Special rules for acquired S corporations*. Except as provided in paragraph (b)(4) of this section, if a corporation (Y) for which an election under section 1362(a) was in effect is acquired, and a QSub election is made effective on the day Y is acquired, Y is deemed to liquidate into the S corporation at the beginning of the day the termination of its S election is effective. As a result, if corporation X acquires Y, an S corporation, and makes an S election for itself and a QSub election for Y effective on the day of acquisition, Y liquidates into X at the beginning of the day when X's S election is effective, and there is no period between the termination of Y's S election and the deemed liquidation of Y during which Y is a C corporation. Y's taxable year ends for all Federal income tax purposes at the close of the preceding day. Furthermore, if Y owns Z, a corporation for which a QSub election was in effect prior to the acquisition of Y by X, and X makes QSub elections for Y and Z, effective on the day of acquisition, the transfer of assets to Z and the deemed liquidation of Z are disregarded. See §§1.1361–4(a)(2) and 1.1361–5(b)(1)(i).

(4) *Coordination with section 338 election*. An S corporation that makes a qualified stock purchase of a target may make an election under section 338 with respect to the acquisition if it meets the requirements for the election, and may make a QSub election with respect to the target. If an S corporation makes an election under section 338 with respect to a subsidiary acquired in a qualified stock purchase, a QSub election made with respect to that subsidiary is not effective before the day after the acquisition date (within the meaning of section 338(h)(2)). If the QSub election is effective on the day after the acquisition date, the liquidation under paragraph (a)(2) of this section occurs immediately after the deemed asset purchase by the new target corporation under section 338. If an S corporation makes an election under section 338 (without a section 338(h)(10) election) with respect to a target, the target must file a final or deemed sale return as a C corporation reflecting the deemed sale. See §1.338–10T(a).

(c) *Carryover of disallowed losses and deductions*. If an S corporation (S1) acquires the stock of another S corporation (S2), and S1 makes a QSub election with respect to S2 effective on the day of the acquisition, see §1.1366–2(c)(1) for provisions relating to the carryover of losses and deductions with respect to a former shareholder of S2 that may be available to that shareholder as a shareholder of S1.

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

Example 1. X, an S corporation, owns 100 percent of the stock of Y, a C corporation. On June 2, 2002, X makes a valid QSub election for Y, effective June 2, 2002. Assume that, under general principles of tax law, including the step transaction doctrine, X's acquisition of the Y stock and the subsequent QSub election would not be treated as related. The liquidation described in paragraph (a)(2) of this section occurs at the close of the day on June 1, 2002, the day before the QSub election is effective, and the plan of liquidation is considered adopted on that date. Y's taxable year and separate existence for Federal tax purposes end at the close of June 1, 2002.

Example 2. X, a C corporation, owns 100 percent of the stock of Y, another C corporation. On December 31, 2002, X makes an election under section 1362 to be treated as an S corporation and a valid QSub election for Y, both effective January 1, 2003. Assume that, under general principles of tax law, including the step transaction doctrine, X's acquisition of the Y stock and the subsequent QSub election would not be treated as related. The liquidation described in paragraph (a)(2) of this section occurs at the close of December 31, 2002, the day before the QSub election is effective. The QSub election for Y is effective on the same day that X's S election is effective, and the deemed liquidation is treated as occurring before the S election is effective, when X is still a C corporation. Y's taxable year ends at the close of December 31, 2002. See §1.381(b)–1.

Example 3. On June 1, 2002, X, an S corporation, acquires 100 percent of the stock of Y, an existing S corporation, for cash in a transaction meeting the requirements of a qualified stock purchase (QSP) under section 338. X immediately makes a QSub election for Y effective June 2, 2002, and also makes a joint election under section 338(h)(10) with the shareholder of Y. Under section 338(a) and §1.338(h)(10)–1T(d)(3), Y is treated as having sold all of its assets at the close of the acquisition date, June 1, 2002. Y is treated as a new corporation which purchased all of those assets as of the beginning of June 2, 2000, the day after the acquisition date. Section 338(a)(2). The QSub election is effective on June 2, 2002, and the liquidation under paragraph (a)(2) of this section occurs immediately after the deemed asset purchase by the new corporation.

Example 4. X, an S corporation, owns 100 percent of Y, a corporation for which a QSub election is in effect. On May 12, 2002, a date on which the QSub election is in effect, X issues Y a $10,000 note under state law that matures in ten years with a market rate of interest. Y is not treated as a separate corporation, and X's issuance of the note to Y on May 12, 2002, is disregarded for Federal tax purposes.

Example 5. X, an S corporation, owns 100 percent of the stock of Y, a C corporation. At a time when Y is indebted to X in an amount that exceeds the fair market value of Y's assets, X makes a QSub election effective on the date it is filed with respect to Y. The liquidation described in paragraph (a)(2) of this section does not qualify under sections 332 and 337 and, thus, Y recognizes gain or loss on the assets distributed, subject to the limitations of section 267.

§1.1361–5 Termination of QSub election.

(a) *In general*—(1) *Effective date*. The termination of a QSub election is effective—

(i) On the effective date contained in the revocation statement if a QSub election is revoked under §1.1361–3(b);

(ii) At the close of the last day of the parent's last taxable year as an S corporation if the parent's S election terminates under §1.1362–2; or

(iii) At the close of the day on which an event (other than an event described in paragraph (a)(1)(ii) of this section) occurs that renders the subsidiary ineligible for QSub status under section 1361(b)(3)(B).

(2) *Information to be provided upon termination of QSub election by failure to qualify as a QSub*. If a QSub election terminates because an event renders the subsidiary ineligible for QSub status, the S corporation must attach to its return for the taxable year in which the termination occurs a notification that a QSub election has terminated, the date of the termination, and the names, addresses, and employer identification numbers of both the parent corporation and the QSub.

(3) *QSub joins a consolidated group*. If a QSub election terminates because the S corporation becomes a member of a consolidated group (and no election under section 338(g) is made) the principles of §1.1502–76(b)(1)(ii)(A)(2) (relating to a special rule for S corporations that join a consolidated group) apply to any QSub of the S corporation that also becomes a member of the consolidated group at the same time as the S corporation. See *Example 4* of paragraph (a)(4) of this section.

(4) *Examples*. The following examples illustrate the application of this paragraph (a):

Example 1. Termination because parent's S election terminates. X, an S corporation, owns 100 percent of Y. A QSub election is in effect with respect to Y for 2001. Effective on January 1, 2002, X revokes its S election. Because X is no longer an S corporation, Y no longer qualifies as a QSub at the close of December 31, 2001.

Example 2. Termination due to transfer of QSub stock. X, an S corporation, owns 100 percent of Y. A QSub election is in effect with respect to Y. On December 10, 2002, X sells one share of Y stock to A, an individual. Because X no longer owns 100 percent of the stock of Y, Y no longer qualifies as a QSub. Accordingly, the QSub election made with respect to Y terminates at the close of December 10, 2002.

Example 3. No termination on stock transfer between QSub and parent. X, an S corporation, owns 100 percent of the stock of Y, and Y owns 100 percent of the stock of Z. QSub elections are in effect with respect to both Y and Z. Y transfers all of its Z stock to X. Because X is treated as owning the stock of Z both before and after the transfer of stock solely for purposes of determining whether the requirements of section 1361(b)(3)(B)(i) and §1.1361–2(a)(1) have been satisfied, the transfer of Z stock does not terminate Z's QSub election. Because the stock of Z is disregarded for all other Federal tax purposes, no gain is recognized under section 311.

Example 4. Termination due to acquisition of S parent by a consolidated group. X, an S corporation, owns 100 percent of Y, a corporation for which a QSub election is in effect. Z, the common parent of a consolidated group of corporations, acquires 80 percent of the stock of X on June 1, 2002. Z does not make an election under section 338(g) with respect to the purchase of X stock. X's S election terminates as of the close of the preceding day, May 31, 2002. Y's QSub election also terminates at the close of May 31, 2002. Under §1.1502–76(b)(1)(ii)(A)(2) and paragraph (a)(3) of this section, X and Y become members of Z's consolidated group of corporations as of the beginning of the day June 1, 2002.

Example 5. Termination due to acquisition of QSub by a consolidated group. The facts are the same as in *Example 4*, except that Z acquires 80 percent of the stock of Y (instead of X) on June 1, 2002. In this case, Y's QSub election terminates as of the close of June 1, 2002, and, under §1.1502–76(b)(1)(ii)(A)(1), Y becomes a member of the consolidated group at that time.

(b) *Effect of termination of QSub election*—(1) *Formation of new corporation*—(i) *In general*. If a QSub election terminates under paragraph (a) of this section, the former QSub is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before the termination from the S corporation parent in exchange for stock of the new corporation. The tax treatment of this transaction or of a larger transaction that includes this transaction will be determined under the Internal Revenue Code and general principles of tax law, including the step transaction doctrine. For purposes of determining the application of section 351 with respect to this transaction, instruments, obligations, or other arrangements that are not treated as stock of the QSub under §1.1361–2(b) are disregarded in determining control for purposes of section 368(c) even if they are equity under general principles of tax law.

(ii) *Termination for tiered QSubs*. If QSub elections terminate for tiered QSubs on the same day, the formation of any higher tier subsidiary precedes the formation of its lower tier subsidiary. See *Example 6* in paragraph (b)(3) of this section.

(2) *Carryover of disallowed losses and deductions*. If a QSub terminates because the S corporation distributes the QSub stock to some or all of the S corporation's shareholders in a transaction to which section 368(a)(1)(D) applies by reason of section 355 (or so much of section 356 as relates to section 355), see §1.1366–2(c)(2) for provisions relating to the carryover of disallowed losses and deductions that may be available.

(3) *Examples*. The following examples illustrate the application of this paragraph (b):

Example 1. X, an S corporation, owns 100 percent of the stock of Y, a corporation for which a QSub election is in effect. X sells 21 percent of the Y stock to Z, an unrelated corporation, for cash, thereby terminating the QSub election. Y is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) in exchange for Y stock immediately before the termination from the S corporation. The deemed exchange by X of assets for Y stock does not qualify under section 351 because X is not in control of Y within the meaning of section 368(c) immediately after the transfer as a result of the sale of stock to Z. Therefore, X must recognize gain, if any, on the assets transferred to Y in exchange for its stock. X's losses, if any, on the assets transferred are subject to the limitations of section 267.

Example 2. (i) X, an S corporation, owns 100 percent of the stock of Y, a corporation for which a QSub election is in effect. As part of a plan to sell a portion of Y, X causes Y to merge into T, a limited liability company wholly owned by X that is disregarded an as entity separate from its owner for Federal tax purposes. X then sells 21 percent of T to Z, an unrelated corporation, for cash. Following the sale, no entity classification election is made under §301.7701–3(c) of this chapter to treat the limited liability company as an association for Federal tax purposes.

(ii) The merger of Y into T causes a termination of Y's QSub election. The new corporation (Newco) that is formed as a result of the termination is immediately merged into T, an entity that is disregarded for Federal tax purposes. Because, at the end of the series of transactions, the assets continue to be held by X for Federal tax purposes, under step transaction principles, the formation of Newco and the transfer of assets pursuant to the merger of Newco into T are disregarded. The sale of 21 percent of T is treated as a sale of a 21 percent undivided interest in each of T's assets. Immediately thereafter, X and Z are treated as contributing their respective interests in those assets to a partnership in exchange for ownership interests in the partnership.

(iii) Under section 1001, X recognizes gain or loss from the deemed sale of the 21 percent interest in each asset of the limited liability company to Z. Under section 721(a), no gain or loss is recognized by X and Z as a result of the deemed contribution of their respective interests in the assets to the partnership in exchange for ownership interests in the partnership.

Example 3. Assume the same facts as in *Example 1*, except that, instead of purchasing Y stock, Z contributes to Y an operating asset in exchange for 21 percent of the Y stock. Y is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) in exchange for Y stock immediately before the termination. Because X and Z are co-transferors that control the transferee immediately after the transfer, the transaction qualifies under section 351.

Example 4. X, an S corporation, owns 100 percent of the stock of Y, a corporation for which a QSub election is in effect. X distributes all of the Y stock pro rata to its shareholders, and the distribution terminates the QSub election. The transaction can qualify as a distribution to which sections 368(a)(1)(D) and 355 apply if the transaction otherwise satisfies the requirements of those sections.

Example 5. X, an S corporation, owns 100 percent of the stock of Y, a corporation for which a QSub election is in effect. X subsequently revokes the QSub election. Y is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before the revocation from its S corporation parent in a deemed exchange for Y stock. On a subsequent date, X sells 21 percent of the stock of Y to Z, an unrelated corporation, for cash. Assume that under general principles of tax law including the step transaction doctrine, the sale is not taken into account in determining whether X is in control of Y immediately after the deemed exchange of assets for stock. The deemed exchange by X of assets for Y stock and the deemed assumption by Y of its liabilities qualify under section 351 because, for purposes of that section, X is in control of Y within the meaning of section 368(c) immediately after the transfer.

Example 6. (i) X, an S corporation, owns 100 percent of the stock of Y, and Y owns 100 percent of the stock of Z. Y and Z are corporations for which QSub elections are in effect. X subsequently revokes the QSub elections and the effective date specified on each revocation statement is June 26, 2002, a date that is less than 12 months after the date on which the revocation statements are filed.

(ii) Immediately before the QSub elections terminate, Y is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) directly from X in exchange for the stock of Y. Z is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) directly from Y in exchange for the stock of Z.

Example 7. (i) The facts are the same as in *Example 6*, except that, prior to June 26, 2002 (the effective date of the revocations), Y distributes the Z stock to X under state law.

(ii) Immediately before the QSub elections terminate, Y is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) directly from X in exchange for the stock of Y. Z is also treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) directly from X in exchange for the stock of Z.

Example 8. Merger of parent into QSub. X, an S corporation, owns 100 percent of the stock of Y, a corporation for which a QSub election is in effect. X merges into Y under state law, causing the QSub election for Y to terminate, and Y survives the merger. The formation of the new corporation, Y, and the merger of X into Y can qualify as a reorganization described in section 368(a)(1)(F) if the transaction otherwise satisfies the requirements of that section.

Example 9. Transfer of 100 percent of QSub. X, an S corporation, owns 100 percent of the stock of Y, a corporation for which a QSub election is in effect. Z, an unrelated C corporation, acquires 100 percent of the stock of Y. The deemed formation of Y by X (as a consequence of the termination of Y's QSub election) is disregarded for Federal income tax purposes. The transaction is treated as a transfer of the assets of Y to Z, followed by Z's transfer of these assets to the capital of Y in exchange for Y stock. Furthermore, if Z is an S corporation and makes a QSub election for Y effective as of the acquisition, Z's transfer of the assets of Y in exchange for Y stock, followed by the immediate liquidation of Y as a consequence of the QSub election are disregarded for Federal income tax purposes.

(c) *Election after QSub termination*—(1) *In general*. Absent the Commissioner's consent, and except as provided in paragraph (c)(2) of this section, a corporation whose QSub election has terminated under paragraph (a) of this section (or a successor corporation as defined in paragraph (b) of this section) may not make an S election under section 1362 or have a QSub election under section 1361(b)(3)(B)(ii) made with respect to it for five taxable years (as described in section 1361(b)(3)(D)). The Commissioner may permit an S election by the corporation or a new QSub election with respect to the corporation before the five-year period expires. The corporation requesting consent to make the election has the burden of establishing that, under the relevant facts and circumstances, the Commissioner should consent to a new election.

(2) *Exception*. In the case of S and QSub elections effective after December 31, 1996, if a corporation's QSub election terminates, the corporation may, without requesting the Commissioner's consent, make an S election or have a QSub election made with respect to it before the expiration of the five-year period described in section 1361(b)(3)(D) and paragraph (c)(1) of this section, provided that—

(i) Immediately following the termination, the corporation (or its successor corporation) is otherwise eligible to make an S election or have a QSub election made for it; and

(ii) The relevant election is made effective immediately following the termination of the QSub election.

(3) *Examples*. The following examples illustrate the application of this paragraph (c):

Example 1. Termination upon distribution of QSub stock to shareholders of parent. X, an S corporation, owns Y, a QSub. X distributes all of its Y stock to X's shareholders. The distribution terminates the QSub election because Y no longer satisfies the requirements of a QSub. Assuming Y is otherwise eligible to be treated as an S corporation, Y's shareholders may elect to treat Y as an S corporation effective on the date of the stock distribution without requesting the Commissioner's consent.

Example 2. Sale of 100 percent of QSub stock. X, an S corporation, owns Y, a QSub. X sells 100 percent of the stock of Y to Z, an unrelated S corporation. Z may elect to treat Y as a QSub effective on the date of purchase without requesting the Commissioner's consent.

§1.1361–6 Effective date.

Except as provided in §§1.1361–4(a)(3)(iii), 1.1361–4(a)(5)(i), and 1.1361–5(c)(2), the provisions of §§1.1361–2 through 1.1361–5 apply to taxable years beginning on or after January 20, 2000; however, taxpayers may elect to apply the regulations in whole, but not in part (aside from those sections with special dates of applicability), for taxable years beginning on or after January 1, 2000, provided all affected taxpayers apply the regulations in a consistent manner. To make this election, the corporation and all affected taxpayers must file a return or an amended return that is consistent with these rules for the taxable year for which the election is made. For purposes of this section, affected taxpayers means all taxpayers whose returns are affected by the election to apply the regulations.

Par. 5. Amend §1.1362–0 by adding an entry for §1.1362–8 to read as follows:

§1.1362–0 Table of contents.

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§1.1362–8 Dividends received from affiliated subsidiaries.

(5) Gross receipts safe harbor.
(c) Allocating distributions to active or passive earnings and profits.
(1) Distributions from current earnings and profits.
(2) Distributions from accumulated earnings and profits.
(3) Adjustments to active earnings and profits.
(4) Special rules for consolidated groups.
(d) Examples.
(e) Effective date.

Par. 6. Section 1.1362–2 is amended by adding a sentence to the end of the paragraph (c)(5)(ii)(C) to read as follows:

§1.1362–2 Termination of election.

* * * * *

(c) * * *

(5) * * *

(ii) * * *

(C) * * * See §1.1362–8 for special rules regarding the treatment of dividends received by an S corporation from a C corporation in which the S corporation holds stock meeting the requirements of section 1504(a)(2).

* * * * *

Par. 7. Section 1.1362–8 is added to read as follows:

§1.1362–8 Dividends received from affiliated subsidiaries.

(a) *In general*. For purposes of section 1362(d)(3), if an S corporation holds stock in a C corporation meeting the requirements of section 1504(a)(2), the term *passive investment income* does not include dividends from the C corporation to the extent those dividends are attributable to the earnings and profits of the C corporation derived from the active conduct of a trade or business (active earnings and profits). For purposes of applying section 1362(d)(3), earnings and profits of a C corporation are active earnings and profits to the extent that the earnings and profits are derived from activities that would not produce passive investment income (as defined in section 1362(d)(3)) if the C corporation were an S corporation.

(b) *Determination of active or passive earnings and profits*—(1) *In general*. An S corporation may use any reasonable method to determine the amount of dividends that are not treated as passive investment income under section 1362(d)(3)(E). Paragraph (b)(5) of this section describes a method of determining the amount of dividends that are not treated as passive investment income under section 1362(d)(3)(E) that is deemed to be reasonable under all circumstances.

(2) *Lower tier subsidiaries*. If a C corporation subsidiary (upper tier corporation) holds stock in another C corporation (lower tier subsidiary) meeting the requirements of section 1504(a)(2), the upper tier corporation's gross receipts attributable to a dividend from the lower tier subsidiary are considered to be derived from the active conduct of a trade or business to the extent the lower tier subsidiary's earnings and profits are attributable to the active conduct of a trade or business by the subsidiary under paragraph (b)(1), (3), (4), or (5) of this section. For purposes of this section, distributions by the lower tier subsidiary will be considered attributable to active earnings and profits according to the rule in paragraph (c) of this section. This paragraph (b)(2) does not apply to any member of a consolidated group (as defined in §1.1502–1(h)).

(3) *De minimis exception*. If less than 10 percent of a C corporation's earnings and profits for a taxable year are derived from activities that would produce passive investment income if the C corporation were an S corporation, all earnings and profits produced by the corporation during that taxable year are considered active earnings and profits.

(4) *Special rules for earnings and profits accumulated by a C corporation prior to 80 percent acquisition*. A C corporation may treat all earnings and profits accumulated by the corporation in all taxable years ending before the S corporation held stock meeting the requirements of section 1504(a)(2) as active earnings and profits in the same proportion as the C corporation's active earnings and profits for the three taxable years ending prior to the time when the S corporation acquired 80 percent of the C corporation bears to the C corporation's total earnings and profits for those three taxable years.

(5) *Gross receipts safe harbor*. A corporation may treat its earnings and profits for a year as active earnings and profits in the same proportion as the corporation's gross receipts (as defined in §1.1362-2(c)(4)) derived from activities that would not produce passive investment income (if the C corporation were an S corporation), including those that do not produce passive investment income under paragraphs (b)(2) through (b)(4) of this section, bear to the corporation's total gross receipts for the year in which the earnings and profits are produced.

(c) *Allocating distributions to active or passive earnings and profits*—(1) *Distributions from current earnings and profits*. Dividends distributed by a C corporation from current earnings and profits are attributable to active earnings and profits in the same proportion as current active earnings and profits bear to total current earnings and profits of the C corporation.

(2) *Distributions from accumulated earnings and profits*. Dividends distributed by a C corporation out of accumulated earnings and profits for a taxable year are attributable to active earnings and profits in the same proportion as accumulated active earnings and profits for that taxable year bear to total accumulated earnings and profits for that taxable year immediately prior to the distribution.

(3) *Adjustments to active earnings and profits*. For purposes of applying paragraph (c)(1) or (2) of this section to a distribution, the active earnings and profits of a corporation shall be reduced by the amount of any prior distribution properly treated as attributable to active earnings and profits from the same taxable year.

(4) *Special rules for consolidated groups*. For purposes of applying section 1362(d)(3) and this section to dividends received by an S corporation from the common parent of a consolidated group (as defined in §1.1502–1(h)), the following rules apply —

(i) The current earnings and profits, accumulated earnings and profits, and active earnings and profits of the common parent shall be determined under the principles of §1.1502–33 (relating to earnings and profits of any member of a consolidated group owning stock of another member); and

(ii) The gross receipts of the common parent shall be the sum of the gross receipts of each member of the consolidated group (including the common parent), adjusted to eliminate gross receipts from intercompany transactions (as defined in §1.1502–13(b)(1)(i)).

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

Example 1. (i) X, an S corporation, owns 85 percent of the one class of stock of Y. On December 31, 2002, Y declares a dividend of $100 ($85 to X), which is equal to Y's current earnings and profits. In 2002, Y has total gross receipts of $1,000, $200 of which would be passive investment income if Y were an S corporation.

(ii) One-fifth ($200/$1,000) of Y's gross receipts for 2002 is attributable to activities that would produce passive investment income. Accordingly, one-fifth of the $100 of earnings and profits is passive, and $17 (1/5 of $85) of the dividend from Y to X is passive investment income.

Example 2. (i) The facts are the same as in *Example 1*, except that Y owns 90 percent of the stock of Z. Y and Z do not join in the filing of a consolidated return. In 2002, Z has gross receipts of $15,000, $12,000 of which are derived from activities that would produce passive investment income. On December 31, 2002, Z declares a dividend of $1,000 ($900 to Y) from current earnings and profits.

(ii) Four-fifths ($12,000/15,000) of the dividend from Z to Y are attributable to passive earnings and profits. Accordingly, $720 (4/5 of $900) of the dividend from Z to Y is considered gross receipts from an activity that would produce passive investment income. The $900 dividend to Y gives Y a total of $1,900 ($1,000 + $900) in gross receipts, $920 ($200 + $720) of which is attributable to passive investment income-producing activities. Under these facts, $41 ($920/1,900 of $85) of Y's distribution to X is passive investment income to X.

(e) *Effective date*. This section applies to dividends received in taxable years beginning on or after January 20, 2000; however, taxpayers may elect to apply the regulations in whole, but not in part, for taxable years beginning on or after January 1, 2000, provided all affected taxpayers apply the regulations in a consistent manner. To make this election, the corporation and all affected taxpayers must file a return or an amended return that is consistent with these rules for the taxable year for which the election is made. For purposes of this section, affected taxpayers means all taxpayers whose returns are affected by the election to apply the regulations.

§1.1368–0 [Amended]

Par. 8. Amend §1.1368–0 in the entry for §1.1368–2(d)(2) by revising "Reorganizations" to read "Liquidations and reorganizations".

§1.1368–2 [Amended]

Par. 9. Amend §1.1368–2 in paragraph (d)(2) by revising "Reorganizations" to read "Liquidations and reorganizations" in the heading and by revising "section 381(a)(2)" to read "section 381(a)" in the first sentence.

Par. 10. Amend §1.1374–8 by adding one sentence to the end of paragraph (b) to read as follows:

§1.1374–8 Section 1374(d)(8) transactions.

* * * * *

(b) *Separate determination of tax*. * * * If an S corporation makes QSub elections under section 1361(b)(3) for a tiered group of subsidiaries effective on the same day, see §1.1361–4(b)(2).

PART 301—PROCEDURE AND ADMINISTRATION

Par. 11. The authority citation for part 301 continues to read in part as follows:

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

Par. 12. Section 301.6109–1 is amended as follows:

1. Paragraph (i) is redesignated as paragraph (j) and the first sentence of newly designated paragraph (j)(1) is amended by removing the language "paragraph (i)" and adding "paragraph (j)" in its place.

2. A new paragraph (i) is added.

The addition reads as follows:

§301.6109–1 Identifying numbers.

* * * * *

(i) *Special rule for qualified subchapter S subsidiaries (QSubs)*—(1) *General rule*. Any entity that has an employer identification number (EIN) will retain that EIN if a QSub election is made for the entity under §1.1361–3 or if a QSub election that was in effect for the entity terminates under §1.1361–5.

(2) *EIN while QSub election in effect*. Except as otherwise provided in regulations or other published guidance, a QSub must use the parent S corporation's EIN for Federal tax purposes.

(3) *EIN when QSub election terminates*. If an entity's QSub election terminates, it may not use the EIN of the parent S corporation after the termination. If the entity had an EIN prior to becoming a QSub or obtained an EIN while it was a QSub in accordance with regulations or other published guidance, the entity must use that EIN. If the entity had no EIN, it must obtain an EIN upon termination of the QSub election.

(4) *Effective date*. The rules of this paragraph (i) apply on January 20, 2000.

Part 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 13. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 14. In §602.101, paragraph (b) is amended by adding entries for §§1.1361–3, 1.1361–5, and 1.1362–8 to the table in numerical order to read as follows:

§602.101 OMB Control numbers.

* * * * *

(b) * * *

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue Service.

Approved January 14, 2000.

Jonathan Talisman,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on January 20, 2000, 1:19 p.m., and published in the issue of the Federal Register for January 25, 2000, 65 F.R. 3843)

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.1361–3	1545-1590
1.1361–5	1545-1590 * * *
1.1361–8	1545-1590
* * * * *	

Section 3121.—Definitions

At what level of compensations does FICA tax apply to election workers? See Rev. Rul. 2000–6 on this page.

Section 3401.—Receipts for Employees

26 CFR 31.3401

Does federal income tax withholding apply to compensation paid to election workers? See Rev. Rul. 2000–6 on this page.

Section 6041.—Information at Source

(Also §§ 3121, 3401, 6051)

26 CFR 1.6041–2: Return of information as to payments to employees.
(Also § 1.6041–1)

Information reporting requirements applicable to election workers. The requirements for information reporting applicable to election workers whose compensation is not subject to FICA tax are found in Code section 6041(a). As a result, reporting is generally not required for election workers earning less than $600 annually. Rev. Rul. 88–36, 1988–1 C.B. 343, modified.

Rev. Rul. 2000–6

ISSUE

How do the information reporting requirements of §§ 6041(a) and 6051(a) of the Internal Revenue Code apply to election workers?

FACTS

Election workers are individuals who are generally employed to perform services for state and local governments (governments) at election booths in connection with national, state, or local elections. Governments typically pay election workers a set fee for each day of work. Election workers' wages are includible in gross income as compensation for services. Section 61(a)(1). An individual employed as an election worker may also perform services for the government in another capacity.

A state and the Social Security Administration may agree to extend social security coverage to services of employees of the state or its political subdivisions under § 218 of the Social Security Act (§ 218 agreement). A § 218 agreement may cover the services of election workers. If so, the § 218 agreement may specify the level of fees the election workers must receive to be entitled to coverage. Information about a state's § 218 agreement can be obtained from the State Social Security Administrator.

Situation 1: Government *A* pays *V* $200 in a calendar year for services as an election worker. *A* does not employ *V* in any other capacity. The services of *A*'s election workers are not covered by a § 218 agreement. *V* is not covered by a retirement plan maintained by *A*.

Situation 2: Government *B* pays *W* $200 in a calendar year for services as an election worker. *B* does not employ *W* in any other capacity. The services of *B*'s election workers are covered by a § 218 agreement if their remuneration is $100 or more in a calendar year. *W* is not covered by a retirement plan maintained by *B*.

Situation 3: Government *C* pays *X* $1,100 in calendar year 2000 for services as an election worker. C does not employ *X* in any other capacity. The services of *C*'s election workers are not covered by a § 218 agreement. *X* is not covered by a retirement plan maintained by *C*.

Situation 4: Government *D* pays *Y* $200 in a calendar year for services as an election worker. *D* also employed *Y* in another capacity, in which *Y* earned wages of $300 that are subject to income tax withholding. The services of *D*'s election workers are not covered by a § 218 agreement. *Y* is not covered by a retirement plan maintained by *D*.

Situation 5: Government *E* pays *Z* $200 in a calendar year for services as an election worker. *E* also employed *Z* in another capacity, in which *Z* earned wages of $500 that are subject to income tax withholding. The services of *E*'s election workers are not covered by a § 218 agreement. *Z* is not covered by a retirement plan maintained by *E*.

LAW

Taxes under the Federal Insurance Contribution Act (FICA) apply to "wages" as defined in § 3121(a). That section provides that the term wages includes only remuneration for "employment." Section 3121(b)(7)(F)(iv) provides that the services of an election worker are not employment for FICA purposes if the worker's remuneration is less than $1,000. For calendar years beginning on or after January 1, 2000, the amount is indexed for inflation. The applicable amount for the year 2000 is $1,100. Because service performed by an election worker for calendar year 2000 for an amount less than $1,100 is excluded from employment for FICA purposes, that amount is not wages for FICA purposes unless covered under a § 218 agreement.

Similarly, section 3121(u)(2)(B)(ii)(V) provides that the services of an election worker are not employment for purposes of the Medicare tax portion of the FICA if the worker's remuneration is less than $1,000 in a calendar year. For calendar years beginning on or after January 1, 2000, the amount is indexed for inflation. The applicable amount for the year 2000 is $1,100. For services performed before January 1, 1995, the § 3121(u)(2)(B)(ii)(V) exclusion was for remuneration of less than $100. Rev. Rul. 88–36, 1988–1 C.B. 343, A2, provides that an election worker is subject to Medicare tax unless the remuneration paid to the worker in a calendar year is less than $100.

Section 3401(a) provides that, for purposes of income tax withholding, the term "wages" means all remuneration (other than fees paid to a public official) for services performed by an employee for an employer. Section 31.3401(a)–2(b)(2) of the Employment Tax Regulations states that amounts paid to precinct workers for services performed at election booths are "in the nature of fees paid to public officials" and not subject to income tax withholding.

Sections 6041(a) and 6051(a) both impose a duty to file information reports of compensation paid to workers.

Section 6041(a) provides:

> All persons engaged in a trade or business and making payment in the course of such trade or business to another person, of rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income ... of $600 or more in any taxable year ... shall render a true and accurate return to the Secretary, under such regulations and in such form and manner

and to such extent as may be prescribed by the Secretary, setting forth the amount of such gains, profits, and income, and the name and address of the recipient of such payment.

Under § 1.6041–1(b)(1) of the Income Tax Regulations, the term "all persons engaged in a trade or business," as used in § 6041(a), includes organizations the activities of which are not for the purpose of gain or profit.

The general rule stated in § 1.6041–1(a)(2) is that the required return is made on Forms 1096 and 1099, except that § 1.6041–1(a)(2)(ii) provides that compensation paid to an employee by an employer shall be reported on Forms W-3 and W-2 under the provisions of § 1.6041–2 (relating to return of information as to payments to employees).

Under § 1.6041–2(a)(1), payments of wages not subject to income tax withholding must be reported on Form W-2 if the total of those payments and the amount of the employee's wages subject to income tax withholding, if any, is $600 or more in a calendar year. For example, if a payment of $700 was made to an employee and $400 thereof represents wages subject to withholding under section 3402 and the remaining $300 represents compensation not subject to withholding, such wages and compensation must both be reported on Form W-2. If the employee has no wages subject to income tax withholding, the employer is required to file Form W-2 for that employee if payments to that employee equal $600 or more in a calendar year.

Section 1.6041–2(a)(1) provides that, at the election of the employer, components of amounts required to be reported on Form W-2 pursuant to this subparagraph may be reported on more than one Form W-2. Thus the amounts paid to an individual for services as an election worker may be reported on a separate W-2 from amounts paid to the individual for service in another capacity, even though the amounts are aggregated to determine whether reporting applies.

Section 6051(a) imposes a reporting requirement on the following two categories of payors of remuneration:

> Every person required to deduct and withhold from an employee a tax under section 3101 [employee FICA tax] or 3402 [income tax withholding], ... or every employer engaged in a trade or business who pays remuneration for services performed by an employee ... .

Section 6051(a) does not require reporting of compensation that is not subject to withholding of FICA tax or income tax.

Section 6051(c) provides that the Secretary may prescribe by regulations the reporting of additional items. No regulations requiring employers to furnish additional information have been published.

ANALYSIS

Compensation of an election worker is not subject to income tax withholding. Sections 3401(a) and 31.3401(a)–2(b)(2). If an election worker's compensation is less than $1,100 for calendar year 2000, it is generally not subject to FICA tax. Sections 3121(b)(7)(F)(iv) and 3121(u)(2)(B)(ii)(V). However, under a state's § 218 agreement, an election worker's compensation may be subject to both the old-age, survivors and disability insurance (OASDI) and the Medicare portions of the FICA tax at a level below $1,100 for calendar year 2000.

Section 6041(a) applies to payments of compensation that are not subject to withholding of FICA or income tax. If an election worker's compensation is not subject to withholding of FICA tax, the § 6041(a) reporting requirement applies to payments that aggregate $600 or more in any taxable year. Under § 1.6041–2(a)(1), compensation subject to income tax withholding is taken into account in determining whether the $600 reporting requirement applies.

Section 6051(a) requires reporting of compensation subject to either FICA tax or income tax withholding. No reporting is required by §§ 6051(a) and 31.6051–1(a) and (b) for items of income that are not subject to withholding of FICA tax or income tax. If an election worker's compensation is subject to withholding of FICA tax, reporting is required by § 6051(a), regardless of the amount of compensation.

HOLDINGS

The reporting requirements applicable to governments that employ election workers are as follows:

Situation 1: Neither FICA tax nor income tax withholding applies to the $200 paid to *V*. The reporting requirements of § 6041(a) apply. Because *V* earns fees that are less than $600, Government *A* is not required to issue Form W-2 to *V*.

Situation 2: FICA tax, but not income tax withholding, applies to the $200 paid to *W* because the fees exceed the $100 threshold in the § 218 agreement. Government *B* must follow the reporting requirements of § 6051(a), reporting on Form W-2 the fees of $200 and the FICA tax withheld.

Situation 3: FICA tax, but not income tax withholding, applies to the $1,100 paid to *X* for calendar year 2000. Government *C* must follow the reporting requirements of §6051(a), reporting on Form W-2 the fees of $1,100 and the FICA tax withheld.

Situation 4: Neither FICA tax nor income tax withholding applies to the $200 paid to *Y* for services as an election worker, but the $300 payment is subject to income tax withholding. Government *D* must follow the reporting requirements of § 6051(a), reporting on Form W-2 the $300 payment and the income tax withheld. Section 6041(a) does not require reporting of the $200 payment because the total of the two payments is less than $600 for the calendar year.

Situation 5: Neither FICA tax nor income tax withholding applies to the $200 paid to *Z* for services as an election worker, but the $500 payment is subject to income tax withholding. Government *E* must follow the reporting requirements of §§ 6041(a) and 6051(a), reporting on Form W-2 both the $200 and the $500 payments and the amount of income tax withheld.

EFFECT ON OTHER REVENUE RULING(S)

This ruling modifies Rev. Rul. 88–36, A2, to reflect the increase in the amount of remuneration applicable for purposes of the Medicare tax exclusion under § 3121(u)(2)(B)(ii)(V), currently $1,100 for calendar year 2000.

DRAFTING INFORMATION

The principal author of this revenue ruling is Elizabeth Edwards of the Office of Chief Counsel (Employee Benefits & Exempt Organizations). For further information regarding this revenue ruling, contact Elizabeth Edwards at (202) 622-6040 (not a toll-free call).

Section 6051.—Receipts for Employees

26 CFR 31.6051–1

How do the information reporting requirements of § 6051(a) apply to election workers? See Rev. Rul. 2000–6, page 512.

Section 7520.—Valuation Tables

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 2000. See Rev. Rul. 2000–9, page 497.

Section 7872.—Treatment of Loans with Below-Market Interest Rates

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of February 2000. See Rev. Rul. 2000–9, page 497.

26 CFR 601.701: Publicity of information.
(Also Part I, Sections 901, 902, 905, 960, 986; 1.901–2, 1.905–3T; Part II, United States-United Kingdom Income Tax Convention.)

Rev. Proc. 2000–13

SECTION 1. PURPOSE

This revenue procedure modifies Rev. Proc. 80–18, 1980–1 C.B. 623, by setting forth new rules and procedures for applying Articles 10(2)(a) and 23(1)(b) and (c) of the United States-United Kingdom Income Tax Convention, signed on December 31, 1975, as amended by an Exchange of Notes, signed on April 13, 1976, and Protocols, signed on August 26, 1976, March 31, 1977, and March 15, 1979 (the "Convention"), 1980–1 C.B. 394, with respect to dividends paid by corporations resident in the United Kingdom after April 5, 1999 to U.S. shareholders. Revised rules and procedures are necessary because the United Kingdom repealed its advance corporation tax ("ACT") and reduced the shareholder tax credit with respect to dividends effective April 6, 1999.

SECTION 2. BACKGROUND

.01 *Prior U.K. Law*. Under prior U.K. law, ACT was levied on a corporation resident in the United Kingdom (U.K. corporation) in respect of a dividend paid, or other qualifying distribution made, by the corporation to its shareholders. The rate of ACT varied over time, but equaled one-fourth of the amount of the dividend immediately prior to the repeal of ACT. At the corporate level, ACT was creditable against the general corporation tax liability of either the distributing corporation or a corporation related to the distributing corporation. At the shareholder level, a shareholder resident in the United Kingdom was generally entitled to a tax credit against the shareholder's income tax liability in respect of the distribution. The tax credit was calculated by reference to the ACT rate and could be paid in cash to the extent that the credit exceeded the shareholder's tax liability. Because the amount of the tax credit was calculated by reference to the ACT rate, the shareholder tax credit was commonly referred to in the United States as an "ACT refund." The tax credit was an integral part of a system of taxation under U.K. law that partially integrated the United Kingdom's corporate and shareholder level income taxes. The shareholder tax credit was designed to eliminate or reduce a second level of tax on corporate profits at the shareholder level. In the absence of a specific tax treaty provision, tax credits were not generally available to shareholders not resident in the United Kingdom. Under its domestic law, the United Kingdom does not impose a withholding tax on dividends paid to nonresidents.

.02 *Relevant Provisions of the Convention*. Paragraph (2) of Article 10 (Dividends) of the Convention provides that, as long as an individual resident in the United Kingdom is entitled under U.K. law to a tax credit in respect of dividends paid by a U.K. corporation, U.S. residents who are the beneficial owners of dividends paid by a U.K. corporation will be entitled to receive a payment from the United Kingdom of a tax credit, subject to a deduction withheld from the payment. In the case of U.S. corporations owning, directly or indirectly, 10 percent or more of the voting stock of a distributing U.K. corporation ("direct investors"), paragraph (2)(a)(i) of Article 10 provides that the amount payable by the United Kingdom is equal to one-half of the tax credit to which an individual shareholder resident in the United Kingdom would have been entitled, reduced by 5 percent of the sum of the dividend and the amount of the tax credit. In the case of all other U.S. investors ("portfolio investors"), paragraph (2)(a)(ii) of Article 10 provides that the amount payable by the United Kingdom is equal to the full amount of the tax credit to which an individual shareholder resident in the United Kingdom would have been entitled, reduced by 15 percent of the sum of the dividend and the amount of the tax credit. Under paragraph (2)(a)(iii) of Article 10, the gross amount of the tax credit (unreduced by the 5 or 15 percent withheld) is treated as an additional dividend paid by the U.K. corporation for U.S. tax credit purposes.

Paragraph (1) of Article 23 (Elimination of Double Taxation) of the Convention generally provides that the United States shall allow to its citizens and residents a foreign tax credit for an appropriate amount of income tax paid to the United Kingdom, subject to the limitations of, and in accordance with, the laws of the United States. Paragraph (1) of Article 23 provides that, in the case of a U.S. corporation owning at least 10 per cent of the voting stock of a U.K. corporation from which it receives dividends in any taxable year, the United States shall allow credit for the appropriate amount of tax paid to the United Kingdom by that corporation with respect to the profits out of which such dividends are paid. Paragraph (1)(b) of Article 23 provides that the United States shall treat the amount withheld under paragraphs (2)(a)(i) and (ii) of Article 10 as an income tax imposed on the recipient of the dividend. Paragraph (1)(c) of Article 23 provides that the United States shall treat the one-half of the tax credit to which an individual shareholder resident in the United Kingdom would have been entitled, but which is not paid to a U.S. direct investor, as an income tax imposed on the U.K. corporation.

.03 *Repeal of ACT and Reduction of Shareholder Tax Credit*. Effective April 6, 1999, the United Kingdom repealed the ACT. Thus, a U.K. corporation is no longer required to pay ACT in respect of a dividend or other qualifying distribution to its shareholders. Notwithstanding the repeal of ACT, the integrated system of taxation under U.K. law remains in force. A U.K. shareholder is generally still entitled to a tax credit upon the receipt of a qualifying distribution to the extent of the shareholder's tax liability, but any excess is no longer payable in cash. The amount of the shareholder tax credit is no longer determined by reference to the ACT rate, but by reference to the "tax credit fraction" in force on the date of the distribution. The current tax credit fraction is one-ninth. Thus, the U.K. shareholder tax credit has been reduced from one-fourth to one-ninth of the amount of the dividend.

Under the literal language of the Convention, paragraph (2) of Article 10 of the Convention continues to apply after the repeal of ACT because individuals resident in the United Kingdom continue to be entitled under U.K. law to a tax credit in respect of dividends paid by a U.K. corporation. Because of the reduction in the amount of the U.K. shareholder tax credit, however, the amount of the payment due to U.S. investors will be reduced. For portfolio investors, the amount permitted to be withheld on the sum of the dividend and the tax credit pursuant to paragraph (2)(a)(ii) of Article 10 will completely eliminate the amount payable. As a result, no additional cash will be payable to the investor under the Convention. For direct investors, only a nominal amount of additional cash will be payable, because the 5-percent amount withheld on the sum of the dividend and the tax credit pursuant to paragraph (2)(a)(i) of Article 10 will almost entirely eliminate the payment.

SECTION 3. APPLICATION OF THE CONVENTION AFTER THE REPEAL OF ACT

.01 *Section 901 Credit for Tax Withheld*. A U.S. shareholder, whether a portfolio or direct investor, who invokes the provisions of paragraph (2)(a) of Article 10 of the Convention upon the receipt of a dividend or other qualifying distribution after April 5, 1999 from a U.K. corporation will continue to be entitled to receive a foreign tax credit under section 901, in accordance with Article 23, for the amount withheld pursuant to paragraph (2)(a) of Article 10. This amount is treated as a creditable withholding tax for U.S. tax purposes pursuant to paragraph (1)(b) of Article 23.

.02 *Portfolio investors*. A U.S. portfolio investor entitled to payment of a tax credit under Article 10 of the Convention upon receipt of a dividend or other qualifying distribution from a U.K. corporation may elect to be treated as receiving the amount due under the Convention without affirmatively making a claim to the United Kingdom. A portfolio investor may make this election by so indicating on Line 5 of Form 8833 (Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)) and filing the completed Form 8833 with the taxpayer's income tax return for the relevant year.

A portfolio investor making this election will be treated as having received an additional dividend equal to the gross amount of the tax credit (unreduced by amounts withheld), and as having paid the withholding tax due under Article 10, on the date of the distribution. Thus, the investor must include in income the gross payment deemed received, and may claim a foreign tax credit under Article 23 for the withholding tax treated as paid to the United Kingdom.

The withholding tax creditable under Article 23 cannot exceed the amount of the tax credit payable under the Convention. Since the tax permitted to be withheld under paragraph (2)(a)(ii) of Article 10 can only be withheld from the amount of the tax credit due to the U.S. portfolio investor, the United Kingdom is not permitted under the Convention to withhold an amount in excess of the tax credit. Accordingly, the tax is considered due and paid only to the extent of the tax credit.

For purposes of section 905(b) of the Code (relating to proof of credits), a U.S. portfolio investor who elects to be treated as receiving a payment and paying a tax under the Convention is not required to obtain a receipt or other evidence from the United Kingdom verifying the payment of the withholding tax, but may use secondary evidence to substantiate the amount of tax treated as paid. See Treas. Reg. § 1.905–2(b)(3).

.03 *Direct Investors*. A U.S. direct investor that claims a tax credit from the United Kingdom is entitled to a small payment net of withholding tax under paragraph (2)(a)(i) of Article 10. The amount of the withholding tax creditable under Article 23 will be equal to 5 percent of the sum of the dividend and the gross amount of the tax credit. The investor must include the gross amount of the tax credit in income as a dividend and satisfy all requirements under section 905(b) and the regulations thereunder relating to the verification and computation of the foreign tax credit. The investor must also file a Form 8833 (Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)) with the taxpayer's income tax return for the relevant year disclosing the benefits claimed under Articles 10 and 23 of the Convention.

.04 *Section 902 or 960 Credit for Corporate-Level Tax*. Under paragraph (1)(c) of Article 23 of the Convention, the portion of the tax credit to which a U.K. shareholder would be entitled upon a qualifying distribution, but which is not paid to a U.S. direct investor, is treated as an income tax imposed on the U.K. corporation paying the dividend. This paragraph made clear that the one-half of the ACT paid by the U.K. corporation that was not paid out to the U.S. investor was to be treated as an income tax imposed on the U.K. corporation for which the U.S. investor could claim an indirect credit under paragraph 1 of Article 23 (and pursuant to sections 902 and 960 of the Code). See S. Exec. Rep. No. 18, 95th Cong., 2d Sess. (1980), *reprinted in* 1980–1 C.B. 411, 428. However, because paragraph (1) of Article 23 and section 901 of the Code specifically limit the allowable indirect credit to the appropriate amount of creditable U.K. income taxes actually paid by the U.K. corporation, the one-half of the ACT not paid out to the U.S. investor was creditable only to the extent it was actually paid by the U.K. corporation.

Under current U.K. law, a U.K. corporation is liable for corporation tax on the corporation's profits, but is not liable for ACT or any other creditable income tax in respect of its profits. Under Article 23, and in accordance with section 902 or 960 of the Code, a direct investor is eligible to claim an indirect foreign tax credit for the U.K. corporation tax paid by the corporation. Because no additional U.K. income tax is paid by the U.K. corporation under current law, no portion of the shareholder tax credit is treated as additional tax paid by the U.K. corporation for which the investor may claim an indirect foreign tax credit under Article 23 and in accordance with section 902 or 960 of the Code.

.05 *Effect of Tax Credit Paid Under the Convention on U.K. Corporation's Earnings and Profits and Foreign Income Taxes*. Under paragraph (2)(a)(iii) of Article 10, the gross amount of the tax credit (unreduced by amounts withheld) due from the United Kingdom under paragraphs (2)(a)(i) and (ii) of Article 10 is characterized as a dividend from the distributing U.K. corporation for U.S. tax credit purposes. The characterization of this amount as a dividend means that the U.K. corporation must be treated as receiving from the United Kingdom an equivalent amount out of which it pays the dividend. Prior to the repeal of ACT, the distributing U.K. corporation was treated as receiving from the United Kingdom a refund of the ACT paid (or one-half of the ACT paid in the case of a distribution to a U.S. direct investor), out of which it paid the tax credit due under the Convention to its U.S. shareholder. See Treasury Explanation, *reprinted in* 1980–1 C.B. 455, 474 (prescribing this treatment under pre-1987 law).

While ACT is no longer payable by U.K. corporations, the shareholder tax credit due under the Convention is still funded out of U.K. corporate tax revenues and is determined by reference to the amount of the dividend, which is a portion of the base used to compute the U.K. corporation's tax. Thus, the payment of the shareholder tax credit gives rise to a refund or indirect subsidy for U.S. tax purposes. See section 901(i) and Treas. Reg. § 1.901–2(e)(3). These purposes include the computation of the corporation's earnings and profits (E&P) and foreign income taxes and corresponding effects on the corporation's U.S. shareholders, which may include the computation of the indirect credit under paragraph 1 of Article 23 (and pursuant to sections 902 and 960 of the Code) and the subpart F provisions under sections 951 through 964 of the Code. Accordingly, for distributions after April 5, 1999 with respect to which a U.S. direct investor applies for benefits under Article 10 of the Convention, the U.K. corporation will be treated as receiving a tax refund in an amount equivalent to the gross amount of the tax credit (unreduced by amounts withheld) payable to the U.S. shareholder under the Convention. This treatment ensures that the U.S. shareholder does not receive combined direct and indirect foreign tax credits in an amount exceeding the income taxes actually paid by the U.K. corporation.

The deemed refund of tax to the U.K. corporation is considered allocable to a separate limitation category in proportion to the ratio of post-1986 foreign income taxes in such category to the total amount of post-1986 foreign income taxes of the U.K. corporation, determined as of the close of the year in which the shareholder tax credit is paid or accrued and prior to accounting for the effect of distributions and deemed distributions during the year. To the extent the refund exceeds the U.K. corporation's total post-1986 foreign income taxes, the refund is treated as attributable to foreign income taxes previously deemed paid on a last-in, first-out basis (*i.e.*, the refund reduces the foreign income taxes most recently deemed paid by the U.S. shareholder). Thus, the U.K. corporation must, in the year the shareholder tax credit is paid or accrued, reduce its post-1986 foreign income taxes in the separate limitation category (or categories) to which the refund relates and correspondingly increase its post-1986 undistributed earnings in the same category (or categories) by the gross amount of the tax credit payable under the Convention. See Treas. Reg. sections 1.905–3T(a)(3) and (4).

As explained in the Treasury Technical Explanation accompanying the Convention, where a U.S. direct investor owns less than all the stock of the distributing U.K. corporation, the indirect credit due under Article 23 and in accordance with sections 902 and 960 will be calculated with reference solely to the proportionate amount of E&P and foreign taxes attributable to that investor. Thus, the amount of the indirect credit will not vary according to the status of any other shareholder or the amount of distributions made, or payments of tax credits under the Convention, to any other shareholder. See Treasury Explanation, *reprinted in* 1980-1 C.B. 455, 473.

06. *Procedures for Direct Investors To Claim a Tax Credit Payment Under the Convention.* Prior to the repeal of ACT, the United Kingdom Inland Revenue could enter into arrangements with a U.K. corporation that paid a dividend or other qualifying distribution, authorizing it to pay the tax credit due under the Convention directly to its U.S. shareholders. The U.K. corporation could offset the amount of the tax credit paid against its ACT liability. Because U.K. corporations no longer pay ACT, this procedure is no longer available.

Because of the changes in U.K. law, all claims for payments of tax credits must be made on the appropriate United Kingdom form and filed directly with the United Kingdom Inland Revenue. The appropriate United Kingdom form is U.S./Corporation/Credit. In the United States, the forms may be obtained from the Internal Revenue Service, Office of Assistant Commissioner (International), Attn: Customer Service OP:IN:D:CS, 950 L'Enfant Plaza South, S.W., Washington, D.C. 20024. In the United Kingdom, the forms may be obtained from the Financial Intermediaries and Claims Office ("FICO"), P.O. Box 46, Fitz Roy House, Nottingham NG2 1BD. The forms may be ordered from the United Kingdom by telephone on (011 44) 115 974 2000 or by fax on (011 44) 115 974 1863.

If a U.S. direct investor has never made a claim for a tax credit under the Convention, the investor should file a completed United Kingdom form (in duplicate) with the Philadelphia Service Center, Foreign Certification Unit, P.O. Box 16347, DP535B, Philadelphia, PA 19114. The Service Center will provide the required certification and transmit the form to the United Kingdom Inland Revenue. If a U.S. investor has previously filed a claim for a tax credit under the Convention, subsequent claims do not require certification by the Philadelphia Service Center. In such cases, the United Kingdom form should be filed directly with the United Kingdom Inland Revenue at the address shown above.

SECTION 4. EXCHANGE RATES

Under section 986(a)(1), as amended by the Taxpayer Relief Act of 1997 (TRA 97), P.L. 105–34, section 1102(a)(1) (1997), taxpayers claiming foreign tax credits on an accrual basis generally must translate foreign taxes, including withholding taxes, into U.S. dollars at the average exchange rate for the taxable year to which the taxes relate. Previously, taxpayers claiming foreign tax credits on an accrual basis translated foreign taxes into U.S. dollars at the so-called "spot" rate on the date the taxes were paid. The spot rate reflects a fair market value rate of exchange available to the public for currency under a spot contract in a free market and involving representative amounts. See Treas. Reg. § 1.988–1(d)(1). TRA 97 did not change this translation rule for taxpayers claiming foreign tax credits on the cash basis. Thus, these taxpayers still translate foreign taxes into U.S. dollars at the spot rate on the payment date. See section 986(a)(2).

Nonfunctional currency dividends, including the tax credit treated as a dividend under paragraph (2)(a)(iii) of Article 10, are treated as property distributions and are included in income on the date of payment. In accordance with section 989(b)(1), such dividends are translated into dollars at the spot rate on the payment date, regardless of whether the taxpayer claims foreign tax credits on an accrual or cash basis.

Thus, for taxpayers claiming foreign tax credits on an accrual basis, the gross dividend is translated into U.S. dollars and included in income at the spot rate on the payment date, but taxes withheld from the dividend are translated into U.S. dollars at the average rate for the taxable year for foreign tax credit purposes. A taxpayer claiming foreign tax credits on the cash basis translates both the dividend and withholding tax into U.S. dollars at the spot rate on the date the dividend is paid.

SECTION 5. EFFECT ON OTHER DOCUMENTS

This revenue procedure modifies the relevant portions of sections 3.01 through 3.07 of Rev. Proc. 80–18, 1980–1 C.B. 623 (as modified by Rev. Proc. 81–58, 1981–2 C.B. 678 and Rev. Proc. 84–60, 1984–2 C.B. 504, and as clarified and amplified by Rev. Proc. 90–61, 1990–2 C.B. 657).

SECTION 6. EFFECTIVE DATE

This revenue procedure is effective on the date of publication and applies to distributions to U.S. shareholders made on or after April 6, 1999 by corporations resident in the United Kingdom.

DRAFTING INFORMATION

The principal author of this revenue procedure is Trina Dang of the Office of Associate Chief Counsel (International). For further information regarding this revenue procedure, contact Ms. Dang at (202) 622-3850 (not a toll-free call).

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PART I. INTRODUCTION TO EMPLOYEE PLANS COMPLIANCE RESOLUTION SYSTEM

SECTION 1. PURPOSE AND OVERVIEW

.01 *Purpose*. This revenue procedure updates and consolidates the comprehensive system of correction programs for sponsors of retirement plans that are intended to satisfy the requirements of § 401(a), § 403(a) or § 403(b) of the Internal Revenue Code (the "Code"), but that have not met these requirements for a period of time. This system, the Employee Plans Compliance Resolution System ("EPCRS"), permits plan sponsors to correct these Qualification or § 403(b) Failures and thereby continue to provide their employees with retirement benefits on a tax-favored basis. The components of EPCRS are the Administrative Policy Regarding Self-Correction ("APRSC"), the Voluntary Compliance Resolution ("VCR") program, the Walk-in Closing Agreement Program ("Walk-in CAP"), the Audit Closing Agreement Program ("Audit CAP") and the Tax Sheltered Annuity Voluntary Correction ("TVC") program.

.02 *Revisions*. This revenue procedure modifies Rev. Proc. 98– 22, 1998–12 I.R.B. 11, which consolidated the correction programs into EPCRS. The modifications to Rev. Proc. 98–22 include:

(1) incorporating Rev. Proc. 99–13, 1999–5 I.R.B. 52, which applies EPCRS to 403(b) Plans;

(2) adding a new Appendix B which incorporates the correction methods described and illustrated in Rev. Proc. 99–31 1999–34 I.R.B. 280;

(3) redesignating Appendix B of Rev. Proc. 98–22 as Appendix C; and

(4) reflecting the new Tax Exempt and Government Entities Division (TE/GE) of the IRS.

.03 *General principles underlying EPCRS*. EPCRS is based on the following general principles:

- Sponsors of tax-qualified retirement plans or 403(b) Plans should be encouraged to establish administrative practices and procedures that ensure that plans are operated properly in accordance with the tax qualification or 403(b) requirements.
- Sponsors of tax-qualified retirement plans should maintain plan documents satisfying the tax qualification requirements.
- Plan sponsors should make voluntary and timely correction of any Qualification or 403(b) Failures, whether involving discrimination in favor of highly compensated employees, plan operations, or the terms of the plan document. Timely and efficient correction protects participating employees by providing them with their expected retirement benefits, including favorable tax treatment.
- Voluntary compliance is promoted by providing for limited fees for voluntary corrections approved by the Service, thereby reducing employers' uncertainty regarding their potential tax liability and participants' potential income tax liability.
- Sanctions for Qualification or 403(b) Failures identified on audit should be reasonable in light of the nature, extent, and severity of the violation.
- Administration of EPCRS should be consistent and uniform.

- Taxpayers should be able to rely on the availability of EPCRS in taking corrective actions to maintain the qualified or 403(b) status of their plans.

.04 *Overview*. EPCRS includes the following basic elements:

- *Self-correction*. A plan sponsor that has established compliance practices and procedures may, at any time, correct insignificant Operational Failures without paying any fee or sanction. In addition, in the case of a Qualified Plan that is the subject of a favorable determination letter from the Service or of a 403(b) Plan, the plan sponsor generally may correct even significant Operational Failures within a two-year period without payment of any fee or sanction. (APRSC)
- *Voluntary correction with Service approval*. In the case of any other Qualification or 403(b) Failure, a plan sponsor, at any time before audit, may pay a limited fee and receive the Service's approval for the correction. (VCR, Walk-in CAP, and TVC)
- *Correction on audit*. If a Qualification or 403(b) Failure (other than a failure corrected as described above) is identified on audit and corrected, the sanction imposed will bear a reasonable relationship to the nature, extent and severity of the failure, taking into account the extent to which correction occurred before audit. (Audit CAP)

.05 *Future enhancements*. The primary purpose of this revenue procedure is to consolidate in a single document, for ease of use and reference, the guidance previously published with respect to EPCRS. Certain clarifications and revisions, discussed below, that do not involve significant substantive modification of EPCRS and that generally reflect the current practice under EPCRS, are included in this revenue procedure.

The Service and Treasury are actively reviewing the comments that have been received on EPCRS that are not reflected in this revenue procedure. These additional enhancements will be incorporated into upcoming guidance on EPCRS. In addition to that guidance, it is anticipated that the consolidated EPCRS revenue procedure will be updated on an annual basis to reflect changes published during the preceding calendar year.

SECTION 2. EFFECT ON PROGRAMS

.01 *Effect on programs*. This revenue procedure affects the programs as follows:

- consolidates and coordinates guidance issued in 1998 and 1999 into a unified EPCRS procedure;
- clarifies the application of FICA and FUTA taxes (and corresponding withholding obligations) to corrected Qualified Plans and 403(b) Plans; and
- clarifies that the statute of limitations for purposes of redetermining taxes for a closed taxable year will not be reopened solely because of correction of a failure that occurred in such year.

.02 *Effect on specific programs*. This revenue procedure affects the specific programs as follows:

(1) *APRSC*. APRSC enables a sponsor of a Qualified Plan or a 403(b) Plan to self-correct Operational Failures it discovers in its plans. The provisions of APRSC are modified and restated to:

- clarify and confirm, under the eligibility requirements for APRSC, that the program is available to correct insignificant defects in plans of all sizes.

(2) *VCR*. The VCR program enables a sponsor of a Qualified Plan to voluntarily disclose to the Service Operational Failures it has discovered in its plan and to pay a fixed fee to the Service. The provisions of VCR are modified to:

- grant, in appropriate cases, a waiver of the excise tax under §4974 for minimum required distribution failures that are corrected by the Plan Sponsor under VCR;
- amplify the permissible correction methods under the Standardized VCR Program (SVP) (see Appendix A and Appendix B of this revenue procedure); and
- clarify that sponsors may use Walk-in CAP for interrelated VCR and Walk-in CAP failures.

(3) *Walk-in CAP*. Walk-in CAP enables a sponsor of a Qualified Plan to voluntarily disclose to the Service Qualification Failures it has discovered in its plan and to pay a compliance correction fee. The provisions of Walk-in CAP are modified to:

- grant, in appropriate cases, a waiver of the excise tax under § 4974 for minimum distribution failures that are corrected by the Plan Sponsor under Walk-in CAP.

(4) *TVC*. Similar to Walk-in CAP, TVC enables an employer that offers a 403(b) Plan to voluntarily disclose to the Service 403(b) Failures it has discovered in its plan and to pay a compliance correction fee. The provisions of TVC are modified to:

- grant, in appropriate cases, a waiver of the excise tax under § 4974 for minimum distribution failures that are corrected by the Plan Sponsor under TVC.
- clarify the types of failures that may be corrected under TVC.

PART II. PROGRAM EFFECT AND ELIGIBILITY

SECTION 3. EFFECT OF EPCRS; RELIANCE

.01 *Effect of EPCRS on Qualified Plans*. If the eligibility requirements of section 4 are satisfied and the Plan Sponsor corrects a Qualification Failure in accordance with the requirements of APRSC in section 7, the VCR program in section 10, Walk-in CAP in section 11, or Audit CAP in section 14, the Service will not treat the Qualified Plan as disqualified on account of the Qualification Failure. If the Plan Sponsor corrects the failures in accordance with the requirements of this revenue procedure the plan will be treated as a qualified plan for purposes of applying § 3121(a)(5) (FICA taxes) and for purposes of applying § 3306(a)(5) (FUTA taxes).

.02 *Effect of EPCRS on 403(b) Plans*. If the applicable eligibility requirements are satisfied and the employer corrects a failure in accordance with the requirements of APRSC, TVC, or Audit CAP for 403(b) Plans, the Service will not pursue income inclusion for affected participants, or liability for income tax withholding, on account of the failure. However, the correction of a failure may result in income tax consequences to participants (for example, participants may be required to include in gross income distributions of Excess Amounts in the year of distribution). In addition, if these requirements are met and correction is made under this revenue procedure, the annuity contracts or custodial accounts under a 403(b) Plan will be treated as annuity contracts described in § 403(b) for purposes of applying § 3121(a)(5) (FICA taxes) and for purposes of applying § 3306(a)(5) (FUTA taxes). However, contributions or allocations of Excess Amounts are generally treated as wages for purposes of FICA and FUTA taxes.

.03 *Other taxes and penalties*. See section 6.04 for rules relating to other taxes and penalties.

.04 *Reliance*. Taxpayers may rely on this revenue procedure, including the relief described in sections 3.01 and 3.02.

SECTION 4. PROGRAM ELIGIBILITY

.01 *Program eligibility for Qualified Plans*. EPCRS includes three specific voluntary correction programs and an audit correction program for Qualified Plans. The voluntary correction programs are APRSC and VCR, both of which are available for Operational Failures, and Walk-in CAP, which applies to Plan Document and Demographic Failures and to Operational Failures that are not eligible for APRSC and VCR. APRSC is a voluntary employer-initiated procedure that generally does not involve Service approval, whereas VCR and Walk-in CAP are voluntary employer-initiated procedures that involve Service approval. The audit correction program is Audit CAP, which is available for all types of Qualification Failures found on examination that cannot be corrected under APRSC.

.02 *Program eligibility for 403(b) Plans*. EPCRS includes two specific voluntary correction programs and an audit correction program for 403(b) Plans. The voluntary correction programs are APRSC and TVC. APRSC is available only for Operational Failures, and is not available to correct Eligibility or Demographic Failures. APRSC is available to correct Excess Amounts using the method described in section 6.02(4)(b)(i) below, but not the method described in section 6.02(4)(b)(ii) below. There is no requirement that an employer obtain a private letter ruling from the Service covering its 403(b) Plan in order to be eligible for APRSC. TVC is a voluntary program that involves Service approval. TVC applies to Eligibility, Demographic, and Operational Failures that are within the jurisdiction of Employee Plans, including Plans of Ineligible Employers. The audit correction program is Audit CAP, which is also available for Eligibility, Demographic, and Operational Failures found on examination that cannot be corrected under APRSC.

.03 *Effect of examination*. If the plan or Plan Sponsor is Under Examination, the VCR, Walk-in CAP, and TVC programs are not available; insignificant Operational Failures can be corrected under APRSC; and significant Operational Failures can be corrected under APRSC in limited circumstances. See section 9.

.04 *Favorable Letter requirement*. The VCR program and the provisions of APRSC relating to significant Operational Failures (see section 9) of a Qualified Plan are available only for a plan that is the subject of a Favorable Letter.

.05 *Established practices and procedures*. In order to be eligible for APRSC, the Plan Sponsor or administrator of a plan must have established practices and procedures (formal or informal) reasonably designed to promote and facilitate overall compliance with the requirements of § 401(a) or § 403(b). For example, the plan administrator of a Qualified Plan might use a check sheet for tracking allocations and indicate on that check sheet whether a particular employee was a key employee for top-heavy purposes. A plan document alone will not constitute evidence of established procedures. These established procedures must have been in place and routinely followed, but through an oversight or mistake in applying them, or because of an inadequacy in the procedures, an Operational Failure occurred. A 403(b) plan document is neither necessary nor sufficient to demonstrate that the employer, plan administrator, insurer or account custodian has in place established practices and procedures reasonably designed to facilitate overall compliance.

.06 *Qualified Plan amendments*. (1) *Correction by plan amendment not permitted in APRSC or VCR*. Neither APRSC nor the VCR program is available for a Plan Sponsor to correct an Operational Failure by a plan amendment that conforms the terms of the plan to the plan's prior operations. Thus, if loans were made to participants, but the plan document did not permit loans to be made to participants, the failure cannot be corrected under VCR by retroactively amending the plan to provide for the loans. Nevertheless, if a Plan Sponsor corrects under APRSC or VCR, it may amend the plan to the extent necessary to reflect operational correction. For example, if the plan failed to satisfy the ADP test required under § 401(k)(3) and the employer must make qualified nonelective contributions not already provided for under the plan, the plan may be amended to provide for qualified nonelective contributions. The issuance of a compliance statement does not constitute a determination as to the effect of any plan amendment on the qualification of the plan.

(2) *Availability of correction by plan amendment in Walk-in CAP*. A Plan Sponsor may use Walk-in CAP for a Qualified Plan to correct an Operational Failure by a plan amendment to conform the terms of the plan to the plan's prior operations, provided that the amendment complies with the requirements of § 401(a), including the requirements of §§ 401(a)(4), 410(b), and 411(d)(6).

.07 *Egregious failures*. Neither APRSC nor the VCR program is available to correct Operational Failures that are egregious. For example, if an employer has consistently and improperly covered only highly compensated employees or if a contribution to a defined contribution plan for a highly compensated individual is several times greater than the dollar limit set forth in § 415, the failure would be considered egregious. Walk-In CAP and TVC are available to correct egregious failures; however, these failures are subject to the fees described in sections 13.05(3) and 13.06(6).

.08 *Diversion or misuse of plan assets*. The APRSC, VCR, Walk-in CAP, TVC and Audit CAP programs are not available for correcting Qualification or 403(b) Failures relating to the diversion or misuse of plan assets.

PART III. DEFINITIONS, CORRECTION PRINCIPLES, AND RULES OF GENERAL APPLICABILITY

SECTION 5. DEFINITIONS

The following definitions apply for purposes of this revenue procedure:

.01 *Definitions for Qualified Plans*. The definitions in this section 5.01 apply to Qualified Plans.

(1) *Qualified Plan*. The term "Qualified Plan" means a plan intended to satisfy the requirements of § 401(a) or § 403(a).

(2) *Qualification Failure*. A Qualification Failure is any failure that adversely affects the qualification of a plan. There are three types of Qualification Failures: (a) Plan Document Failures, (b) Operational Failures, and (c) Demographic Failures.

(a) *Plan Document Failure*. The term "Plan Document Failure" means a plan provision (or the absence of a plan provision) that, on its face, violates the requirements of § 401(a) or § 403(a). Thus, for example, the failure of a plan to be amended to reflect a new qualification requirement within the plan's applicable remedial amendment period under § 401(b) is a Plan Document Failure. For purposes of this revenue procedure, a Plan Document Failure includes any Qualification Failure that is a violation of the requirements of § 401(a) or § 403(a) and that is neither an Operational Failure nor a Demographic Failure.

(b) *Operational Failure*. The term "Operational Failure" means a Qualification Failure that arises solely from the failure to follow plan provisions.

A failure to follow the terms of the plan providing for the satisfaction of the requirements of § 401(k) and § 401(m) is considered to be an Operational Failure. A plan does not have an Operational Failure to the extent the plan is permitted to be amended retroactively pursuant to § 401(b) or another statutory provision to reflect the plan's operations. However, if within an applicable remedial amendment period under § 401(b), a plan has been properly amended for statutory or regulatory changes, and, on or after the later of the date the amendment is effective or is adopted, the amended provisions are not followed, then the plan is considered to have an Operational Failure.

(c) *Demographic Failure*. The term "Demographic Failure" means a failure to satisfy the requirements of § 401(a)(4), § 401(a)(26), or § 410(b) that is not an Operational Failure.

The correction of a Demographic Failure generally requires a substantive corrective amendment to the plan adding more benefits or increasing existing benefits (cf., § 1.401(a)(4)–11(g) of the Income Tax Regulations).

(3) *Excess Amount*. The term "Excess Amount" means (a) an Overpayment, (b) an elective deferral or employee after-tax contribution returned to satisfy § 415, (c) an elective deferral in excess of the limitation of § 402(g) that is distributed, (d) an excess contribution or excess aggregate contribution that is distributed to satisfy § 401(k) or § 401(m), or (e) any similar amount required to be distributed in order to maintain plan qualification.

(4) *Favorable Letter*. The term "Favorable Letter" means a current favorable determination letter for an individually designed plan (including a volume submitter plan), a current favorable opinion letter for a Plan Sponsor that has adopted a master or prototype plan, or a current favorable notification letter for a Plan Sponsor that has adopted a regional prototype plan. A plan has a current favorable determination letter, opinion letter, or notification letter if either (a), (b), or (c) below is satisfied:

(a) The plan has a favorable determination, opinion, or notification letter that considers the Tax Reform Act of 1986 ("TRA '86").

(b) The plan is a governmental plan or non-electing church plan described in Rev. Proc. 99–23, 1999–16 I.R.B. 5, and has a favorable determination, opinion, or notification letter that considers the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), the Deficit Reduction Act of 1984 ("DEFRA"), and the Retirement Equity Act of 1984 ("REA"), and the § 401(b) remedial amendment period for TRA '86 has not yet expired.

(c) The plan is initially adopted or effective after December 7, 1994, and the Plan Sponsor timely submits an application for a determination, opinion, or notification letter within the plan's remedial amendment period under § 401(b).

(5) *Maximum Payment Amount*. The term "Maximum Payment Amount" means a monetary amount that is approximately equal to the tax the Service could collect upon plan disqualification and is the sum for the open taxable years of the:

(a) tax on the trust (Form 1041),

(b) additional income tax resulting from the loss of employer deductions for plan contributions (and any interest or penalties applicable to the Plan Sponsor's return), and

(c) additional income tax resulting from income inclusion for participants in the plan (Form 1040).

For purposes of determining the maximum compliance correction fee applicable under section 13.05(3), relating to egregious failures under Walk-in CAP, paragraph (b) above is modified to exclude interest or penalties applicable to the Plan Sponsor's return, and paragraph (c) above is modified to include only the additional income tax resulting from income inclusion for highly compensated employees, as defined in § 414(q).

(6) *Overpayment*. The term "Overpayment" means a distribution to an employee or beneficiary that exceeds the employee's or beneficiary's benefit under the terms of the plan because of a failure to comply with plan terms that implement § 401(a)(17), 401(m) (but only with respect to the forfeiture of nonvested matching contributions that are excess aggregate contributions), 411(a)(3)(G), or 415. An Overpayment does not include a distribution of an Excess Amount described in section 5.01(3) (b), (c), (d), or (e).

(7) *Plan Sponsor*. The term "Plan Sponsor" means the employer that establishes or maintains a qualified retirement plan for its employees.

.02 *Definitions for 403(b) Plans*. The definitions in this section 5.02 apply to 403(b) Plans.

(1) *403(b) Plan. The* term "403(b) Plan" means a plan or program intended to satisfy the requirements of § 403(b), including a Plan of an Ineligible Employer.

(2) *403(b) Failure*. A 403(b) Failure is any Operational, Eligibility or Demographic Failure as defined below.

(a) *Demographic Failure*. The term "Demographic Failure" means a failure to satisfy the requirements of § 401(a)(4), § 401(a)(26), or § 410(b) (as applied to 403(b) Plans pursuant to § 403(b)(12)(A)(i)).

(b) *Eligibility Failure*. The term "Eligibility Failure" means any of the following :

(i) A Plan of an Ineligible Employer;

(ii) A failure to satisfy the nontransferability requirement of § 401(g);

(iii) A failure to initially establish or maintain a custodial account as required by § 403(b)(7); or

(iv) A failure to purchase (initially or subsequently) either an annuity contract from an insurance company (unless grandfathered under Rev. Rul. 82–102, 1982–1 C.B. 62) or a custodial account from a regulated investment company utilizing a bank or an approved non-bank trustee/custodian.

(c) *Operational Failure*. The term "Operational Failure" means, with respect to a 403(b) Plan, any of the following:

(i) A failure to satisfy the requirements of § 403(b)(12)(A)(ii) (relating to the availability of salary reduction contributions);

(ii) A failure to satisfy the requirements of § 401(m) (as applied to 403(b) Plans pursuant to § 403(b)(12)(A)(i));

(iii) A failure to satisfy the requirements of § 401(a)(17) (as applied to 403(b) Plans pursuant to § 403(b)(12)(A)(i));

(iv) A failure to satisfy the distribution restrictions of § 403(b)(7) or § 403(b)(11);

(v) A failure to satisfy the incidental death benefit rules of § 403(b)(10);

(vi) A failure to pay minimum required distributions under § 403(b)(10);

(vii) A failure to give employees the right to elect a direct rollover under § 403(b)(10), including the failure to give meaningful notice of such right;

(viii) A failure of the annuity contract or custodial agreement to provide participants with a right to elect a direct rollover under §§ 403(b)(10) and 401(a)(31);

(ix) A failure to satisfy the limit on elective deferrals under § 403(b)(1)(E);

(x) A failure of the annuity contract or custodial agreement to provide the limit on elective deferrals under §§ 403(b)(1)(E) and 401(a)(30);

(xi) A failure involving contributions or allocations of Excess Amounts; or

(xii) Any other failure to satisfy applicable requirements under § 403(b) that (i) results in the loss of § 403(b) status for the plan or the loss of § 403(b) status for one or more custodial account(s) or annuity contract(s) under the plan and (ii) is not a Demographic Failure, an Eligibility Failure, or a failure related to the purchase of annuity contracts, or contributions to custodial accounts, on behalf of individuals who are not employees of the employer.

(3) *Excess Amount*. The term "Excess Amount" means, in the case of a 403(b) Plan, any contributions or allocations that are in excess of the limits under § 415 or § 403(b)(2) (the exclusion allowance limit) for the year.

(4) *Plan of an Ineligible Employer*. The term "Plan of an Ineligible Employer" means a plan intended to satisfy the requirements of § 403(b) but which is not eligible for favorable tax treatment under § 403(b) because the employer is not a tax-exempt organization described in § 501(c)(3) or a public educational organization described in § 170(b)(1)(A)(ii).

(5) *Plan Sponsor*. The term "Plan Sponsor" means the employer that offers a 403(b) Plan to its employees.

(6) *Total Sanction Amount*. The term "Total Sanction Amount" means a monetary amount that is approximately equal to the income tax the Service could collect as a result of the failure.

.03 *Under Examination*. This definition applies to Qualified Plans and 403(b) Plans. The term "Under Examination" means: (1) a plan that is under an Employee Plans examination (that is, an examination of a Form 5500 series or other Employee Plans examination), or (2) a Plan Sponsor that is under an Exempt Organizations examination (that is, an examination of a Form 990 series or other Exempt Organizations examination).

A plan that is under an Employee Plans examination includes any plan for which the Plan Sponsor, or a representative, has received verbal or written notification from Employee Plans of an impending Employee Plans examination, or of an impending referral for an Employee Plans examination, and also includes any plan that has been under an Employee Plans examination and is now in Appeals or in litigation for issues raised in an Employee Plans examination. A plan is considered to be Under Examination if it is aggregated for purposes of satisfying the nondiscrimination requirements of § 401(a)(4), the minimum participation requirements of § 401(a)(26), the minimum coverage requirements of § 410(b), or the requirements of § 403(b)(12), with a plan(s) that is Under Examination. In addition, a plan is considered to be Under Examination with respect to a failure of a qualification requirement (other than those described in the preceding sentence) if the plan is aggregated with another plan for purposes of satisfying that qualification requirement (for example, § 402(g), § 415, or § 416) and that other plan is Under Examination. For example, assume Plan A has a § 415 failure, Plan A is aggregated with Plan B only for purposes of § 415, and Plan B is Under Examination. In this case, Plan A is considered to be Under Examination with respect to the § 415 failure. However, if Plan A has a failure relating to the spousal consent rules under § 417 or the vesting rules of § 411, Plan A is not considered to be Under Examination with respect to the § 417 or § 411 failure. For purposes of this revenue procedure, the term aggregation does not include consideration of benefits provided by various plans for purposes of the average benefits test set forth in § 410(b)(2).

An Employee Plans examination also includes a case in which a Plan Sponsor has submitted a Form 5310, Application for Determination of Qualification Upon Termination, and the Employee Plans agent notifies the Plan Sponsor, or a representative, of possible Qualification Failures, whether or not the Plan Sponsor is officially notified of an "examination." This would include a case where, for example, a Plan Sponsor has applied for a determination letter on plan termination, and an Employee Plans agent notifies the Plan Sponsor that there are partial termination concerns.

A Plan Sponsor that is under an Exempt Organizations examination includes any Plan Sponsor that has received (or whose representative has received) verbal or written notification from Exempt Organizations of an impending Exempt Organizations examination or of an impending referral for an Exempt Organizations examination and also includes any Plan Sponsor that has been under an Exempt Organizations examination and is now in Appeals or in litigation for issues raised in an Exempt Organizations examination.

SECTION 6. CORRECTION PRINCIPLES AND RULES OF GENERAL APPLICABILITY

.01 *Correction principles; rules of general applicability*. The following general correction principles and rules of general applicability apply for purposes of this revenue procedure.

.02 *Correction*. Generally, a Qualification or 403(b) Failure is not corrected unless full correction is made with respect to all participants and beneficiaries, and for all taxable years (whether or not the taxable year is closed). Even if correction is made for a closed taxable year, the tax liability associated with that year will not be redetermined because of the correction. In the case of a Qualified Plan with an Operational Failure, correction is determined taking into account the terms of the plan at the time of the failure. Correction should be accomplished taking into account the following principles:

(1) *Restoration of benefits*. The correction method should restore the plan to the position it would have been in had the Qualification or 403(b) Failure not occurred, including restoration of current and former participants and beneficiaries to the benefits and rights they would have had if the Qualification or 403(b) Failure had not occurred.

(2) *Reasonable and appropriate correction*. The correction should be reasonable and appropriate for the Qualification or 403(b) Failure. Depending on the nature of the Qualification or 403(b) Failure, there may be more than one reasonable and appropriate correction for the failure. Any correction method permitted under Appendix A or Appendix B is deemed to be a reasonable and appropriate method of correcting the related Qualification Failure. Any correction method permitted under Appendix A applicable to a 403(b) Plan is deemed to be a reasonable and appropriate method of correcting the related 403(b) Failure. Whether any other particular correction method is reasonable and appropriate is determined taking into account the applicable facts and circumstances and the following principles:

(a) The correction method should, to the extent possible, resemble one already provided for in the Code, Income Tax Regulations, or other guidance of general applicability. For example, for Qualified Plans, the defined contribution plan correction methods set forth in § 1.415–6(b)(6) would be the typical means of correcting a failure under § 415. Likewise, the correction method set forth in § 1.402(g)–1(e)(2) would be the typical means of correcting a failure under § 402(g).

(b) The correction method for Qualification or 403(b) Failures relating to nondiscrimination should provide benefits for nonhighly compensated employees. For example, for Qualified Plans, the correction method set forth in § 1.401(a)(4)–11(g) (rather than methods making use of the special testing provisions set forth in § 1.401(a)(4)–8 or § 1.401(a)(4)–9) would be the typical means of correcting a failure to satisfy nondiscrimination requirements. Similarly, the correction of a failure to satisfy the requirements of § 401(k)(3), 401(m)(2), or 401(m)(9) (relating to nondiscrimination) solely by distributing excess amounts to highly compensated employees would not be the typical means of correcting such a failure.

(c) The correction method should keep plan assets in the plan, except to the extent the Code, regulations, or other guidance of general applicability provide for correction by distribution to participants or beneficiaries or return of assets to the employer or Plan Sponsor. For example, if an excess allocation (not in excess of the § 415 limits) made under a Qualified Plan was made for a participant under a plan (other than a cash or deferred arrangement), the excess should be reallocated to other participants or, depending on the facts and circumstances, used to reduce future employer contributions.

(d) The correction method should not violate another applicable specific requirement of § 401(a) or § 403(b) (for example, § 401(a)(4), 411(d)(6) or 403(b)(12), as applicable). If an additional failure is created as a result of the use of a correction method in this revenue procedure, then that failure also must be corrected in conjunction with the use of that correction method and in accordance with the requirements of this revenue procedure.

(3) *Consistency Requirement*. Generally, where more than one correction method is available to correct a type of Operational Failure for a plan year (or where there are alternative ways to apply a correction method), the correction method (or one of the alternative ways to apply the correction method) should be applied consistently in correcting all Operational Failures of that type for that plan year. Similarly, earnings adjustment methods generally should be applied consistently with respect to corrective contributions or allocations for a particular type of Operational Failure for a plan year.

(4) *Treatment of Excess Amounts*. The following provisions apply for purposes of treating Excess Amounts under Qualified Plans and 403(b) Plans.

(a) *Treatment of Excess Amounts under Qualified Plans*. A distribution of an Excess Amount is not eligible for the favorable tax treatment accorded to distributions from Qualified Plans (such as eligibility for rollover under § 402(c)). To the extent that a current or prior distribution was a distribution of an Excess Amount, distribution of that Excess Amount is not an eligible rollover distribution. Thus, for example, if such a distribution was contributed to an individual retirement arrangement ("IRA"), the contribution is not a valid rollover contribution for purposes of determining the amount of excess contributions (within the meaning of § 4973) to the individual's IRAs. Where an Excess Amount has been distributed the employer must notify the recipient that (i) the Excess Amount was distributed and (ii) the Excess Amount was not eligible for favorable tax treatment accorded to distributions from Qualified Plans (and, specifically, was not eligible for tax-free rollover).

(b) *Treatment of Excess Amounts under 403(b) Plans*. (i) Distribution of Excess Amounts. Excess Amounts for a year, adjusted for earnings through the date of distribution, must be distributed to affected participants and beneficiaries and are includible in their gross income in the year of distribution. The distribution of Excess Amounts is not an eligible rollover distribution within the meaning of § 403(b)(8). A distribution of Excess Amounts is generally treated in the manner described in section 3 of Rev. Proc. 92–93, 1992–2 C.B. 505, relating to the corrective disbursement of elective deferrals. The distribution must be reported on Forms 1099–R for the year of distribution with respect to each participant or beneficiary receiving such a distribution. In addition, the employer must inform affected participants and beneficiaries that the distribution of Excess Amounts is not eligible for rollover. Excess Amounts distributed pursuant to this subparagraph (4)(b)(i) are not treated as amounts previously excludable under § 403(b)(2)(A)(ii) for purposes of calculating the maximum exclusion allowance for the taxable year of the distribution and for subsequent taxable years.

(ii) Retention of Excess Amounts. Under TVC and Audit CAP, Excess Amounts will be treated as corrected (even though the Excess Amounts are retained in the 403(b) Plan) if the following requirements are satisfied. Excess Amounts arising from a § 415 failure, adjusted for earnings through the date of correction, must reduce affected participants' applicable § 415 limit for the year following the year of correction (or for the year of correction if the employer so chooses), and subsequent years, until the excess is eliminated. Excess Amounts (whether arising from a § 415 failure or a § 403(b)(2) failure), adjusted for earnings through the date of correction, must also reduce participants' exclusion allowances by being treated as amounts previously excludable under § 403(b)(2)(A)(ii) beginning with the year following the year of correction (or the year of correction if the employer so chooses). This correction must generally be used for all participants who have Excess Amounts.

(5) *Principles regarding corrective allocations and corrective distributions*. The following principles apply where an appropriate correction method includes the use of corrective allocations or corrective distributions. Corrective allocations are generally not made with respect to a 403(b) Plan.

(a) Corrective allocations under a defined contribution plan should be based upon the terms of the plan and other applicable information at the time of the Qualification Failure (including the compensation that would have been used under the plan for the period with respect to which a corrective allocation is being made) and should be adjusted for earnings and forfeitures that would have been allocated to the participant's account if the failure had not occurred. The corrective allocation need not be adjusted for losses. For administrative convenience, in the case of corrective allocations, if the plan permitted directed investments for the years at issue, and thus had more than one fund, the plan would be permitted to use the highest rate earned in the plan for the period of the failure as the rate used for all corrective allocations, provided that most of the employees receiving the corrective allocations are nonhighly compensated employees.

(b) A corrective allocation to a participant's account because of a failure to make a required allocation in a prior limitation year will not be considered an annual addition with respect to the participant for the limitation year in which the correction is made, but will be considered an annual addition for the limitation year to which the corrective allocation relates. However, the normal rules of § 404, regarding deductions, apply.

(c) Corrective allocations should come only from employer contributions (including forfeitures if the plan permits their use to reduce employer contributions).

(d) In the case of a defined benefit plan, a corrective distribution for an individual should be increased to take into account the delayed payment, consistent with the plan's actuarial adjustments.

(6) *Special exceptions to full correction*. In general, a Qualification or 403(b) Failure must be fully corrected. Although the mere fact that correction is inconvenient or burdensome is not enough to relieve a Plan Sponsor of the need to make full correction, full correction may not be required in certain situations because it is unreasonable or not feasible. Even in these situations, the correction method adopted must be one that does not have significant adverse effects on participants and beneficiaries or the plan, and that does not discriminate significantly in favor of highly compensated employees. The exceptions described below specify those situations in which full correction is not required.

(a) *Reasonable estimates*. If it is not possible to make a precise calculation, or the probable difference between the approximate and the precise restoration of a participant's benefits is insignificant and the administrative cost of determining precise restoration would significantly exceed the probable difference, reasonable estimates may be used in calculating appropriate correction.

(b) *Delivery of very small benefits*. If the total corrective distribution due a participant or beneficiary is $20 or less, the Plan Sponsor is not required to make the corrective distribution if the reasonable direct costs of processing and delivering the distribution to the participant or beneficiary would exceed the amount of the distribution.

(c) *Locating lost participants*. Reasonable actions must be taken to find all current and former participants and beneficiaries to whom additional benefits are due, but who have not been located after a mailing to the last known address. In general, such actions include use of the Internal Revenue Service Letter Forwarding Program (see Rev. Proc. 94–22, 1994–1 C.B. 608) or the Social Security Administration Reporting Service. A plan will not be considered to have failed to correct a failure due to the inability to locate an individual if either of these programs is used; provided that, if the individual is later located, the additional benefits must be provided to the individual at that time.

(7) *Correction of a Plan of an Ineligible Employer*. The permitted correction of a Plan of an Ineligible Employer under TVC is the cessation of all contributions (including salary reduction and after-tax contributions) beginning no later than the date the application under TVC is filed. Pursuant to TVC correction, the assets in such a plan are to remain in the annuity contract or custodial account and are to be distributed no earlier than the occurrence of one of the distribution events described in § 403(b)(7)(to the extent the assets are held in custodial accounts) or § 403(b)(11) (for those assets invested in annuity contracts that would be subject to § 403(b)(11) restrictions if the employer were eligible). A Plan of an Ineligible Employer that is corrected through TVC will be treated as subject to all of the requirements and provisions of § 403(b), including the provisions of § 403(b)(8) (relating to rollovers). Because a Plan of an Ineligible Employer will be treated as subject to all of the requirements of § 403(b), the plan must, as part of TVC correction, also correct all other Operational, Demographic, and Eligibility Failures in accordance with this revenue pro-

cedure. The correction of a Plan of an Ineligible Employer is subject to the fee described in section 13.06(4) below (or, with respect to the correction of multiple failures, section 13.06(5)).

(8) *Reporting*. Any distributions from the plan should be properly reported.

.03 *Correction under statute or regulations*. Generally, none of the correction programs are available to correct failures that can be corrected under the Code and related regulations. For example, as a general rule, a Plan Document Failure that is a disqualifying provision for which the remedial amendment period under § 401(b) has not expired can be corrected by operation of the Code through retroactive remedial amendment.

.04 *Matters subject to excise taxes*. (1) Except as provided in paragraph (3) below, excise taxes and additional taxes, to the extent applicable, are not waived merely because the underlying failure has been corrected or because the taxes result from the correction. Thus, for example, the excise tax on certain excess contributions under § 4979 is not waived under these correction programs.

(2) Except as provided in paragraph (3) below, for Qualified Plans, the correction programs are not available for events for which the Code provides tax consequences other than plan disqualification (such as the imposition of an excise tax or additional income tax). For example, funding deficiencies (failures to make the required contributions to a plan subject to § 412), prohibited transactions, and failures to file the Form 5500 cannot be corrected under the correction programs. However, if the event is also an Operational Failure (for example, if the terms of the plan document relating to plan loans to participants were not followed and loans made under the plan did not satisfy § 72(p)(2)), the correction programs will be available to correct the Operational Failure, even though the excise or income taxes generally still will apply.

(3) For Qualified Plans and 403(b) Plans, as part of the VCR, Walk-in CAP, or TVC programs, if the failure involves the failure to satisfy the minimum required distribution requirements of § 401(a)(9), in appropriate cases, the Service will waive the excise tax under § 4974 applicable to plan participants.

.05 *Confidentiality and disclosure*. Because each correction program relates directly to the enforcement of the qualification or § 403(b) requirements, the information received or generated by the Service under the program is subject to the confidentiality requirements of § 6103, and is not a written determination within the meaning of § 6110.

.06 *No effect on other law*. Correction under these programs has no effect on the rights of any party under any other law, including Title I of the Employee Retirement Income Security Act of 1974.

PART IV. SELF-CORRECTION (APRSC)

SECTION 7. IN GENERAL

The requirements of this section are satisfied with respect to an Operational Failure if the Plan Sponsor satisfies the requirements of section 8 (relating to insignificant Operational Failures), or section 9 (relating to significant Operational Failures).

SECTION 8. SELF-CORRECTION OF INSIGNIFICANT OPERATIONAL FAILURES

.01 *Requirements*. The requirements of this section are satisfied with respect to an Operational Failure if the Operational Failure is corrected and, given all the facts and circumstances, the Operational Failure is insignificant. This section is available for correcting an insignificant Operational Failure even if the plan or Plan Sponsor is Under Examination.

.02 *Factors*. The factors to be considered in determining whether or not an Operational Failure under a plan is insignificant include, but are not limited to: (1) whether other failures occurred during the period being examined (for this purpose, a failure is not considered to have occurred more than once merely because more than one participant is affected by the failure); (2) the percentage of plan assets and contributions involved in the failure; (3) the number of years the failure occurred; (4) the number of participants affected relative to the total number of participants in the plan; (5) the number of participants affected as a result of the failure relative to the number of participants who could have been affected by the failure; (6) whether correction was made within a reasonable time after discovery of the failure; and (7) the reason for the failure (for example, data errors such as errors in the transcription of data, the transposition of numbers, or minor arithmetic errors). No single factor is determinative. Additionally, factors (4) and (5) should not be interpreted to exclude small businesses.

.03 *Multiple failures*. In the case of a plan with more than one Operational Failure in a single year, or Operational Failures that occur in more than one year, the Operational Failures are eligible for correction under this section only if all of the Operational Failures are insignificant in the aggregate. Operational Failures that have been corrected under APRSC in section 9, the VCR program in section 10, Walk-in CAP in section 11 or TVC in section 11 are not taken into account for purposes of determining if Operational Failures are insignificant in the aggregate.

.04 *Examples*. The following examples illustrate the application of this section. It is assumed, in each example, that the eligibility requirements of section 4 relating to APRSC have been satisfied and that no Operational Failures occurred other than the Operational Failures identified below.

Example 1: In 1984, Employer X established Plan A, a profit-sharing plan that satisfies the requirements of § 401(a) in form. In 1999, the benefits of 50 of the 250 participants in Plan A were limited by § 415(c). However, when the Service examined Plan A in 2002, it discovered that, during the 1999 limitation year, the annual additions allocated to the accounts of 3 of these employees exceeded the maximum limitations under § 415(c). Employer X contributed $3,500,000 to the plan for the plan year. The amount of the excesses totaled $4,550. Under these facts, because the number of participants affected by the failure relative to the total number of participants who could have been affected by the failure, and the monetary amount of the failure relative to the total employer contribution to the plan for the 1999 plan year, are insignificant, the § 415(c) failure in Plan A that occurred in 1999 would be eligible for correction under this section.

Example 2: The facts are the same as in *Example* 1, except that the failure to satisfy § 415 occurred during each of the 1998, 1999, and 2000 limitation years. In addition, the three participants affected by the § 415 failure were not identical each year. The fact that the § 415 failures occurred during more than one limitation year did not cause the failures to be significant; accordingly, the failures are still eligible for correction under this section.

Example 3: The facts are the same as in *Example 1*, except that the annual additions of 18 of the 50 employees whose benefits were limited by § 415(c) nevertheless exceeded the maximum limitations under § 415(c) during the 1999 limitation year, and the amount of the excesses ranged from $1,000 to $9,000, and totaled $150,000. Under these facts, taking into account the number of participants affected by the failure relative to the total number of participants who could have been affected by the failure for the 1999 limitation year (and the monetary amount of the failure relative to the total employer contribution), the failure is significant. Accordingly, the § 415(c) failure in Plan A that occurred in 1999 is ineligible for correction under this section as an insignificant failure.

Example 4: Employer J maintains Plan C, a money purchase pension plan established in 1992. The plan document satisfies the requirements of § 401(a) of the Code. The formula under the plan provides for an employer contribution equal to 10% of compensation, as defined in the plan. During its examination of the plan for the 1999 plan year, the Service discovered that the employee responsible for entering data into the employer's computer made minor arithmetic errors in transcribing the compensation data with respect to 6 of the plan's 40 participants, resulting in excess allocations to those 6 participants' accounts. Under these facts, the number of participants affected by the failure relative to the number of participants that could have been affected is insignificant, and the failure is due to minor data errors. Thus, the failure occurring in 1999 would be insignificant and therefore eligible for correction under this section.

Example 5: Public School maintains for its 200 employees a salary reduction 403(b) plan (the "Plan") which satisfies the requirements of § 403(b). The business manager has primary responsibility for administering the Plan, in addition to other administrative functions within Public School. During the 1998 plan year, a former employee should have received an additional minimum required distribution of $278 under § 403(b)(10). Another participant received an impermissible hardship withdrawal of $2,500. Another participant made elective deferrals of $11,000, $1,000 of which was in excess of the § 402(g) limit. Under these facts, even though multiple failures occurred in a single plan year, the failures will be eligible for correction under this section because in the aggregate the failures are insignificant.

SECTION 9. SELF-CORRECTION OF SIGNIFICANT OPERATIONAL FAILURES

.01 *Requirements*. The requirements of this section are satisfied with respect to an Operational Failure (even if significant) if the Operational Failure is corrected and the correction is either completed or substantially completed (in accordance with section 9.03) by the last day of the correction period described in section 9.02.

.02 *Correction period*. The last day of the correction period for an Operational Failure is the last day of the second plan year following the plan year for which the failure occurred. However, in the case of a failure to satisfy the requirements of § 401(k)(3), 401(m)(2), or 401(m)(9), the plan year that includes the last day of the additional period for correction permitted under § 401(k)(8) or 401(m)(6) is treated, for this purpose, as the plan year for which the Operational Failure occurs. The correction period for an Operational Failure that occurs for any plan year ends, in any event, on the first date the plan or Plan Sponsor is Under Examination for that plan year (determined without regard to the exception in the preceding sentence). (But see section 9.03 for special rules permitting completion of correction after the end of the correction period.) If a 403(b) Plan does not have a plan year, the calendar year is considered to be the plan year for purposes of this section.

.03 *Substantial completion of correction*. Correction of an Operational Failure is substantially completed by the last day of the correction period only if the requirements of either paragraph (1) or (2) are satisfied.

(1) The requirements of this paragraph (1) are satisfied if:

(a) during the correction period, the Plan Sponsor is reasonably prompt in identifying the Operational Failure, formulating a correction method, and initiating correction in a manner that demonstrates a commitment to completing correction of the Operational Failure as expeditiously as practicable, and

(b) within 90 days after the last day of the correction period, the Plan Sponsor completes correction of the Operational Failure.

(2) The requirements of this paragraph (2) are satisfied if:

(a) during the correction period, correction is completed with respect to 85% of all participants affected by the Operational Failure, and

(b) thereafter, the Plan Sponsor completes correction of the Operational Failure with respect to the remaining affected participants in a diligent manner.

.04 *Example*. The following example illustrates the application of this section. Assume that the eligibility requirements of section 4 relating to APRSC have been met.

Employer Z established a qualified defined contribution plan in 1986 and received a favorable determination letter for TRA '86. During 1999, while doing a self-audit of the operation of the plan for the 1998 plan year, the plan administrator discovered that, despite the practices and procedures established by Employer Z with respect to the plan, several employees eligible to participate in the plan were excluded from participation. The administrator also found that for 1998 the elective deferrals of additional employees exceeded the § 402(g) limit and discovered Operational Failures in 1998 with respect to the top-heavy provisions of the plan. During the 1999 plan year, the Plan Sponsor made corrective contributions on behalf of the excluded employees, distributed the excess deferrals to the affected participants, and made a top-heavy minimum contribution to all participants entitled to that contribution for the 1999 plan year. Each corrective contribution and distribution was credited with earnings at a rate appropriate for the plan from the date the corrective contribution or distribution should have been made to the date of correction. Under these facts, the Plan Sponsor has corrected the Operational Failures for the 1998 plan year within the correction period and thus satisfied the requirements of this section.

PART V. VOLUNTARY CORRECTION WITH SERVICE APPROVAL (VCR, WALK-IN CAP AND TVC)

SECTION 10. VCR PROGRAM

.01 *VCR requirements*. The requirements of this section are satisfied with respect to an Operational Failure if the submission requirements of section 12 below are satisfied and the Plan Sponsor corrects the failures identified in accordance with the compliance statement described in section 10.13.

.02 *Identification of failures*. The VCR program is not based upon an examination of the plan by the Service. The Service will not make any investigation or finding under the VCR program concerning whether there are Operational Failures. Only the Operational Failures raised by the Plan Sponsor or Operational Failures identified by the Service in processing the application will be addressed under the program, and only those failures will be covered by the program. However, because the VCR program does not arise out of an examination, consideration under the VCR program does not preclude or impede (under § 7605(b) or any administrative provisions adopted by the Service) a subsequent examination of the Plan Sponsor or the plan by the Service with respect to the taxable year (or years) involved with respect to matters that are outside the compliance statement. A Plan Sponsor's statements describing Operational Failures are made only for purposes of the VCR program and will not be regarded by the Service as an admission of a failure for purposes of any subsequent examination. If the plan failures include failures correctable under VCR and failures correctable under Walk-in CAP, (e.g., interrelated Operational and Document Failures), the Plan Sponsor may include all such failures in a submission under Walk-in CAP.

.03 *No concurrent examination activity*. Except in unusual circumstances, a plan that has been properly submitted under the VCR program will not be examined while the submission is pending. This practice regarding concurrent examinations does not extend to other plans of the Plan Sponsor. Thus, any plan of the Plan Sponsor that is not pending under the VCR program could be subject to examination.

.04 *Insufficient information*. Where it is not possible to obtain sufficient information to properly determine the nature or extent of a failure or there is insufficient information to effect proper correction, or in other special circumstances where the application of the VCR program would be inappropriate or impractical, the failure cannot be corrected under the VCR program.

.05 *Initial processing*. (1) The Service will review whether the eligibility requirements of section 4 and the submission requirements of section 12 are satisfied.

(2) If the plan is not the subject of a Favorable Letter or the failure is not an Operational Failure, the compliance fee will be returned to the Plan Sponsor, and the Plan Sponsor will be informed of the option to voluntarily request consideration under Walk-in CAP.

(3) If a Plan Sponsor requests a compliance statement under the VCR program for a plan with egregious failures described in section 4.07, the compliance fee will be returned and the Plan Sponsor will be given 60 days to voluntarily request consideration under Walk-in CAP. If by the end of the 60-day period, a request for consideration under Walk-in CAP has not been received, the VCR request will be forwarded to Employee Plans Examinations (see section 12.12 of this revenue procedure)for examination consideration.

(4) If the Service determines that a submission is seriously deficient, the Service reserves the right to return the submission and the compliance fee without contacting the Plan Sponsor.

(5) If a request for consideration under the VCR program is not described in paragraph (2), (3), or (4) above, but nevertheless fails to comply with the provisions of this revenue procedure or if additional information is required, a Service representative will generally contact the Plan Sponsor or the Plan Sponsor's representative and explain what is needed to complete the submission. The Plan Sponsor will have 21 calendar days from the date of this contact to provide the requested information. If the information is not received within 21 days, the matter will be closed, the compliance fee will not be returned, and the case may be referred to Employee Plans Examinations in accordance with section 10.05(3). Any request for an extension of the 21-day time period must be made in writing within the 21-day time period and must be approved by the Service.

.06 *Processing of acceptable submission*. Once the Service determines that a request for consideration under the VCR program is acceptable, the Service will consult with the Plan Sponsor or the Plan Sponsor's representative to discuss the proposed corrections and the plan's administrative procedures. If agreement is reached, the Service will issue a compliance statement with an enclosed acknowledgment letter for signature by the Plan Sponsor. The case will not be closed favorably until the Service has received the signed acknowledgement letter from the Plan Sponsor. The Service will discuss the appropriateness of the plan's existing administrative procedures with the Plan Sponsor. Where current procedures are inadequate for operating the plan in conformance with the qualification requirements of the Code, the compliance statement will be conditioned upon the implementation of stated procedures within the stated time period. The Service may prescribe appropriate administrative procedures in the compliance statement.

.07 *Failures discovered after initial submission*.

(1) A Plan Sponsor that discovers additional, unrelated Operational Failures after its initial submission may request that such failures be added to its submission. The Service retains the discretion to reject the inclusion of such failures if the request is not timely, for example, if the Plan Sponsor makes its request when processing of the VCR submission is substantially complete.

(2) If the Service discovers an unrelated Operational Failure while the request is pending under the VCR program, the failure generally will be added to the failures under consideration in the submission. The Service retains the discretion to determine that a failure is outside the scope of the voluntary request for consideration because it was not voluntarily brought forward by the Plan Sponsor. In this case, the plan may be forwarded to Employee Plans Examinations for consideration on examination, but forwarding to Employee Plans Examinations will occur only in rare or unusual circumstances.

.08 *Conference right*. If the Service initially determines that it cannot issue a compliance statement because the parties cannot agree upon correction or a change in administrative procedures, the Plan Sponsor or the Plan Sponsor's representative will be contacted by the Service representative and offered a conference with the Service. The conference can be held either in person or by telephone, and must be held within 21 calendar days of the date of contact. The Plan Sponsor will have 21 calendar days after the date of the conference to submit additional information in support of the submission. Any request for an extension of the 21-day time period must be made in writing within the 21-day time period and must be approved by the Service. Additional conferences may be held at the discretion of the Service.

.09 *Failure to reach resolution*. If resolution cannot be reached (for example, where information is not timely provided to the Service or because agreement cannot be reached on correction or a change in administrative procedures), the compliance fee will not be returned, and the case may be referred to Employee Plans Examinations for examination consideration.

.10 *Concurrent processing of determination letter applications*. The Service may process a determination letter application (including an application requested on Form 5310, Application for Determination of Qualification Upon Termination) concurrently with a VCR submission for the same plan. However, issuance of the determination letter in response to an application made on a Form 5310 will be suspended pending the closure of the VCR submission.

.11 *Special rules relating to SVP*. (1) Under the VCR program, certain Operational Failures may be corrected under the Standardized VCR Procedure ("SVP") rules in this section. SVP is available if the plan's only identified Operational Failure or Failures are listed in Appendix A or Appendix B of this revenue procedure and the failures are corrected in accordance with an applicable correction method set forth in Appendix A or Appendix B. Appropriate correction must be made for any Qualification Failure that results from the application of an SVP correction. The Plan Sponsor must request an SVP compliance statement and pay the reduced compliance fee set forth in section 13.04.

(2) The correction methods set forth in Appendix A and Appendix B are strictly construed and are the only acceptable correction methods for failures corrected under SVP. If the Plan Sponsor wishes to modify a correction method provided in Appendix A or Appendix B or to propose another method, the Plan Sponsor may not use SVP, but may request a compliance statement under the regular VCR procedures.

(3) SVP is not available if the Plan Sponsor has identified more than two SVP failures in a single SVP request. If there are one or two failures that can be corrected under SVP and other failures that cannot be corrected under SVP, SVP is not available. The Service reserves the right to shift requests for consideration under SVP into the regular VCR program if the Plan Sponsor submits a second SVP request with respect to the same plan while the first SVP request is being considered or during the 12 months after the first SVP compliance statement is issued. Both SVP requests may be shifted into the regular VCR program if the first SVP request is still being considered.

(4) The Service will review an SVP request within 120 days of the date the submission is received and determined to be complete. If the Service determines that the request is acceptable, the Service will issue a compliance statement on the Plan Sponsor's proposed correction.

.12 *General description of compliance statement*. Under the VCR program, a Plan Sponsor receives a compliance statement from the Service. The compliance statement addresses the failures identified, the terms of correction, and any revision of administrative procedures, and provides that the Service will not treat the plan as disqualified on account of the Operational Failures described in the compliance statement. In addition, the time period within which proposed corrections and changes in administrative procedures must be implemented are set forth in the compliance statement. The compliance statement is conditioned on the accuracy and acceptability of any calculations or other material submitted in connection with the request.

.13 *Compliance statement conditioned upon timely correction*. The compliance statement is conditioned upon the implementation of the specific corrections and administrative changes set forth in the compliance statement within 150 days of the date of the compliance statement. Any request for an extension of this time period must be made in advance and in writing and must be approved by the Service.

.14 *Compliance statement for new plans conditioned upon timely amendment*. Reliance on any compliance statement issued for a plan initially adopted or effective after December 7, 1994, other than an adoption of a master or prototype or regional prototype plan, is conditioned upon the plan being timely submitted for a determination letter within the plan's remedial amendment period under § 401(b).

.15 *Acknowledgement letter*. Within 30 calendar days after the compliance statement is issued, a Plan Sponsor that wishes to agree to the terms of the compliance statement must send a signed acknowledgement letter to the Service, agreeing to the terms of the compliance statement. If the Plan Sponsor does not send the Service a signed acknowledgement letter within 30 calendar days, the plan may be referred to Employee Plans Examinations for examination consideration. Once the compliance statement has been issued (based on the information provided), the Plan Sponsor cannot request a modification of the compliance terms except by a new request for a compliance statement. However, if the requested modification is minor and is postmarked no later than 30 days after the compliance statement is issued, the VCR compliance fee for the modification will be the lesser of the original compliance fee or $1,250.

.16 *Verification*. Once the compliance statement has been issued, the Service may require verification that the corrections have been made and that any plan administrative procedures required by the statement have been implemented. This verification does not constitute an examination of the books and records of the employer or the plan (within the meaning of § 7605(b)). If the Service determines that the Plan Sponsor did not implement the corrections and procedures within the stated time period, the Service may consider the issues in an examination.

SECTION 11. WALK-IN CAP AND TVC

.01 *Walk-in CAP requirements*. (1) The requirements of this section are satisfied with respect to a Plan Document, Operational, or a Demographic Failure if the submission requirements of section 12 are satisfied, the Plan Sponsor pays the compliance correction fee, and the Plan Sponsor corrects the failures identified in accordance with a closing agreement entered into by the Service and the Plan Sponsor. Payment of the compliance correction fee is generally required at the time the closing agreement is signed.

(2) A determination letter application does not satisfy the submission requirements under Walk-in CAP.

(3) Depending on the nature of the failure, the Service will discuss the appropriateness of the plan's existing administrative procedures with the Plan Sponsor. Where current administrative procedures are inadequate for operating the plan in conformance with the qualification re-

quirements of the Code, the closing agreement may be conditioned upon the implementation of stated administrative procedures.

(4) In addition, the Plan Sponsor is required to obtain a Favorable Letter before the closing agreement is signed unless the Service determines that it is unnecessary based on the facts and circumstances (for example, because the plan already has a Favorable Letter and no significant amendments are adopted). If a Favorable Letter is required, the Plan Sponsor would be required to pay the applicable user fee for obtaining the letter.

.02 *Failures discovered after initial submission*. (1) A Plan Sponsor that discovers additional, unrelated failures after its initial submission may request that such failures be added to its submission. However, the Service retains the discretion to reject the inclusion of such failures if the request is not timely, for example, if the Plan Sponsor makes its request when processing of the submission is substantially complete.

(2) If the Service discovers an unrelated plan failure while the request is pending, the failure generally will be added to the failures under consideration. However, the Service retains the discretion to determine that a failure is outside the scope of the voluntary request for consideration because it was not voluntarily brought forward by the Plan Sponsor. In this case, if the additional failure is significant, all aspects of the plan will be examined, and the rules pertaining to Audit CAP will apply.

.03 *Failure to reach resolution*. If the Service and the Plan Sponsor cannot reach agreement with respect to the submission, all aspects of the plan may be examined, and the rules pertaining to Audit CAP will apply.

.04 *Effect of closing agreement*. The closing agreement is binding upon both the Service and the Plan Sponsor with respect to the specific tax matters identified therein for the periods specified, but does not preclude or impede an examination of the plan by the Service relating to matters outside the closing agreement, even with respect to the same taxable year or years to which the closing agreement relates.

.05 *TVC*. The provisions in section 11.01 through .04 above apply to TVC except that TVC applies to Operational, Demographic, and Eligibility Failures with respect to a 403(b) Plan. In addition, there is no requirement that the employer obtain a private letter ruling from the Service covering its 403(b) Plan.

SECTION 12. APPLICATION PROCEDURES FOR VCR, WALK-IN CAP AND TVC

.01 *General rules*. This section sets forth the procedures for requesting a compliance statement from the Service under the VCR program (including SVP) and for requesting a closing agreement under Walk-in CAP and TVC. In general, a request under the VCR program, Walk-in CAP or TVC consists of a letter from the Plan Sponsor or the Plan Sponsor's representative to the Service that contains a description of the failures, a description of the proposed methods of correction, and other procedural items, and includes supporting information and documentation as described below.

.02 *Multiemployer and multiple employer plans*. In the case of a multiemployer or multiple employer plan, the plan administrator (rather than any contributing or adopting employer) must request consideration of the plan under the programs. The request must be with respect to the plan, rather than a portion of the plan affecting any particular employer.

.03 *Submission requirements*. The letter from the Plan Sponsor or the Plan Sponsor's representative must contain the following:

(1) A complete description of the failures and the years in which the failures occurred, including closed years (that is, years for which the statutory period has expired).

(2) A description of the administrative procedures in effect at the time the failures occurred.

(3) An explanation of how and why the failures arose.

(4) A detailed description of the method for correcting the failures that the Plan Sponsor has implemented or proposes to implement. Each step of the correction method must be described in narrative form. The description must include the specific information needed to support the suggested correction method. This information includes, for example, the number of employees affected and the expected cost of correction (both of which may be approximated if the exact number cannot be determined at the time of the request), the years involved, and calculations or assumptions the Plan Sponsor used to determine the amounts needed for correction. See section 10.11 for special procedures regarding SVP.

(5) A description of the methodology that will be used to calculate earnings or actuarial adjustments on any corrective contributions or distributions (indicating the computation periods and the basis for determining earnings or actuarial adjustments, in accordance with section 6.02(5)).

(6) Specific calculations for each affected employee or a representative sample of affected employees. The sample calculations must be sufficient to demonstrate each aspect of the correction method proposed. For example, if a Plan Sponsor requests a compliance statement with respect to a failure to satisfy the contribution limits of § 415(c) and proposes a correction method that involves elective contributions (both matched and unmatched) and matching contributions, the Plan Sponsor must submit calculations illustrating the correction method proposed with respect to each type of contribution. As another example, with respect to a failure to satisfy the actual deferral percentage ("ADP") test in § 401(k)(3), the Plan Sponsor must submit the ADP test results both before the correction and after the correction.

(7) The method that will be used to locate and notify former employees and beneficiaries, or an affirmative statement that no former employees or beneficiaries were affected by the failures.

(8) A description of the measures that have been or will be implemented to ensure that the same failures will not recur.

(9) A statement that, to the best of the Plan Sponsor's knowledge, neither the plan nor the Plan Sponsor is Under Examination.

(10) In the case of a VCR submission, a statement (if applicable) that the plan is currently being considered in a determination letter application. If the request for a determination letter is made while a request for consideration under VCR is pending, the Plan Sponsor must update the VCR request to add this information.

(11) In the case of an SVP submission, a statement that it is an SVP request, a description of the applicable correction in accordance with Appendix A or Appendix B, and a statement that the Plan Sponsor proposes to implement (or has implemented) the correction(s).

(12) In the case of a TVC submission, an application under TVC must contain a statement that the employer has contacted all other entities involved with the plan and has been assured of cooperation in implementing the applicable correction, to the extent necessary. For example, if the plan's failure is the failure to satisfy the requirements of § 403(b)(1)(E) on elective deferrals, the employer must, prior to making the TVC application, contact the insurance company or custodian with control over the plans's assets to assure cooperation in effecting a distribution of the excess deferrals and the earnings thereon.

.04 *Required documents*. The submission must be accompanied by the following documents:

(1) In the case of a VCR submission, a copy of the first page and a copy of the page containing employee census information (currently, line 7f of the 1998 Form 5500) and a copy of the page containing the total amount of plan assets (currently, line 31f of the 1998 Form 5500) of the most recently filed Form 5500 series return, or in the case of a Walk-in CAP submission, a copy of the most recently filed Form 5500 series return.

(2) Under TVC, the first two pages of the most recently filed Form 5500, or if inapplicable, the information generally included on the first two pages, including the name and number of the plan, and the employer's Employer Identification Number.

(3) A copy of the relevant portions of the plan document. For example, in a case involving improper exclusion of eligible employees from a profit-sharing plan with a cash or deferred arrangement, relevant portions of the plan document include the eligibility, allocation, and cash or deferred arrangement provisions of the basic plan document (and the adoption agreement, if applicable), along with applicable definitions in the plan. If the plan is a 403(b) Plan and a plan document is not available, written descriptions of the plan, and sample salary reduction agreements if relevant.

(4) In the case of a VCR submission, a copy of the determination letter, opinion letter, or notification letter that considered TRA '86, except:

(a) a governmental plan, or a nonelecting church plan described in Rev. Proc. 99–23 for which the TRA '86 remedial amendment period has not yet expired should submit a copy of the determination, opinion, or notification letter that considered TEFRA, DEFRA, and REA and a statement that explains the reason why the period has not yet expired, and

(b) plans initially adopted or effective after December 7, 1994, should submit a statement that the plan will be submitted timely for a determination, opinion, or notification letter within the plan's remedial amendment period under § 401(b).

(5) In the case of a TVC submission, a statement as to the type of employer (e.g., a tax-exempt organization described in § 501(c)(3)) submitting the TVC application.

.05 *Fee*. The VCR submission must include the appropriate fee described in section 13.02 or 13.04 below. The Walk-in CAP or TVC compliance correction fee described in section 13.05 or 13.06 below is due at the time the closing agreement is signed.

.06 *Signed submission*. The submission must be signed by the Plan Sponsor or the sponsor's representative.

.07 *Power of attorney requirements*. To sign the submission or to appear before the Service in connection with the submission, the Plan Sponsor's representative must comply with the requirements of section 9.02(11) and (12) of Rev. Proc. 2000–4, 2000–1 I.R.B. 115.

.08 *Penalty of perjury statement*. The following declaration must accompany a request and any factual information or change in the submission at a later time: "**Under penalties of perjury, I declare that I have examined this submission, including accompanying documents, and, to the best of my knowledge and belief, the facts presented in support of this submission are true, correct, and complete.**" The declaration must be signed by the Plan Sponsor, not the Plan Sponsor's representative.

.09 *Checklist.* The Service will be able to respond more quickly to a VCR, Walk-in CAP or TVC request if the request is carefully prepared and complete. The checklist in Appendix C is designed to assist Plan Sponsors and their representatives in preparing a submission that contains the information and documents required under this revenue procedure. The checklist in Appendix C must be completed, signed, and dated by the Plan Sponsor or the Plan Sponsor's representative, and should be placed on top of the submission. A photocopy of this checklist may be used.

.10 *Designation*. The letter to the Service should be designated "VCR PROGRAM," "SVP/VCR PROGRAM," "WALK-IN CAP PROGRAM," or "TVC PROGRAM" as appropriate, in the upper right hand corner of the letter.

.11 *VCR/SVP mailing address*. VCR/SVP submissions should be mailed to:

Internal Revenue Service
Attention: T:EP:RA:VC
P.O. Box 14073
Ben Franklin Station
Washington, D.C. 20044

.12 *Walk-in CAP and TVC mailing address*. Walk-in CAP and TVC submissions should be mailed to the appropriate Closing Agreement Coordinator at the address provided below:

If the entity is in:	*Walk-in CAP and TVC applications should be sent to:*
Connecticut, Maine, Massachusetts, Michigan, New Hampshire, New Jersey, New York, Ohio, Pennsylvania, Rhode Island, Vermont	Employee Plans Walk-in CAP Internal Revenue Service 10 Metro Tech Center 625 Fulton Street Brooklyn, NY 11201 Phone (718) 488-2372 FAX (718) 488-2405
Alabama, Delaware, District of Columbia, Florida, Georgia, Indiana, Kentucky, Louisiana, Maryland, Mississippi, North Carolina, South Carolina, Tennessee, Virginia, West Virginia, any U.S. possession or foreign country	Employee Plans Walk-in CAP Internal Revenue Service Room 1550 P.O. Box 13163 Baltimore, MD 21203 Phone (410) 962-3499 FAX (410) 962-0882
Arkansas, Illinois, Iowa, Kansas, Minnesota, Missouri, Nebraska, North Dakota, Oklahoma, South Dakota, Texas, Wisconsin	Employee Plans Walk-in CAP Internal Revenue Service 230 S. Dearborn MC 4913 Chi Chicago, IL 60604 Phone (312) 886-1277 FAX (312) 886-2386
Alaska, Arizona, California, Colorado, Hawaii, Idaho, Montana, Nevada, New Mexico, Oregon, Utah, Washington, Wyoming	Employee Plans Walk-in CAP Internal Revenue Service 2 Cupania Circle Monterey Park, CA 91755-7431 Phone (323) 869-3905 FAX (323) 869-3949

.13 *Maintenance of copies of submissions*. Plan Sponsors and their representatives should maintain copies of all correspondence submitted to the Service with respect to their VCR, Walk-in CAP and TVC requests.

SECTION 13. FEES

.01 *Rev. Proc. 2000–8 modified*. The VCR compliance fee is processed under the user fee program described in Rev. Proc. 2000–8, 2000–1 I.R.B. 230.

.02 *VCR fee*. Unless SVP is applicable, the VCR compliance fee depends on the assets of the plan and the number of plan participants.

(1) The fee for a plan with assets of less than $500,000, and no more than 1,000 plan participants, is $500.

(2) The fee for a plan with assets of at least $500,000, and no more than 1,000 plan participants, is $1,250.

(3) The fee for a plan with more than 1,000 plan participants but less than 10,000 plan participants is $5,000.

(4) The fee for a plan with 10,000 or more plan participants is $10,000.

.03 *Establishing number of plan participants*. The compliance fee is calculated by the Plan Sponsor using the numbers from the most recently filed Form 5500 series to establish the fee. Thus, with respect to the 1998 Form 5500, the Plan Sponsor would use the number shown on line 7(f) (or the equivalent line on the Form 5500 C/R or EZ) to establish the number of plan participants and would use line 31(f) (or the equivalent line on the Form 5500 C/R or EZ) to establish the amount of plan assets.

.04 *SVP fee*. The SVP compliance fee is $350.

.05 *Walk-in CAP compliance correction fee*. (1) *Compliance correction fee chart*. The compliance correction fee for a Walk-in CAP application is determined in accordance with the chart below. The chart contains a graduated range of fees based on the size of the plan (with the number of participants determined as provided in section 13.03). Each range includes a minimum amount, a maximum amount, and a presumptive amount. In each case, the minimum amount is the applicable VCR fee in section 13.02. It is expected that in most instances the compliance correction fee imposed will be at or near the presumptive amount in each range; however, the fee may be a higher or lower amount within the range, depending on the factors in paragraph (2) below.

WALK-IN CAP COMPLIANCE CORRECTION FEES		
# of participants	**Fee range**	**Presumptive Amount**
10 or fewer	VCR fee* to $4,000	$2,000
11 to 50	VCR fee* to $8,000	$4,000
51 to 100	VCR fee* to $12,000	$6,000
101 to 300	VCR fee* to $16,000	$8,000
301 to 1,000	VCR fee* to $30,000	$15,000
over 1,000	VCR fee* to $70,000	$35,000

* Items marked by asterisk refer to the VCR compliance fee that would apply under section 13.02 if the plan had been submitted under the VCR program.

(2) *Factors considered*. Consideration of whether the compliance correction fee should be equal to, greater than, or less than the presumptive amount will depend on factors relating to the nature, extent, and severity of the failure. These factors include: (a) whether the failure is a failure to satisfy the requirements of § 401(a)(4), § 401(a)(26), or § 410(b), (b) whether the plan has both Operational and Plan Document Failures, (c) the period over which the violation occurred (for example, the time that has elapsed since the end of the applicable remedial amendment period under § 401(b) for a Plan Document Failure), and (d) whether the plan has a Favorable Letter.

(3) *Egregious failures*. In cases involving failures that are egregious (as described in section 4.07), (a) the maximum compliance correction fee applicable to the plan under the chart in 13.05(1) is increased to 40 percent of the Maximum Payment Amount, and (b) no presumptive amount applies.

.06 *TVC fee*. (1) *TVC Compliance correction fee*. The applicable TVC compliance correction fee depends on the type of failure and, generally, the number of employees of the employer.

(2) *Fee for Operational Failures*. Subject to section 13.06(5) below, the compliance correction fees for Operational Failures are as follows:

(a) The fee for an employer with fewer than 25 employees is $500.

(b) The fee for an employer with at least 25 and no more than 1,000 employees is $1,250.

(c) The fee for an employer with more than 1,000 employees but less than 10,000 is $5,000.

(d) The fee for an employer with 10,000 or more employees is $10,000.

(3) *Fee for certain Excess Amounts*. Subject to section 13.06(5) below, the compliance correction fee for Excess Amounts that are corrected pursuant to section 6.02(4)(b)(i) above is equal to the sum of (1) the applicable fee described in section 13.06(2) above and (2) two percent of the Excess Amounts, adjusted for earnings through the date of the TVC application, contributed or allocated in the calendar year of the TVC application and in the three calendar years prior thereto. For purposes of determining the fee described in this section 13.06(3), where there is a failure to satisfy both the § 403(b)(2) and § 415 limits with respect to a single employee for a year, the fee will take into account only the greater Excess Amount.

(4) *Fee for Demographic and Eligibility Failures*. (a) Subject to section 13.06(5) below, the compliance correction fee for a 403(b) Plan with failures that include Demographic or Eligibility Failures is determined in accordance with the table set forth above in section 13.05 with respect to Walk-In CAP, except that (i) the reference to the "VCR fee" is changed to refer to the TVC compliance correction fee for Operational Failures set forth in section 13.06(2) above, and (ii) the fee is determined with reference to the number of employees rather than participants.

(b) Factors considered in determining the compliance correction fee for failures that include Demographic and Eligibility Failures under TVC include: (i) whether the failure is a Demographic Failure; (ii) whether the plan is a Plan of an Ineligible Employer; (iii) whether the 403(b) Plan has a combination of Operational, Demographic, and Eligibility failures; and (iv) the period of time over which the failure occurred.

(5) *Fee for multiple failures.* If correction is requested for multiple failures, the compliance correction fee will be determined in accordance with the table set forth below.

Multiple Operational Failures	Fee described in section 13.06(2)
Multiple Demographic/Eligibility Failures	Fee described in section 13.06(4)
Combination of Operational and Demographic/Eligibility Failures	Fee described in section 13.06(4)
Operational Failure(s) with section 6.02(4)(b)(i) correction of Excess Amounts	Fee described in section 13.06(3)
Demographic/Eligibility Failures and Operational Failures including section 6.02(4)(b)(i) correction of Excess Amounts	Fee described in section 13.06(3), substituting section 13.06(4) fee for section 13.06(2) fee

(6) *Fee for egregious failures.* In cases involving failures that are egregious, the maximum compliance correction fee applicable to the plan is increased to 40 percent of the Total Sanction Amount and no presumptive amount applies.

PART VI. CORRECTION ON AUDIT (AUDIT CAP)

SECTION 14. DESCRIPTION OF AUDIT CAP

.01 *Audit CAP requirements*. In the event the Service identifies a Qualification or 403(b)Failure (other than a failure that is not treated as resulting in disqualification of the plan under APRSC, VCR, Walk-in CAP, or TVC) upon an Employee Plans or Exempt Organizations examination of a Qualified Plan or a 403(b) Plan, the requirements of this section are satisfied with respect to the failure if the Plan Sponsor corrects the failure, pays a sanction in accordance with section 14.02, satisfies any additional requirements of section 14.03, and enters into a closing agreement with the Service.

.02 *Payment of sanction*. Under Audit CAP, the Plan Sponsor is subject to a sanction determined in accordance with section 15. Payment of the sanction generally will be required at the time the closing agreement is signed.

.03 *Additional requirements*. Depending on the nature of the failure, the Service will discuss the appropriateness of the plan's existing administrative procedures with the Plan Sponsor. Where existing administrative procedures are inadequate for operating the plan in conformance with the qualification requirements of the Code, the closing agreement may be conditioned upon the implementation of stated procedures. In addition, for Qualified Plans, the Plan Sponsor may be required to obtain a Favorable Letter before the closing agreement is signed unless the Service determines that it is unnecessary based on the facts and circumstances (for example, because the plan already has a Favorable Letter and no significant amendments are adopted). If a Favorable Letter is required, the Plan Sponsor would be required to pay the applicable user fee for obtaining the letter.

.04 *Failure to reach resolution*. If the Service and the Plan Sponsor cannot reach an agreement with respect to the correction of the failure(s) or the amount of the sanction, the plan will be disqualified or, in the case of a 403(b) Plan, would not have reliance on this revenue procedure.

.05 *Effect of closing agreement*. A closing agreement constitutes an agreement between the Service and the Plan Sponsor that is binding with respect to the tax matters identified therein for the periods specified.

.06 *Other procedural rules.* The procedural rules for Audit CAP are set forth in Internal Revenue Manual ("IRM") 7.9.2, EPCRS.

SECTION 15. AUDIT CAP SANCTION

.01 *Determination of sanction*. The sanction under Audit CAP is a negotiated percentage of the Maximum Payment Amount. For 403(b) Plans, the sanction is a negotiated percentage of the Total Sanction Amount. Sanctions will not be excessive and will bear a reasonable relationship to the nature, extent, and severity of the failures.

.02 *Factors considered*. The amount of the sanction will depend on factors relating to the nature, extent, and severity of the failures, including the extent to which correction had progressed before the examination was initiated. For both Qualified Plans and 403(b) Plans, other factors relating to the nature, extent, and severity of the failures include: (1) the number and type of employees affected by the failure, (2) the number of nonhighly compensated employees who would be adversely affected if the plan was not treated as qualified or as satisfying the requirements of § 403(b), (3) whether the failure is a failure to satisfy the requirements of § 401(a)(4), § 401(a)(26), or § 410(b), either directly or through § 403(b)(12), (4) the period over which the failure occurred (for example, the time that has elapsed since the end of the applicable remedial amendment period under § 410(b) for a Plan Document Failure), and (5) the reason for the failure (for example, data errors such as errors in transcription of data, the transposition of numbers, or minor arithmetic errors). Factors relating to Qualified Plans also include: (1) whether the plan is the subject of a Favorable Letter, and (2) whether the plan has both Operational and Plan Document Failures. Additional factors relating to 403(b) Plans include: (1) whether the plan has a combination of Operational, Demographic, or Eligibility Failures, (2) the extent to which the failure relates to Excess Amounts, and (3) whether the plan is a Plan of an Ineligible Employer.

PART VII. EFFECT ON OTHER DOCUMENTS AND EFFECTIVE DATE

SECTION 16. EFFECT ON OTHER DOCUMENTS

.01 *Revenue procedures modified and superseded.* Rev. Procs. 98– 22, 99–13, and 99–31 are modified and superseded by this revenue procedure.

.02 *Rev. Proc. 2000–8 modified*. Rev. Proc. 2000–8 is modified as provided in section 12.

SECTION 17. EFFECTIVE DATE

This revenue procedure is generally effective May 1, 2000. In addition, employers are permitted, at their option, to apply the provisions of this revenue procedure on or after March 9, 1998 (the release date of Rev. Proc. 98–22). Unless an employer applies this revenue procedure earlier, this revenue procedure is effective:

(1) with respect to VCR, Walk-in CAP and TVC, for applications submitted on or after May 1, 2000;

(2) with respect to Audit CAP, for examinations begun on or after May 1, 2000; and

(3) with respect to APRSC, for failures for which correction is not complete before May 1, 2000.

SECTION 18. PAPERWORK REDUCTION ACT

The collection of information contained in this revenue procedure has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1673.

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

The collection of information in this revenue procedure is in sections 4.06, 6.02(4), 6.02(6)(c), 10.01, 10.02, 10.05–10.08, 10.11, 10.15, 11.01–11.03, 11.05, 12.01–12.04, 12.06–12.12, 14.01, section 2.01–2.07 of Appendix B, and Appendix C. This information is required to enable the Commissioner, Tax Exempt and Government Entities Division of the Internal Revenue Service to make determinations regarding the issuance of various types of closing agreements and compliance statements. This information will be used to issue closing agreements and compliance statements to allow individual plans to continue to maintain their tax qualified and tax-deferred status. As a result, favorable tax treatment of the benefits of the eligible employees is retained. The likely respondents are individuals, state or local governments, business or other for-profit institutions, nonprofit institutions, and small businesses or organizations.

The estimated total annual reporting and/or recordkeeping burden is 61,697 hours.

The estimated annual burden per respondent/recordkeeper varies from .5 to 42.5 hours, depending on individual circumstances, with an estimated average of 14.54 hours. The estimated number of respondents and/or recordkeepers is 4,242.

The estimated frequency of responses is occasionally.

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 authors of this revenue procedure are Maxine Terry and Carlton Watkins of the Tax Exempt and Government Entities Division. For further information concerning this revenue procedure, please contact Employee Plans' taxpayer assistance telephone service between 1:30 and 3:30 p.m., Eastern Time, Monday through Thursday at (202) 622-6074/6075. (These telephone numbers are not toll-free numbers.) Ms. Terry and Mr. Watkins may be reached at (202) 622-6214 (also not a toll-free number).

APPENDIX A

OPERATIONAL FAILURES AND CORRECTIONS UNDER SVP

.01 *General rule*. This appendix sets forth Operational Failures relating to Qualified Plans and corrections under SVP in accordance with section 10.11. In each case, the method described corrects the Operational Failure identified in the headings below. Corrective allocations and distributions should reflect earnings and actuarial adjustments in accordance with section 6.02(5)(a). The correction methods in this appendix are acceptable under APRSC. Additionally, the correction methods (other than correction by plan amendment under Walk-in CAP) and the earnings adjustment methods in Appendix B are acceptable under SVP.

.02 *Failure to properly provide the minimum top-heavy benefit under § 416 of the Code to non-key employees*. In a defined contribution plan, the permitted correction method is to properly contribute and allocate the required top-heavy minimums to the plan in the manner provided for in the plan on behalf of the non-key employees (and any other employees required to receive top-heavy allocations under the plan). In a defined benefit plan, the minimum required benefit must be accrued in the manner provided in the plan.

.03 *Failure to satisfy the ADP test set forth in § 401(k)(3), the ACP test set forth in § 401(m)(2), or the multiple use test of § 401(m)(9)*. The permitted correction method is to make qualified nonelective contributions (QNCs) (as defined in § 1.401(k)–1(g)(13)(ii)) on behalf of the nonhighly compensated employees to the extent necessary to raise the actual deferral percentage or actual contribution percentage of the nonhighly compensated employees to the percentage needed to pass the test or tests. The contributions must be made on behalf of all eligible nonhighly compensated employees (to the extent permitted under § 415) and must either be the same flat dollar amount or the same percentage of compensation. QNCs contributed to satisfy the ADP test need not be matched. Employees who would have been eligible for a matching contribution had they made elective contributions must be counted as eligible employees for the ACP test, and the plan must satisfy the ACP test. Under this SVP correction method, a plan may not be treated as two separate plans, one covering otherwise excludable employees and the other covering all other employees (as permitted in § 1.410(b)–6(b)(3)) in order to reduce the number of employees eligible to receive QNCs. Likewise, under this SVP correction method, the plan may not be restructured into component plans (as permitted in § 1.401(k)–1(h)(3)(iii) for plan years before January 1, 1992) in order to reduce the number of employees eligible to receive QNCs.

.04 *Failure to distribute elective deferrals in excess of the § 402(g) limit (in contravention of § 401(a)(30))*. The permitted correction method is to distribute the excess deferral to the employee and to report the amount as taxable in the year of deferral and in the year distributed. In accordance with § 1.402(g)–1(e)(1)(ii), a distribution to a highly compensated employee is included in the ADP test; a distribution to a nonhighly compensated employee is not included in the ADP test.

.05 *Exclusion of an eligible employee from all contributions or accruals under the plan for one or more plan years*. The permitted correction method is to make a contribution to the plan on behalf of the employees excluded from a defined contribution plan or to provide benefit accruals for the employees excluded from a defined benefit plan. If the employee should have been eligible to make an elective contribution under a cash or deferred arrangement, the employer must make a QNC to the plan on behalf of the employee that is equal to the actual deferral percentage for the employee's group (either highly compensated or nonhighly compensated). If the employee should have been eligible to make employee contributions or for matching contributions (on either elective contributions or employee contributions), the employer must make a QNC to the plan on behalf of the employee that is equal to the actual contribution percentage for the employee's group (either highly compensated or nonhighly compensated). Contributing the actual deferral or contribution percentage for such employees eliminates the need to rerun the ADP or ACP test to account for the previously excluded employees. Under this SVP correction method, a plan may not be treated as two separate plans, one covering otherwise excludable employees and the other covering all other employees (as permitted in § 1.410(b)–6(b)(3)) in order to reduce the amount of QNCs. Likewise, restructuring the plan into component plans under § 1.401(k)–1(h)(3)(iii) is not permitted in order to reduce the amount of QNCs.

.06 *Failure to timely pay the minimum distribution required under § 401(a)(9).* In a defined contribution plan, the permitted correction method is to distribute the required minimum distributions. The amount to be distributed for each year in which the failure occurred should be determined by dividing the adjusted account balance on the applicable valuation date by the applicable divisor. For this purpose, adjusted account balance means the actual account balance, determined in accordance with § 1.401(a)(9)–1 Q&A F–5 of the proposed regulations, reduced by the amount of the total missed minimum distributions for prior years. In a defined benefit plan, the permitted correction method is to distribute the required minimum distributions, plus an interest payment representing the loss of use of such amounts.

.07 *Failure to obtain participant and/or spousal consent for a distribution subject to the participant and spousal consent rules under §§ 401(a)(11), 411(a)(11) and 417.* The permitted correction method is to give each affected participant a choice between providing informed consent for the distribution actually made or receiving a qualified joint and survivor annuity. In order to use this SVP correction method, the Plan Sponsor must have contacted each affected participant and spouse (to whom the participant was married at the annuity starting date) and received responses from each such individual before requesting consideration under SVP. In the event that participant and/or spousal consent is required but cannot be obtained, the participant must receive a qualified joint and survivor annuity based on the monthly amount that would have been provided under the plan at his or her retirement date. This annuity may be actuarially reduced to take into account distributions already received by the participant. However, the portion of the qualified joint and survivor annuity payable to the spouse upon the death of the participant may not be actuarially reduced to take into account prior distributions to the participant. Thus, for example, if in accordance with the automatic qualified joint and survivor annuity option under a plan, a married participant who retired would have received a qualified joint and survivor annuity of $600 per month payable for life with $300 per month payable to the spouse upon the participant's death but instead received a single-sum distribution equal to the actuarial present value of the participant's accrued benefit under the plan, then the $600 monthly annuity payable during the participant's lifetime may be actuarially reduced to take the single-sum distribution into account. However, the spouse must be entitled to receive an annuity of $300 per month payable for life beginning at the participant's death.

.08 *Failure to satisfy the § 415 limits in a defined contribution plan*. The permitted correction for failure to limit annual additions (other than elective deferrals and employee contributions) allocated to participants in a defined contribution plan as required in § 415 (even if the excess did not result from the allocation of forfeitures or from a reasonable error in estimating compensation) is to place the excess annual additions into an unallocated account, similar to the suspense account described in § 1.415–6(b)(6)(iii), to be used as an employer contribution in the succeeding year(s). While such amounts remain in the unallocated account, the employer is not permitted to make additional contributions to the plan. The permitted SVP correction for failure to limit annual additions that are elective deferrals or employee contributions (even if the excess did not result from a reasonable error in determining the amount of elective deferrals or employee contributions that could be made with respect to an individual under the § 415 limits) is to distribute the elective deferrals or employee contributions using a method similar to that described under § 1.415–6(b)(6)(iv). Elective deferrals and employee contributions that are matched may be returned, provided that the matching contributions relating to such contributions are forfeited (which will also reduce excess annual additions for the affected individuals). The forfeited matching contributions are to be placed into an unallocated account to be used as an employer contribution in succeeding periods.

APPENDIX B

CORRECTION METHODS AND EXAMPLES AND EARNINGS ADJUSTMENT METHODS AND EXAMPLES

SECTION 1. PURPOSE, ASSUMPTIONS FOR EXAMPLES AND SECTION REFERENCES

.01 *Purpose*. (1) This appendix sets forth correction methods relating to Operational Failures under Qualified Plans. This appendix also sets forth earnings adjustment methods. The correction methods and earnings adjustment methods described in this appendix are acceptable under SVP and APRSC.

(2) This appendix does not apply to 403(b) Plans. Accordingly, sponsors of 403(b) Plans cannot rely on the correction methods and the earnings adjustment methods.

.02 *Assumptions for Examples*. Unless otherwise specified, for ease of presentation, the examples assume that:

(1) the plan year and the § 415 limitation year are the calendar year;

(2) the employer maintains a single plan intended to satisfy § 401(a) and has never maintained any other plan;

(3) in a defined contribution plan, the plan provides that forfeitures are used to reduce future employer contributions;

(4) the Qualification Failures are Operational Failures and the eligibility and other requirements for APRSC, VCR, Walk-in CAP, or Audit CAP, whichever applies, are satisfied; and

(5) there are no Qualification Failures other than the described Operational Failures, and if a corrective action would result in any additional Qualification Failure, appropriate corrective action is taken for that additional Qualification Failure in accordance with EPCRS.

.03 *Section References*. References to section 2 and section 3 are references to the section 2 and 3 of this appendix.

SECTION 2. CORRECTION METHODS AND EXAMPLES

.01 *ADP/ACP Failures*.

(1) Correction Methods. (a) SVP Correction Method. Appendix A, section .03 sets forth the SVP correction method for a

failure to satisfy the actual deferral percentage ("ADP"), actual contribution percentage ("ACP"), or multiple use test set forth in §§ 401(k)(3), 401(m)(2), and 401(m)(9), respectively.

(b) One-to-One Correction Method. (i) General. In addition to the SVP correction method, a failure to satisfy the ADP, ACP, or multiple use test may be corrected using the one-to-one correction method set forth in this section 2.01(1)(b). Under the one-to-one correction method, an excess contribution amount is determined and assigned to highly compensated employees as provided in paragraph (1)(b)(ii) below. That excess contribution amount (adjusted for earnings) is either distributed to the highly compensated employees or forfeited from the highly compensated employees' accounts as provided in paragraph (1)(b)(iii) below. That same dollar amount (i.e., the excess contribution amount, adjusted for earnings) is contributed to the plan and allocated to nonhighly compensated employees as provided in paragraph (1)(b)(iv) below.

(ii) Determination of the Excess Contribution Amount. The excess contribution amount for the year is equal to the excess of (A) the sum of the excess contributions (as defined in § 401(k)(8)(B)), the excess aggregate contributions (as defined in § 401(m)(6)(B)), and the amount treated as excess contributions or excess aggregate contributions under the multiple use test pursuant to § 401(m)(9) and § 1.401(m)–2(c) of the Income Tax Regulations for the year, as assigned to each highly compensated employee in accordance with § 401(k)(8)(C) and (m)(6)(C), over (B) previous corrections that complied with § 401(k)(8), (m)(6), and (m)(9). See Notice 97–2, 1997–1 C.B. 348.

(iii) Distributions and Forfeitures of the Excess Contribution Amount. (A) The portion of the excess contribution amount assigned to a particular highly compensated employee under paragraph (1)(b)(ii) is adjusted for earnings through the date of correction. The amount assigned to a particular highly compensated employee, as adjusted, is distributed or, to the extent the amount was forfeitable as of the close of the plan year of the failure, is forfeited. If the amount is forfeited, it is used in accordance with the plan provisions relating to forfeitures that were in effect for the year of the failure. If the amount so assigned to a particular highly compensated employee has been previously distributed, the amount is an Excess Amount within the meaning of section 5.01(3). Thus, pursuant to section 6.02(4)(a), the employer must notify the employee that the Excess Amount was not eligible for favorable tax treatment accorded to distributions from qualified plans (and, specifically, was not eligible for tax-free rollover).

(B) If any matching contributions (adjusted for earnings) are forfeited in accordance with § 411(a)(3)(G), the forfeited amount is used in accordance with the plan provisions relating to forfeitures that were in effect for the year of the failure.

(C) If a payment was made to an employee and that payment is a forfeitable match described in either paragraph (1)(b)(iii)(A) or (B), then it is an Overpayment defined in section 2.05(2) that must be corrected (see section 2.05(1)).

(iv) Contribution and Allocation of Equivalent Amount. (A) The employer makes a contribution to the plan that is equal to the aggregate amounts distributed and forfeited under paragraph (1)(b)(iii)(A) (i.e., the excess contribution amount adjusted for earnings, as provided in paragraph (1)(b)(iii)(A), which does not include any matching contributions forfeited in accordance with § 411(a)(3)(G) as provided in paragraph (1)(b)(iii)(B)). The contribution must satisfy the vesting requirements and distribution limitations of § 401(k)(2)(B) and (C).

(B)(*1*) This paragraph (1)(b)(iv)(B)(*1*) applies to a plan that uses the current year testing method described in Notice 98–1, 1998–3 I.R.B. 42. The contribution made under paragraph (1)(b)(iv)(A) is allocated to the account balances of those individuals who were either (I) the eligible employees for the year of the failure who were not highly compensated employees for that year or (II) the eligible employees for the year of the failure who were not highly compensated employees for that year and who also are not highly compensated employees for the year of correction. Alternatively, the contribution is allocated to account balances of eligible employees described in (I) or (II) of the preceding sentence, except that the allocation is made only to the account balances of those employees who are employees on a date during the year of the correction that is no later than the date of correction. Regardless of which of these four options (described in the two preceding sentences) the employer selects, the contribution is allocated to each such employee either as the same percentage of the employee's compensation for the year of the failure or as the same dollar amount for each employee. (See Examples 1, 2 and 3.) Under the one-to-one correction method, the amount allocated to the account balance of an employee (i.e, the employee's share of the total amount contributed under paragraph (1)(b)(iv)(A)) is not further adjusted for earnings and is treated as an annual addition under § 415 for the year of the failure for the employee for whom it is allocated.

(*2*) This paragraph (1)(b)(iv)(B)(*2*) applies to a plan that uses the prior year testing method described in Notice 98–1. Paragraph (1)(b)(iv)(B)(*1*) is applied by substituting "the year prior to the year of the failure" for "the year of the failure."

(2) Examples.

Example 1: Employer A maintains a profit-sharing plan with a cash or deferred arrangement that is intended to satisfy § 401(k) ("401(k) plan") using the current year testing method described in Notice 98–1. The plan does not provide for matching contributions or employee after-tax contributions. In 1999, it was discovered that the ADP test for 1997 was not performed correctly. When the ADP test was performed correctly, the test was not satisfied for 1997. For 1997, the ADP for highly compensated employees was 9% and the ADP for nonhighly compensated employees was 4%. Accordingly, the ADP for highly compensated employees exceeded the ADP for nonhighly compensated employees by more than two percentage points (in violation of § 401(k)(3)). (The ADP for nonhighly compensated employees for 1996 also was 4%, so the ADP test for 1997 would not have been satisfied even if the plan had used the prior year testing method described in Notice 98–1.) There were two highly compensated employees eligible under the 401(k) plan during 1997, Employee P and Employee Q. Employee P made elective deferrals of $8,000, which is equal to 10% of Employee P's compensation of $80,000 for 1997. Employee Q made elective deferrals of $9,500, which is equal to 8% of Employee Q's compensation of $118,750 for 1997.

Correction: On June 30, 1999, Employer A uses the one-to-one correction method to correct the failure to satisfy the ADP test for 1997. Accordingly, Employer A calculates the dollar amount of the excess contributions for the two highly compensated employees in the manner described in § 401(k)(8)(B). The amount of the excess contribution for Employee P is $3,200 (4% of $80,000) and the amount of the excess contribution for Employee Q is $2,375 (2% of $118,750), or a total of $5,575. In accordance with § 401(k)(8)(C), $5,575, the excess contribution amount, is assigned $2,037.50 to Employee P and

$3,537.50 to Employee Q. It is determined that the earnings on the assigned amounts through June 30, 1999 are $407 and $707 for Employees P and Q, respectively. The assigned amounts and the earnings are distributed to Employees P and Q. Therefore, Employee P receives $2,444.50 ($2,037.50 + $407) and Employee Q receives $4,244.50 ($3,537.50 + $707). In addition, on the same date, a corrective contribution is made to the 401(k) plan equal to $6,689 (the sum of the $2,444.50 distributed to Employee P and the $4,244.50 distributed to Employee Q). The corrective contribution is allocated to the account balances of eligible nonhighly compensated employees for 1997, pro rata based on their compensation for 1997 (subject to § 415 for 1997).

Example 2: The facts are the same as in Example 1.

Correction: The correction is the same as in Example 1, except that the corrective contribution of $6,689 is allocated in an equal dollar amount to the account balances of eligible nonhighly compensated employees for 1997 who are employees on June 30, 1999 and who are nonhighly compensated employees for 1999 (subject to § 415 for 1997).

Example 3: The facts are the same as in Example 1, except that for 1997 the plan also provides (1) for employee after-tax contributions and (2) for matching contributions equal to 50% of the sum of an employee's elective deferrals and employee after-tax contributions that do not exceed 10% of the employee's compensation. The plan provides that matching contributions are subject to the plan's 5-year graded vesting schedule and that matching contributions are forfeited and used to reduce employer contributions if associated elective deferrals or employee after-tax contributions are distributed to correct an ADP, ACP or multiple use test failure. For 1997, nonhighly compensated employees made employee after-tax contributions and no highly compensated employee made any employee after-tax contributions. Employee P received a matching contribution of $4,000 (50% of $8,000) and Employee Q received a matching contribution of $4,750 (50% of $9,500). Employees P and Q were 100% vested in 1997. It is determined that, for 1997, the ACP for highly compensated employees was not more than 125% of the ACP for nonhighly compensated employees, so that the ACP and multiple use tests would have been satisfied for 1997 without any corrective action.

Correction: The same corrective actions are taken as in Example 1. In addition, in accordance with the plan's terms, corrective action is taken to forfeit Employee P's and Employee Q's matching contributions associated with their distributed excess contributions. Employee P's distributed excess contributions and associated matching contributions are $2,037.50 and $1,018.75, respectively. Employee Q's distributed excess contributions and associated matching contributions are $3,537.50 and $1,768.75, respectively. Thus, $1,018.75 is forfeited from Employee P's account and $1,768.75 is forfeited from Employee Q's account. In addition, the earnings on the forfeited amounts are also forfeited. It is determined that the respective earnings on the forfeited amount for Employee P is $150 and for Employee Q is $204. The total amount of the forfeitures of $3,141.50 (Employee P's $1,018.75 + $150 and Employee Q's $1,768.75 + $204) is used to reduce contributions for 1999 and subsequent years.

.02 *Exclusion of Eligible Employees*.

(1) Exclusion of Eligible Employees in a 401(k) or (m) Plan. (a) Correction Method. (i) SVP Correction Method for Full Year Exclusion. Appendix A, section .05 sets forth the SVP correction method for the exclusion of an eligible employee from all contributions under a 401(k) or (m) plan for one or more full plan years. (See Example 4.) In section 2.02(1)(a)(ii) below, the SVP correction method for the exclusion of an eligible employee from all contributions under a 401(k) or (m) plan for a full year is expanded to include correction for the exclusion of an eligible employee from all contributions under a 401(k) or (m) plan for a partial plan year. This correction for a partial year exclusion may be used in conjunction with the correction for a full year exclusion.

(ii) Expansion of SVP Correction Method to Partial Year Exclusion. (A) In General. The correction method in Appendix A, section .05 is expanded to cover an employee who was improperly excluded from making elective deferrals or employee after-tax contributions for a portion of a plan year or from receiving matching contributions (on either elective deferrals or employee after-tax contributions) for a portion of a plan year. In such case, a permitted correction method for the failure is for the employer to satisfy this section 2.02(1)(a)(ii). The employer makes a corrective contribution on behalf of the excluded employee that satisfies the vesting requirements and distribution limitations of § 401(k)(2)(B) and (C).

(B) Elective Deferral Failures. The appropriate corrective contribution for the failure to allow employees to make elective deferrals for a portion of the plan year is equal to the ADP of the employee's group (either highly or nonhighly compensated), determined prior to correction under this section 2.02(1)(a)(ii), multiplied by the employee's plan compensation for the portion of the year during which the employee was improperly excluded. The corrective contribution for the portion of the plan year during which the employee was improperly excluded from being eligible to make elective deferrals is reduced to the extent that (*1*) the sum of that contribution and any elective deferrals actually made by the employee for that year would exceed (*2*) the maximum elective deferrals permitted under the plan for the employee for that plan year (including the § 402(g) limit). The corrective contribution is adjusted for earnings. (See Examples 5 and 6.)

(C) Employee After-tax and Matching Contribution Failures.

The appropriate corrective contribution for the failure to allow employees to make employee after-tax contributions or to receive matching contributions because the employee was precluded from making employee after-tax contributions or elective deferrals for a portion of the plan year is equal to the ACP of the employee's group (either highly or nonhighly compensated), determined prior to correction under this section 2.02(1)(a)(ii), multiplied by the employee's plan compensation for the portion of the year during which the employee was improperly excluded. The corrective contribution is reduced to the extent that (*1*) the sum of that contribution and the actual total employee after-tax and matching contributions made by and for the employee for the plan year would exceed (*2*) the sum of the maximum employee after-tax contributions permitted under the plan for the employee for the plan year and the matching contributions that would have been made if the employee had made the maximum matchable contributions permitted under the plan for the employee for that plan year. The corrective contribution is adjusted for earnings.

(D) Use of Prorated Compensation. For purposes of this paragraph (1)(a)(ii), for administrative convenience, in lieu of using the employee's actual plan compensation for the portion of the year during which the employee was improperly excluded, a pro rata portion of the employee's plan compensation that would have been taken into account for the plan year, if the employee had not been improperly excluded, may be used.

(E) Special Rule for Brief Exclusion from Elective Deferrals. An employer is not required to make a corrective contribution with respect to elective deferrals, as provided in section 2.02(1)(a)(ii)(B), (but is required to make a corrective contribution with respect to any employee after-tax and matching contributions, as provided in section 2.02(1)(a)(ii)(C)) for an employee for a plan year if the employee has been provided the opportunity to make elective deferrals under the plan for a period of at least the last 9 months in that plan year and during that period the employee had the opportunity to make elective deferrals in an amount not less than the maximum amount that would have been permitted if no failure had occurred. (See Example 7.)

(b) Examples.

Example 4: Employer B maintains a 401(k) plan. The plan provides for matching contributions for eligible employees equal to 100% of elective deferrals that do not exceed 3% of an employee's compensation. The plan provides that employees who complete one year of service are eligible to participate in the plan on the next January 1 or July 1 entry date. Twelve employees (8 nonhighly compensated employees and 4 highly compensated employees) who had met the one year eligibility requirement after July 1, 1995 and before January 1, 1996 were inadvertently excluded from participating in the plan beginning on January 1, 1996. These employees were offered the opportunity to begin participating in the plan on January 1, 1997. For 1996, the ADP for the highly compensated employees was 8% and the ADP for the nonhighly compensated employees was 6%. In addition, for 1996, the ACP for the highly compensated employees was 2.5% and the ACP for the nonhighly compensated employees was 2%. The failure to include the 12 employees was discovered during 1998.

Correction: Employer B uses the SVP correction method for full year exclusions to correct the failure to include the 12 eligible employees in the plan for the full plan year beginning January 1, 1996. Thus, Employer B makes a corrective contribution (that satisfies the vesting requirements and distribution limitations of § 401(k)(2)(B) and (C)) for each of the excluded employees. The contribution for each of the improperly excluded highly compensated employees is 10.5% (the highly compensated employees' ADP of 8% plus ACP of 2.5%) of the employee's plan compensation for the 1996 plan year (adjusted for earnings). The contribution for each of the improperly excluded nonhighly compensated employees is 8% (the nonhighly compensated employee's ADP of 6% plus ACP of 2%) of the employee's plan compensation for the 1996 plan year (adjusted for earnings).

Example 5: Employer C maintains a 401(k) plan. The plan provides for matching contributions for each payroll period that are equal to 100% of an employee's elective deferrals that do not exceed 2% of the eligible employee's plan compensation during the payroll period. The plan does not provide for employee after-tax contributions. The plan provides that employees who complete one year of service are eligible to participate in the plan on the next January 1 or July 1 entry date. A nonhighly compensated employee who met the eligibility requirements and should have entered the plan on January 1, 1996 was not offered the opportunity to participate in the plan. In August of 1996, the error was discovered and Employer C offered the employee an election opportunity as of September 1, 1996. The employee made elective deferrals equal to 4% of the employee's plan compensation for each payroll period from September 1, 1996 through December 31, 1996 (resulting in elective deferrals of $500). The employee's plan compensation for 1996 was $36,000 ($23,500 for the first eight months and $12,500 for the last four months). Employer C made matching contributions equal to $250 for the excluded employee, which is 2% of the employee's plan compensation for each payroll period from September 1, 1996 through December 31, 1996 ($12,500). The ADP for nonhighly compensated employees for 1996 was 3% and the ACP for nonhighly compensated employees for 1996 was 1.8%.

Correction: Employer C uses the SVP correction method for partial year exclusions to correct the failure to include the eligible employee in the plan. Thus, Employer C makes a corrective contribution (that satisfies the vesting requirements and distribution limitations of § 401(k)(2)(B) and (C)) for the excluded employee. In determining the amount of corrective contributions (both for the elective deferral and for the matching contribution), for administrative convenience, in lieu of using actual plan compensation of $23,500 for the period the employee was excluded, the employee's annual plan compensation is pro rated for the eight-month period that the employee was excluded from participating in the plan. The failure to provide the excluded employee the right to make elective deferrals is corrected by the employer making a corrective contribution on behalf of the employee that is equal to $720 (the 3% ADP percentage for nonhighly compensated employees multiplied by $24,000, which is 8/12ths of the employee's 1996 plan compensation of $36,000), adjusted for earnings. In addition, to correct for the failure to receive the plan's matching contribution, a corrective contribution is made on behalf of the employee that is equal to $432 (the 1.8% ACP for the nonhighly compensated group multiplied by $24,000, which is 8/12ths of the employee's 1996 plan compensation of $36,000), adjusted for earnings. Employer C determines that $682, the sum of the actual matching contribution received by the employee for the plan year ($250) and the corrective contribution to correct the matching contribution failure ($432), does not exceed $720, the maximum matching contribution available to the employee under the plan (2% of $36,000) determined as if the employee had made the maximum matchable contributions. In addition to correcting the failure to include the eligible employee in the plan, Employer C reruns the ADP and ACP tests for 1996 (taking into account the corrective contribution and plan compensation for 1996 for the excluded employee) and determines that the tests were satisfied.

Example 6: The facts are the same as in Example 5, except that the plan provides for matching contributions that are equal to 100% of an eligible employee's elective deferrals that do not exceed 2% of the employee's plan compensation for the plan year. Accordingly, the actual matching contribution made by Employer C for the excluded employee for the last four months of 1996 is $500 (which is equal to 100% of the $500 of elective deferrals made by the employee for the last four months of 1996).

Correction: The correction is the same as in Example 5, except that the corrective contribution made for the first 8 months of 1996 to correct the failure to make matching contributions is equal to $220 (adjusted for earnings), instead of the $432 (adjusted for earnings) in Example 5, because the corrective contribution is limited to the maximum matching contributions available under the plan for the employee for the plan year, $720 (2% of $36,000), reduced by the actual matching contributions made for the employee for the plan year, $500.

Example 7: The facts are the same as in Example 5, except that the error is discovered in March of 1996 and the employee was given the opportunity to make elective deferrals beginning on April 1, 1996. The amount of elective deferrals that the employee was given the opportunity to make during 1996 was not less than the maximum elective deferrals that the employee could have made if the employee had been given the opportunity to make elective deferrals beginning on January 1, 1996. The employee made elective deferrals equal to 4% of the employee's plan compensation for each payroll period from April 1, 1996 through December 31, 1996 of $28,000 (resulting in elective deferrals of $1,120). Employer C made a matching contribution equal to $560, which is 2% of the employee's plan compensation for each payroll period from April 1, 1996 through December 31, 1996 ($28,000). The employee's plan compensation for 1996 was $36,000 ($8,000 for the first three months and $28,000 for the last nine months).

Correction: Employer C uses the SVP correction method for partial year exclusions to correct the failure to include an eligible employee in the plan. Because the employee was given an opportunity to make elective deferrals to the plan for at least the last 9 months of the plan year (and the amount of the elective deferrals that the employee had the opportunity to make was not less than the maximum elective deferrals that the employee could have made if the employee had been given the opportunity to make elective deferrals beginning on January 1, 1996), under the special rule set forth in section 2.02(1)(a)(ii)(E), Employer C is not required to make a corrective contribution for the failure to allow the employee to make elective deferrals. In determining the amount of corrective contribution with respect to the failure to allow the employee to receive matching contributions, in lieu of using actual plan compensation of $8,000 for the period the employee was excluded, the employee's annual plan compensation is pro rated for the three-month period that the employee was excluded from participating in the plan. Accordingly, a corrective contribution is made on behalf of the employee that is equal to $160, which is the lesser of (i) $162 (a matching contribution of 1.8% of $9,000, which is 3/12ths of the employee's 1996 plan compensation of $36,000), and (ii) $160 (the excess of the maximum matching contribution for the entire plan year, which is equal to 2% of $36,000, or $720, over the matching contributions made after March 31, 1996, $560). The contribution is adjusted for earnings.

(2) Exclusion of Eligible Employees In a Profit-Sharing Plan.

(a) Correction Methods. (i) SVP Correction Method. Appendix A, section .05 sets forth the SVP correction method for correcting the exclusion of an eligible employee. In the case of a defined contribution plan, the SVP correction method is to make a contribution on behalf of the excluded employee. Section 2.02(2)(a)(ii) below clarifies the SVP correction method in the case of a profit-sharing or stock bonus plan that provides for nonelective contributions (within the meaning of § 1.401(k)–1(g)(10)).

(ii) Clarification of SVP Correction Method for Profit-Sharing Plans. To correct for the exclusion of an eligible employee from nonelective contributions in a profit-sharing or stock bonus plan under the SVP correction method, an allocation amount is determined for each excluded employee on the same basis as the allocation amounts were determined for the other employees under the plan's allocation formula (e.g., the same ratio of allocation to compensation), taking into account all of the employee's relevant factors (e.g., compensation) under that formula for that year. The employer makes a corrective contribution on behalf of the excluded employee that is equal to the allocation amount for the excluded employee. The corrective contribution is adjusted for earnings. If, as a result of excluding an employee, an amount was improperly allocated to the account balance of an eligible employee who shared in the original allocation of the nonelective contribution, no reduction is made to the account balance of the employee who shared in the original allocation on account of the improper allocation. (See Example 8.)

(iii) Reallocation Correction Method. (A) In General. Subject to the limitations set forth in section 2.02(2)(a)(iii)(F) below, in addition to the SVP correction method, the exclusion of an eligible employee for a plan year from a profit-sharing or stock bonus plan that provides for nonelective contributions may be corrected using the reallocation correction method set forth in this section 2.02(2)(a)(iii). Under the reallocation correction method, the account balance of the excluded employee is increased as provided in paragraph (2)(a)(iii)(B) below, the account balances of other employees are reduced as provided in paragraph (2)(a)(iii)(C) below, and the increases and reductions are reconciled, as necessary, as provided in paragraph (2)(a)(iii)(D) below. (See Examples 9 and 10.)

(B) Increase in Account Balance of Excluded Employee. The account balance of the excluded employee is increased by an amount that is equal to the allocation the employee would have received had the employee shared in the allocation of the nonelective contribution. The amount is adjusted for earnings.

(C) Reduction in Account Balances of Other Employees. (*1*) The account balance of each employee who was an eligible employee who shared in the original allocation of the nonelective contribution is reduced by the excess, if any, of (I) the employee's allocation of that contribution over (II) the amount that would have been allocated to that employee had the failure not occurred. This amount is adjusted for earnings taking into account the rules set forth in section 2.02(2)(a)(iii)(C)(*2*) and (*3*) below. The amount after adjustment for earnings is limited in accordance with section 2.02(2)(a)(iii)(C)(*4*) below.

(*2*) This paragraph (2)(a)(iii)(C)(*2*) applies if most of the employees with account balances that are being reduced are nonhighly compensated employees. If there has been an overall gain for the period from the date of the original allocation of the contribution through the date of correction, no adjustment for earnings is required to the amount determined under section 2.02(2)(a)(iii)(C)(*1*) for the employee. If the amount for the employee is being adjusted for earnings and the plan permits investment of account balances in more than one investment fund, for administrative convenience, the reduction to the employee's account balance may be adjusted by the lowest earnings rate of any fund for the period from the date of the original allocation of the contribution through the date of correction.

(*3*) If an employee's account balance is reduced and the original allocation was made to more than one investment fund or there was a subsequent distribution or transfer from the fund receiving the original allocation, then reasonable, consistent assumptions are used to determine the earnings adjustment.

(*4*) The amount determined in section 2.02(2)(a)(iii)(C)(*1*) for an employee after the application of section 2.02(2)(a)(iii)(C)(*2*) and (*3*) may not exceed the account balance of the employee on the date of correction, and the employee is permitted to retain any distribution made prior to the date of correction.

(D) Reconciliation of Increases and Reductions. If the aggregate amount of the increases under section 2.02(2)(a)(iii)(B) exceeds the aggregate amount of the reductions under section 2.02(2)(a)(iii)(C), the employer makes a corrective contribution to the plan for the amount of the excess. If the aggregate amount of the reductions under section 2.02(2)(a)(iii)(C) exceeds the aggregate amount of the increases under section 2.02(2)(a)(iii)(B), then the amount by which each employee's account balance is reduced under section 2.02(2)(a)(iii)(C) is decreased on a pro rata basis.

(E) Reductions Among Multiple Investment Funds. If an employee's account balance is reduced and the employee's account balance is invested in more than one investment fund, then the reduction may be made from the investment funds selected in any reasonable manner.

(F) Limitations on Use of Reallocation Correction Method. If any employee would be permitted to retain any distribution pursuant to section 2.02(2)(a)(iii)(C)(*4*), then the reallocation correction method may not be used unless most of the employees who would be permitted to retain a distribution are nonhighly compensated employees.

(b) Examples.

Example 8: Employer D maintains a profit-sharing plan that provides for discretionary nonelective employer contributions. The plan provides that the employer's contributions are allocated to account balances in the ratio that each eligible employee's compensation for the plan year bears to the compensation of all eligible employees for the plan year and, therefore, the only relevant factor for determining an allocation is the employee's compensation. The plan provides for self-directed investments among four investment funds and daily valuations of account balances. For the 1997 plan year, Employer D made a contribution to the plan of a fixed dollar amount. However, five employees who met the eligibility requirements were inadvertently excluded from participating in the plan. The contribution resulted in an allocation on behalf of each of the eligible employees, other than the excluded employees, equal to 10% of compensation. Most of the employees who received allocations under the plan for the year of the failure were nonhighly compensated employees. No distributions have been made from the plan since 1997. If the five excluded employees had shared in the original allocation, the allocation made on behalf of each employee would have equaled 9% of compensation. The excluded employees began participating in the plan in the 1998 plan year.

Correction: Employer D uses the SVP correction method to correct the failure to include the five eligible employees. Thus, Employer D makes a corrective contribution to the plan. The amount of the corrective contribution on behalf of the five excluded employees for the 1997 plan year is equal to 10% of compensation of each excluded employee, the same allocation that was made for other eligible employees, adjusted for earnings. The excluded employees receive an allocation equal to 10% of compensation (adjusted for earnings) even though, had the excluded employees originally shared in the allocation for the 1997 contribution, their account balances, as well as those of the other eligible employees, would have received an allocation equal to only 9% of compensation.

Example 9: The facts are the same as in Example 8.

Correction: Employer D uses the reallocation correction method to correct the failure to include the five eligible employees. Thus, the account balances are adjusted to reflect what would have resulted from the correct allocation of the employer contribution for the 1997 plan year among all eligible employees, including the five excluded employees. The inclusion of the excluded employees in the allocation of that contribution would have resulted in each eligible employee, including each excluded employee, receiving an allocation equal to 9% of compensation. Accordingly, the account balance of each excluded employee is increased by 9% of the employee's 1997 compensation, adjusted for earnings. The account balance of each of the eligible employees other than the excluded employees is reduced by 1% of the employee's 1997 compensation, adjusted for earnings. Employer D determines the adjustment for earnings using the earnings rate of each eligible employee's excess allocation (using reasonable, consistent assumptions). Accordingly, for an employee who shared in the original allocation and directed the investment of the allocation into more than one investment fund or who subsequently transferred a portion of a fund that had been credited with a portion of the 1997 allocation to another fund, reasonable, consistent assumptions are followed to determine the adjustment for earnings. It is determined that the total of the initially determined reductions in account balances exceeds the total of the required increases in account balances. Accordingly, these initially determined reductions are decreased pro rata so that the total of the actual reductions in account balances equals the total of the increases in the account balances, and Employer D does not make any corrective contribution. The reduction from the account balances are made on a pro rata basis among all of the funds in which each employee's account balance is invested.

Example 10: The facts are the same as in Example 8.

Correction: The correction is the same as in Example 9, except that, because most of the employees whose account balances are being reduced are nonhighly compensated employees, for administrative convenience, Employer D uses the earnings rate of the fund with the lowest earnings rate for the period of the failure to adjust the reduction to each account balance. It is determined that the aggregate amount (adjusted for earnings) by which the account balances of the excluded employees is increased exceeds the aggregate amount (adjusted for earnings) by which the other employees' account balances are reduced. Accordingly, Employer D makes a contribution to the plan in an amount equal to the excess. The reduction from account balances is made on a pro rata basis among all of the funds in which each employee's account balance is invested.

.03 *Vesting Failures*.

(1) Correction Methods. (a) Contribution Correction Method. A failure in a defined contribution plan to apply the proper vesting percentage to an employee's account balance that results in forfeiture of too large a portion of the employee's account balance may be corrected using the contribution correction method set forth in this paragraph. The employer makes a corrective contribution on behalf of the employee whose account balance was improperly forfeited in an amount equal to the improper forfeiture. The corrective contribution is adjusted for earnings. If, as a result of the improper forfeiture, an amount was improperly allocated to the account balance of another employee, no reduction is made to the account balance of that employee. (See Example 11.)

(b) Reallocation Correction Method. In addition to the contribution correction method, in a defined contribution plan under which forfeitures of account balances are reallocated among the account balances of the other eligible employees in the plan, a failure to apply the proper vesting percentage to an employee's account balance which results in forfeiture of too large a portion of the employee's account balance may be corrected under the reallocation correction method set forth in this paragraph. A corrective reallocation is made in accordance with the reallocation correction method set forth in section 2.02(2)(a)(iii), subject to the limitations set forth in section 2.02(2)(a)(iii)(F). In applying section 2.02(2)(a)(iii)(B), the account balance of the employee who incurred the improper forfeiture is increased by an amount equal to the amount of the improper forfeiture and the amount is adjusted for earnings. In applying section 2.02(2)(a)(iii)(C)(*1*), the account balance of each employee who shared in the allocation of the improper forfeiture is reduced by the amount of the improper forfeiture that was allocated to that employee's account. The earnings adjustments for the account balances that are being reduced are determined in accordance with sections 2.02(2)(a)(iii)(C)(*2*) and (*3*) and the reductions after adjustments for earnings are limited in accordance with section 2.02(2)(a)(iii)(C)(*4*). In accordance with section 2.02(2)(a)(iii)(D), if the aggregate amount of the increases exceeds the aggregate amount of the reductions, the employer makes a corrective contribution to the plan for the amount of the excess. In accordance with section 2.02(2)(a)(iii)(D), if the aggregate amount of the reductions exceeds the aggregate amount of the increases, then the amount by which each employee's account balance is reduced is decreased on a pro rata basis. (See Example 12.)

(2) Examples.

Example 11: Employer E maintains a profit-sharing plan that provides for nonelective contributions. The plan provides for self-directed investments among four investment funds and daily valuation of account balances. The plan provides that forfeitures of account balances are reallocated among the account balances of other eligible employees on the basis of compensation. During the 1997 plan year, Employee R terminated employment with Employer E and elected and received a single-sum distribution of the vested portion of his account balance. No other distributions have been made since 1997. However, an incorrect determination of Employee R's vested percentage was made resulting in Employee R receiving a distribution of less than the amount to which he was entitled under the plan. The remaining portion of Employee R's account balance was forfeited and reallocated (and these reallocations were not affected by the limitations of § 415). Most of the employees who received allocations of the improper forfeiture were nonhighly compensated employees.

Correction: Employer E uses the contribution correction method to correct the improper forfeiture. Thus, Employer E makes a contribution on behalf of Employee R equal to the incorrectly forfeited amount (adjusted for earnings) and Employee R's account balance is increased accordingly. No reduction is made from the account balances of the employees who received an allocation of the improper forfeiture.

Example 12: The facts are the same as in Example 11.

Correction: Employer E uses the reallocation correction method to correct the improper forfeiture. Thus, Employee R's account balance is increased by the amount that was improperly forfeited (adjusted for earnings). The account of each employee who shared in the allocation of the improper forfeiture is reduced by the amount of the improper forfeiture that was allocated to that employee's account (adjusted for earnings). Because most of the employees whose account balances are being reduced are nonhighly compensated employees, for administrative convenience, Employer E uses the earnings rate of the fund with the lowest earnings rate for the period of the failure to adjust the reduction to each account balance. It is determined that the amount (adjusted for earnings) by which the account balance of Employee R is increased exceeds the aggregate amount (adjusted for earnings) by which the other employees' account balances are reduced. Accordingly, Employer E makes a contribution to the plan in an amount equal to the excess. The reduction from the account balances is made on a pro rata basis among all of the funds in which each employee's account balance is invested.

.04 *§ 415 Failures*.

(1) Failures Relating to a § 415(b) Excess.

(a) Correction Methods. (i) Return of Overpayment Correction Method. Overpayments as a result of amounts being paid in excess of the limits of § 415(b) may be corrected using the return of overpayment correction method set forth in this paragraph (1)(a)(i). The employer takes reasonable steps to have the Overpayment (with appropriate interest) returned by the recipient to the plan and reduces future benefit payments (if any) due to the employee to reflect § 415(b). To the extent the amount returned by the recipient is less than the Overpayment, adjusted for earnings at the plan's earnings rate, then the employer or another person contributes the difference to the plan. In addition, in accordance with section 6.02(4)(a), the employer must notify the recipient that the Overpayment was not eligible for favorable tax treatment accorded to distributions from qualified plans (and, specifically, was not eligible for tax-free rollover). (See Examples 15 and 16.)

(ii) Adjustment of Future Payments Correction Method. (A) In General. In addition to the return of overpayment correction method, in the case of plan benefits that are being distributed in the form of periodic payments, Overpayments as a result of amounts being paid in excess of the limits in § 415(b) may be corrected by using the adjustment of future payments correction method set forth in this paragraph (1)(a)(ii). Future payments to the recipient are reduced so that they do not exceed the § 415(b) maximum limit and an additional reduction is made to recoup the Overpayment (over a period not longer than the remaining payment period) so that the actuarial present value of the additional reduction is equal to the Overpayment plus interest at the interest rate used by the plan to determine actuarial equivalence. (See Examples 13 and 14.)

(B) Joint and Survivor Annuity Payments. If the employee is receiving payments in the form of a joint and survivor annuity, with the employee's spouse to receive a life annuity upon the employee's death equal to a percentage (e.g., 75%) of the amount being paid to the employee, the reduction of future annuity payments to reflect § 415(b) reduces the amount of benefits payable during the lives of both the employee and spouse, but any reduction to recoup Overpayments made to the employee does not reduce the amount of the spouse's survivor benefit. Thus, the spouse's benefit will be based on the previous specified percentage (e.g., 75%) of the maximum permitted under § 415(b), instead of the reduced annual periodic amount payable to the employee.

(C) Overpayment Not Treated as an Excess Amount. An Overpayment corrected under this adjustment of future payment correction method, is not treated as an Excess Amount as defined in section 5.01(3).

(b) Examples.

Example 13: Employer F maintains a defined benefit plan funded solely through employer contributions. The plan provides that the benefits of employees are limited to the maximum amount permitted under § 415(b), disregarding cost-of-living adjustments under § 415(d) after benefit payments have commenced. At the beginning of the 1998 plan year, Employee S retired and started receiving an annual straight life annuity of $140,000 from the plan. Due to an administrative error, the annual amount received by Employee S for 1998 included an Overpayment of $10,000 (because the § 415(b)(1)(A) limit for 1998 was $130,000). This error was discovered at the beginning of 1999.

Correction: Employer F uses the adjustment of future payments correction method to correct the failure to satisfy the limit in § 415(b). Future annuity benefit payments to Employee S are reduced so that they do not exceed the § 415(b) maximum limit, and, in addition, Employee S's future benefit payments from the plan are actuarially reduced to recoup the Overpayment. Accordingly, Employee S's future benefit payments from the plan are reduced to $130,000 and further reduced by $1,000 annually for life, beginning in 1999. The annual benefit amount is reduced by $1,000 annually for life because, for Employee S, the actuarial present value of a benefit of $1,000 annually for life commencing in 1999 is equal to the sum of $10,000 and interest at the rate used by the plan to determine actuarial equivalence beginning with the date of the first Overpayment and ending with the date the reduced annuity payment begins. Thus, Employee S's remaining benefit payments are reduced so that Employee S receives $129,000 for 1999, and for each year thereafter.

Example 14: The facts are the same as in Example 13.

Correction: Employer F uses the adjustments of future payments correction method to correct the § 415(b) failure, by recouping the entire excess payment made in 1998 from Employee S's remaining benefit payments for 1999. Thus, Employee S's annual annuity benefit for 1999 is reduced to $119,400 to reflect the excess benefit amounts (increased by interest) that were paid from the plan to Employee S during the 1998 plan year. Beginning in 2000, Employee S begins to receive annual benefit payments of $130,000.

Example 15: The facts are the same as in Example 13, except that the benefit was paid to Employee S in the form of a single-sum distribution in 1998, which exceeded the maximum § 415(b) limits by $110,000.

Correction: Employer F uses the return of overpayment correction method to correct the § 415 (b) failure. Thus, Employer F notifies Employee S of the $110,000 Overpayment and that the Overpayment was not eligible for favorable tax treatment accorded to distributions from qualified plans (and, specifically, was not eligible for tax-free rollover). The notice also informs Employee S that the Overpayment (with interest at the rate used by the plan to calculate the single-sum payment) is owed to the plan. Employer F takes reasonable steps to have the Overpayment (with interest at the rate used by the plan to calculate the single-sum payment) paid to the plan. Employee S pays the $110,000 (plus the requested interest) to the plan. It is determined that the plan's earnings rate for the relevant period was 2 percentage points more than the rate used by the plan to calculate the single-sum payment. Accordingly, Employer F contributes the difference to the plan.

Example 16: The facts are the same as in Example 15.

Correction: Employer F uses the return of overpayment correction method to correct the § 415(b) failure. Thus, Employer F notifies Employee S of the $110,000 Overpayment and that the Overpayment was not eligible for favorable tax treatment accorded to distributions from qualified plans (and, specifically, was not eligible for tax-free rollover). The notice also informs Employee S that the Overpayment (with interest at the rate used by the plan to calculate the single-sum payment) is owed to the plan. Employer F takes reasonable steps to have the Overpayment (with interest at the rate used by the plan to calculate the single-sum payment) paid to the plan. As a result of Employer F's recovery efforts, some, but not all, of the Overpayment (with interest) is recovered from Employee S. It is determined that the amount returned by Employee S to the plan is less than the Overpayment adjusted for earnings at the plan's earnings rate. Accordingly, Employer F contributes the difference to the plan.

(2) Failures Relating to a § 415(c) Excess.

(a) Correction Methods. (i) SVP Correction Method. Appendix A, section .08 sets forth the SVP correction method for correcting the failure to satisfy the § 415(c) limits on annual additions.

(ii) Forfeiture Correction Method. In addition to the SVP correction method, the failure to satisfy § 415(c) with respect to a nonhighly compensated employee (A) who in the limitation year of the failure had annual additions consisting of both (I) either elective deferrals or employee after-tax contributions or both and (II) either matching or nonelective contributions or both, (B) for whom the matching and nonelective contributions equal or exceed the portion of the employee's annual addition that exceeds the limits under § 415(c) ("§

415(c) excess") for the limitation year, and (C) who has terminated with no vested interest in the matching and nonelective contributions (and has not been reemployed at the time of the correction), may be corrected by using the forfeiture correction method set forth in this paragraph. The § 415(c) excess is deemed to consist solely of the matching and nonelective contributions. If the employee's § 415(c) excess (adjusted for earnings) has previously been forfeited, the § 415(c) failure is deemed to be corrected. If the § 415(c) excess (adjusted for earnings) has not been forfeited, that amount is placed in an unallocated account, similar to the suspense account described in § 1.415–6(b)(6)(iii), to be used to reduce employer contributions in succeeding year(s) (or if the amount would have been allocated to other employees who were in the plan for the year of the failure if the failure had not occurred, then that amount is reallocated to the other employees in accordance with the plan's allocation formula). Note that while this correction method will permit more favorable tax treatment of elective deferrals for the employee than the SVP correction method, this correction method could be less favorable to the employee in certain cases, for example, if the employee is subsequently reemployed and becomes vested. (See Examples 17 and 18.)

(iii) Return of Overpayment Correction Method. A failure to satisfy § 415(c) that includes a distribution of the § 415(c) excess attributable to nonelective contributions and matching contributions may be corrected using the return of overpayment correction method set forth in this paragraph. The employer takes reasonable steps to have the Overpayment (i.e., the distribution of the § 415(c) excess adjusted for earnings to the date of the distribution), plus appropriate interest from the date of the distribution to the date of the repayment, returned by the employee to the plan. To the extent the amount returned by the employee is less than the Overpayment adjusted for earnings at the plan's earnings rate, then the employer or another person contributes the difference to the plan. The Overpayment, adjusted for earnings at the plan's earnings rate to the date of the repayment, is to be placed in an unallocated account, similar to the suspense account described in § 1.415–6(b)(6)(iii), to be used to reduce employer contributions in succeeding year(s) (or if the amount would have been allocated to other eligible employees who were in the plan for the year of the failure if the failure had not occurred, then that amount is reallocated to the other eligible employees in accordance with the plan's allocation formula). In addition, the employer must notify the employee that the Overpayment was not eligible for favorable tax treatment accorded to distributions from qualified plans (and, specifically, was not eligible for tax-free rollover).

(b) Examples.

Example 17: Employer G maintains a 401(k) plan. The plan provides for nonelective employer contributions, elective deferrals, and employee after-tax contributions. The plan provides that the nonelective contributions vest under a 5-year cliff vesting schedule. The plan provides that when an employee terminates employment, the employee's nonvested account balance is forfeited five years after a distribution of the employee's vested account balance and that forfeitures are used to reduce employer contributions. For the 1998 limitation year, the annual additions made on behalf of two nonhighly compensated employees in the plan, Employees T and U, exceeded the limit in § 415(c). For the 1998 limitation year, Employee T had § 415 compensation of $60,000, and, accordingly, a § 415(c)(1)(B) limit of $15,000. Employee T made elective deferrals and employee after-tax contributions. For the 1998 limitation year, Employee U had § 415 compensation of $40,000, and, accordingly, a § 415(c)(1)(B) limit of $10,000. Employee U made elective deferrals. Also, on January 1, 1999, Employee U, who had three years of service with Employer G, terminated his employment and received his entire vested account balance (which consisted of his elective deferrals). The annual additions for Employees T and U consisted of:

	T	U
Nonelective Contributions	$7,500	$4,500
Elective Deferrals	10,000	5,800
After-tax Contributions	500	0
Total Contributions	$18,000	$10,300
§ 415(c) Limit	$15,000	$10,000
§ 415(c) Excess	$3,000	$300

Correction: Employer G uses the SVP correction method to correct the § 415(c) excess with respect to Employee T (i.e., $3,000). Thus, a distribution of plan assets (and corresponding reduction of the account balance) consisting of $500 (adjusted for earnings) of employee after-tax contributions and $2,500 (adjusted for earnings) of elective deferrals is made to Employee T. Employer G uses the forfeiture correction method to correct the § 415(c) excess with respect to Employee U. Thus, the § 415(c) excess is deemed to consist solely of the nonelective contributions. Accordingly, Employee U's nonvested account balance is reduced by $300 (adjusted for earnings) which is placed in an unallocated account, similar to the suspense account described in § 1.415–6(b)(6)(iii), to be used to reduce employer contributions in succeeding year(s). After correction, it is determined that the ADP and ACP tests for 1998 were satisfied.

Example 18: Employer H maintains a 401(k) plan. The plan provides for nonelective employer contributions, matching contributions and elective deferrals. The plan provides for matching contributions that are equal to 100% of an employee's elective deferrals that do not exceed 8% of the employee's plan compensation for the plan year. For the 1998 limitation year, Employee V had § 415 compensation of $50,000, and, accordingly, a § 415(c)(1)(B) limit of $12,500. During that limitation year, the annual additions for Employee V totaled $15,000, consisting of $5,000 in elective deferrals, a $4,000 matching contribution (8% of $50,000), and a $6,000 nonelective employer contribution. Thus, the annual additions for Employee V exceeded the § 415(c) limit by $2,500.

Correction: Employer H uses the SVP correction method to correct the § 415(c) excess with respect to Employee V (i.e., $2,500). Accordingly, $1,000 of the unmatched elective deferrals (adjusted for earnings) are distributed to Employee V. The remaining $1,500 excess is apportioned equally between the elective deferrals and the associated matching employer contributions, so Employee V's account balance is further reduced by distributing to Employee V $750 (adjusted for earnings) of the elective deferrals and forfeiting $750 (adjusted for earnings) of the associated employer matching contributions. The forfeited matching contributions are placed in an unallocated account, similar to the suspense account described in § 1.415–6(b)(6)(iii), to be used to reduce employer contributions in succeeding year(s). After correction, it is determined that the ADP and ACP tests for 1998 were satisfied.

.05 *Correction of Other Overpayment Failures.*

An Overpayment, other than one described in section 2.04(1) (relating to a § 415(b) excess) or section 2.04(2) (relating to a § 415(c) excess), may be corrected in accordance with this section 2.05. An Overpayment from a defined benefit plan is corrected in accordance with the rules in section 2.04(1). An Overpayment from a defined contribution plan is corrected in accordance with the rules in section 2.04(2)(a)(iii).

.06 *§ 401(a)(17) Failures.*

(1) Reduction of Account Balance Correction Method. The allocation of contributions or forfeitures under a defined contribution plan for a plan year on the basis of compensation in excess of the limit under § 401(a)(17) for the plan year may be corrected using the reduction of account balance correction method set forth in this paragraph. The account balance of an employee who received an allocation on the basis of compensation in excess of the § 401(a)(17) limit is reduced by this improperly allocated amount (adjusted for earnings). If the improperly allocated amount would have been allocated to other employees in the year of the failure if the failure had not occurred, then that amount (adjusted for earnings) is reallocated to those employees in accordance with the plan's allocation formula. If the improperly allocated amount would not have been allocated to other employees absent the failure, that amount (adjusted for earnings) is placed in an unallocated account, similar to the suspense account described in § 1.415–6(b)(6)(iii), to be used to reduce employer contributions in succeeding year(s). For example, if a plan provides for a fixed level of employer contributions for each eligible employee, and the plan provides that forfeitures are used to reduce future employer contributions, the improperly allocated amount (adjusted for earnings) would be used to reduce future employer contributions. (See Example 19.) If a payment was made to an employee and that payment was attributable to an improperly allocated amount, then it is an Overpayment defined in section 2.05(2) that must be corrected (see section 2.05(1)).

(2) Example.

Example 19: Employer J maintains a money purchase pension plan. Under the plan, an eligible employee is entitled to an employer contribution of 8% of the employee's compensation up to the § 401(a)(17) limit ($160,000 for 1998). During the 1998 plan year, an eligible employee, Employee W, inadvertently was credited with a contribution based on compensation above the § 401(a)(17) limit. Employee W's compensation for 1998 was $220,000. Employee W received a contribution of $17,600 for 1998 (8% of $220,000), rather than the contribution of $12,800 (8% of $160,000) provided by the plan for that year, resulting in an improper allocation of $4,800.

Correction: The § 401(a)(17) failure is corrected using the reduction of account balance method by reducing Employee W's account balance by $4,800 (adjusted for earnings) and crediting that amount to an unallocated account, similar to the suspense account described in § 1.415–6(b)(6)(iii), to be used to reduce employer contributions in succeeding year(s).

.07 *Correction by Amendment Under Walk-in CAP.*

(1) § 401(a)(17) Failures. (a) Contribution Correction Method. In addition to the reduction of account balance correction method under section 2.06 of this Appendix B, an employer may correct a § 401(a)(17) failure for a plan year under a defined contribution plan under the Walk-in Closing Agreement Program ("Walk-in CAP") (in accordance with the requirements of section 11) by using the contribution correction method set forth in this paragraph. The employer contributes an additional amount on behalf of each of the other employees (excluding each employee for whom there was a § 401(a)(17) failure) who received an allocation for the year of the failure, amending the plan (as necessary) to provide for the additional allocation. The amount contributed for an employee is equal to the employee's plan compensation for the year of the failure multiplied by a fraction, the numerator of which is the improperly allocated amount made on behalf of the employee with the largest improperly allocated amount, and the denominator of which is the limit under § 401(a)(17) applicable to the year of the failure. The resulting additional amount for each of the other employees is adjusted for earnings. (See Example 20.)

(b) Examples.

Example 20: The facts are the same as in Example 19.

Correction: Employer J corrects the failure under Walk-in CAP using the contribution correction method by (1) amending the plan to increase the contribution percentage for all eligible employees (other than Employee W) for the 1998 plan year and (2) contributing an additional amount (adjusted for earnings) for those employees for that plan year. To determine the increase in the plan's contribution percentage (and the additional amount contributed on behalf of each eligible employee), the improperly allocated amount ($4,800) is divided by the § 401(a)(17) limit for 1998 ($160,000). Accordingly, the plan is amended to increase the contribution percentage by 3 percentage points ($4,800/$160,000) from 8% to 11%. In addition, each eligible employee for the 1998 plan year (other than Employee W) receives an additional contribution of 3% multiplied by that employee's plan compensation for 1998. This additional contribution is adjusted for earnings.

(2) Hardship Distribution Failures. (a) Plan Amendment Correction Method. The Operational Failure of making hardship distributions to employees under a plan that does not provide for hardship distributions may be corrected under Walk-in CAP (in accordance with the requirements of section 11) using the plan amendment correction method set forth in this paragraph. The plan is amended retroactively to provide for the hardship distributions that were made available. This paragraph does not apply unless (i) the amendment satisfies § 401(a), and (ii) the plan as amended would have satisfied the qualification requirements of § 401(a)(including the requirements applicable to hardship distributions under § 401(k), if applicable) had the amendment been adopted when hardship distributions were first made available. (See Example 21.)

(b) Example.

Example 21: Employer K, a for-profit corporation, maintains a 401(k) plan. Although plan provisions in 1998 did not provide for hardship distributions, beginning in 1998 hardship distributions of amounts allowed to be distributed under § 401(k) were made currently and effectively available to all employees (within the meaning of § l.401(a)(4)–4). The standard used to determine hardship satisfied the deemed hardship distribution standards in § 1.401(k)–1(d)(2). Hardship distributions were made to a number of employees during the 1998 and 1999 plan years, creating an Operational Failure. The failure was discovered in 2000.

Correction: Employer K corrects the failure through Walk-in CAP by adopting a plan amendment, effective January 1, 1998, to provide a hardship distribution option that satisfies the rules applicable to hardship distributions in § 1.401(k)–1(d)(2). The amendment provides that the hardship distribution option is available to all employees. Thus, the amendment satisfies § 401(a), and the plan as amended in 2000 would have satisfied § 401(a) (including § 1.401(a)(4)–4 and the requirements applicable to hardship distributions under § 401(k)) if the amendment had been adopted in 1998.

SECTION 3. EARNINGS ADJUSTMENT METHODS AND EXAMPLES

.01 *Earnings Adjustment Methods*. (1) In general. (a) Under section 6.02(5)(a), whenever the appropriate correction method for an Operational Failure in a defined contribution plan includes a corrective contribution or allocation that increases one or more employees' account balances (now or in the future), the contribution or allocation is adjusted for earnings and forfeitures. This section 3 provides earnings adjustment methods (but not forfeiture adjustment methods) that may be used by an employer to adjust a corrective contribution or allocation for earnings in a defined contribution plan. Consequently, these earnings adjustment methods may be used to determine the earnings adjustments for corrective contributions or allocations made under the correction methods in section 2 and under the SVP correction methods in Appendix A. If an earnings adjustment method in this section 3 is used to adjust a corrective contribution or allocation, that adjustment is treated as satisfying the earnings adjustment requirement of section 6.02(5)(a). Other earnings adjustment methods, different from those illustrated in this section 3, may also be appropriate for adjusting corrective contributions or allocations to reflect earnings.

(b) Under the earnings adjustment methods of this section 3, a corrective contribution or allocation that increases an employee's account balance is adjusted to reflect an "earnings amount" that is based on the earnings rate(s) (determined under section 3.01(3)) for the period of the failure (determined under section 3.01(2)). The earnings amount is allocated in accordance with section 3.01(4).

(c) The rule in section 6.02(6)(a) permitting reasonable estimates in certain circumstances applies for purposes of this section 3. For this purpose, a determination of earnings made in accordance with the rules of administrative convenience set forth in this section 3 is treated as a precise determination of earnings. Thus, if the probable difference between an approximate determination of earnings and a determination of earnings under this section 3 is insignificant and the administrative cost of a precise determination would significantly exceed the probable difference, reasonable estimates may be used in calculating the appropriate earnings.

(d) This section 3 does not apply to corrective distributions or corrective reductions in account balances. Thus, for example, while this section 3 applies in increasing the account balance of an improperly excluded employee to correct the exclusion of the employee under the reallocation correction method described in section 2.02(2)(a)(iii)(B), this section 3 does not apply in reducing the account balances of other employees under the reallocation correction method. (See section 2.02(2)(a)(iii)(C) for rules that apply to the earnings adjustments for such reductions.) In addition, this section 3 does not apply in determining earnings adjustments under the one-to-one correction method described in section 2.01(1)(b)(iii).

(2) Period of the Failure. (a) General Rule. For purposes of this section 3, the "period of the failure" is the period from the date that the failure began through the date of correction. For example, in the case of an improper forfeiture of an employee's account balance, the beginning of the period of the failure is the date as of which the account balance was improperly reduced.

(b) Rules for Beginning Date for Exclusion of Eligible Employees from Plan. (i) General Rule. In the case of an exclusion of an eligible employee from a plan contribution, the beginning of the period of the failure is the date on which contributions of the same type (e.g., elective deferrals, matching contributions, or discretionary nonelective employer contributions) were made for other employees for the year of the failure. In the case of an exclusion of an eligible employee from an allocation of a forfeiture, the beginning of the period of the failure is the date on which forfeitures were allocated to other employees for the year of the failure.

(ii) Exclusion from a 401(k) or (m) Plan. For administrative convenience, for purposes of calculating the earnings rate for corrective contributions for a plan year (or the portion of the plan year) during which an employee was improperly excluded from making periodic elective deferrals or employee after-tax contributions, or from receiving periodic matching contributions, the employer may treat the date on which the contributions would have been made as the midpoint of the plan year (or the midpoint of the portion of the plan year) for which the failure occurred. Alternatively, in this case, the employer may treat the date on which the contributions would have been made as the first date of the plan year (or the portion of the plan year) during which an employee was excluded, provided that the earnings rate used is one half of the earnings rate applicable under section 3.01(3) for the plan year (or the portion of the plan year) for which the failure occurred.

(3) Earnings Rate. (a) General Rule. For purposes of this section 3, the earnings rate generally is based on the investment results that would have applied to the corrective contribution or allocation if the failure had not occurred.

(b) Multiple Investment Funds. If a plan permits employees to direct the investment of account balances into more than one investment fund, the earnings rate is based on the rate applicable to the employee's investment choices for the period of the failure. In accordance with section 6.02(5)(a), for administrative convenience, if most of the employees for whom the corrective contribution or allocation is made are nonhighly compensated employees, the rate of return of the fund with the highest earnings rate under the plan for the period of the failure may be used to determine the earnings rate for all corrective contributions or allocations. If the employee had not made any applicable investment choices, the earnings rate may be based on the earnings rate under the plan as a whole (i.e., the average of the rates earned by all of the funds in the valuation periods during the period of the failure weighted by the portion of the plan assets invested in the various funds during the period of the failure).

(c) Other Simplifying Assumptions. For administrative convenience, the earnings rate applicable to the corrective contribution or allocation for a valuation period with respect to any investment fund may be assumed to be the actual earnings rate for the plan's investments in that fund during that valuation period. For example, the earnings rate may be determined without regard to any special investment provisions that vary according to the size of the fund. Further, the earnings rate applicable to the corrective contribution or allocation for a portion of a valuation period may be a pro rata portion of the earnings rate for the entire valuation period, unless the application of this rule would result in either a significant understatement or overstatement of the actual earnings during that portion of the valuation period.

(4) Allocation Methods. (a) In General. For purposes of this section 3, the earnings amount generally may be allocated in accordance with any of the methods set forth in this paragraph (4). The methods under paragraph (4)(c), (d), and (e) are intended to be particularly helpful where corrective contributions are made at dates between the plan's valuation dates.

(b) Plan Allocation Method. Under the plan allocation method, the earnings amount is allocated to account balances under the plan in accordance with the plan's method for allocating earnings as if the failure had not occurred. (See Example 22.)

(c) Specific Employee Allocation Method. Under the specific employee allocation method, the entire earnings amount is allocated solely to the account balance of the employee on whose behalf the corrective contribution or allocation is made (regardless of whether the plan's allocation method would have allocated the earnings solely to that employee). In determining the allocation of plan earnings for the valuation period during which the corrective contribution or allocation is made, the corrective contribution or allocation (including the earnings amount) is treated in the same manner as any other contribution under the plan on behalf of the employee during that valuation period. Alternatively, where the plan's allocation method does not allocate plan earnings for a valuation period to a contribution made during that valuation period, plan earnings for the valuation period during which the corrective contribution or allocation is made may be allocated as if that employee's account balance had been increased as of the last day of the prior valuation period by the corrective contribution or allocation, including only that portion of the earnings amount attributable to earnings through the last day of the prior valuation period. The employee's account balance is then further increased as of the last day of the valuation period during which the corrective contribution or allocation is made by that portion of the earnings amount attributable to earnings after the last day of the prior valuation period. (See Example 23.)

(d) Bifurcated Allocation Method. Under the bifurcated allocation method, the entire earnings amount for the valuation periods ending before the date the corrective contribution or allocation is made is allocated solely to the account balance of the employee on whose behalf the corrective contribution or allocation is made. The earnings amount for the valuation period during which the corrective contribution or allocation is made is allocated in accordance with the plan's method for allocating other earnings for that valuation period in accordance with section 3.01(4)(b). (See Example 24.)

(e) Current Period Allocation Method. Under the current period allocation method, the portion of the earnings amount attributable to the valuation period during which the period of the failure begins ("first partial valuation period") is allocated in the same manner as earnings for the valuation period during which the corrective contribution or allocation is made in accordance section 3.01(4)(b). The earnings for the subsequent full valuation periods ending before the beginning of the valuation period during which the corrective contribution or allocation is made are allocated solely to the employee for whom the required contribution should have been made. The earnings amount for the valuation period during which the corrective contribution or allocation is made ("second partial valuation period") is allocated in accordance with the plan's method for allocating other earnings for that valuation period in accordance with section 3.01(4)(b). (See Example 25.)

.02 Examples.

Example 22: Employer L maintains a profit-sharing plan that provides only for nonelective contributions. The plan has a single investment fund. Under the plan, assets are valued annually (the last day of the plan year) and earnings for the year are allocated in proportion to account balances as of the last day of the prior year, after reduction for distributions during the current year but without regard to contributions received during the current year (the "prior year account balance"). Plan contributions for 1997 were made on March 31, 1998. On April 20, 2000 Employer L determines that an operational failure occurred for 1997 because Employee X was improperly excluded from the plan. Employer L decides to correct the failure by using the SVP correction method for the exclusion of an eligible employee from nonelective contributions in a profit-sharing plan. Under this method, Employer L determines that this failure is corrected by making a contribution on behalf of Employee X of $5,000 (adjusted for earnings). The earnings rate under the plan for 1998 was +20%. The earnings rate under the plan for 1999 was +10%. On May 15, 2000, when Employer L determines that a contribution to correct for the failure will be made on June 1, 2000, a reasonable estimate of the earnings rate under the plan from January 1, 2000 to June 1, 2000 is +12%.

Earnings Adjustment on the Corrective Contribution:

The $5,000 corrective contribution on behalf of Employee X is adjusted to reflect an earnings amount based on the earnings rates for the period of the failure (March 31, 1998 through June 1, 2000) and the earnings amount is allocated using the plan allocation method. Employer L determines that a pro rata simplifying assumption may be used to determine the earnings rate for the period from March 31, 1998 to December 31, 1998, because that rate does not significantly understate or overstate the actual earnings for that period. Accordingly, Employer L determines that the earnings rate for that period is 15% (9/12 of the plan's 20% earnings rate for the year). Thus, applicable earnings rates under the plan during the period of the failure are:

Time Periods	Earnings Rate
3/31/98 - 12/31/98 (First Partial Valuation Period)	+15%
1/1/99 - 12/31/99	+10%
1/1/00 - 6/1/00 (Second Partial Valuation Period)	+12%

If the $5,000 corrective contribution had been contributed for Employee X on March 31, 1998, (1) earnings for 1998 would have been increased by the amount of the earnings on the additional $5,000 contribution from March 31, 1998 through December 31, 1998 and would have been allocated as 1998 earnings in proportion to the prior year (December 31, 1997) account balances, (2) Employee X's account balance as of December 31, 1998 would have been increased by the additional $5,000 contribution, (3) earnings for 1999 would have been increased by the 1999 earnings on the additional $5,000 contribution (including 1998 earnings thereon) allocated in proportion to the prior year (December 31, 1998) account balances along with other 1999 earnings, and (4) earnings for 2000 would have been increased by the earnings on the additional $5,000 (including 1998 and 1999 earnings thereon) from January 1 to June 1, 2000 and would be allocated in proportion to the prior year (December 31, 1999) account balances along with other 2000 earnings. Accordingly, the $5,000 corrective contribution is adjusted to reflect an earnings amount of $2,084 ($5,000[(1.15)(1.10)(1.12)–1]) and the earnings amount is allocated to the account balances under the plan allocation method as follows:

(a) Each account balance that shared in the allocation of earnings for 1998 is increased, as of December 31, 1998, by its appropriate share of the earnings amount for 1998, $750 ($5,000(.15)).

(b) Employee X's account balance is increased, as of December 31, 1998, by $5,000.

(c) The resulting December 31, 1998 account balances will share in the 1999 earnings, including the $575 for 1999 earnings included in the corrective contribution ($5,750(.10)), to determine the account balances as of December 31, 1999. However, each account balance other than Employee X's account balance has already shared in the 1999 earnings, excluding the $575. Accordingly, Employee X's account balance as of December 31, 1999 will include $500 of the 1999 portion of the earnings amount based on the $5,000 corrective contribution allocated to Employee X's account balance as of December 31, 1998 ($5,000(.10)). Then each account balance that originally shared in the allocation of earnings for 1999 (i.e., excluding the $5,500 additions to Employee X's account balance) is increased by its appropriate share of the remaining 1999 portion of the earnings amount, $75.

(d) The resulting December 31, 1999 account balances (including the $5,500 additions to Employee X's account balance) will share in the 2000 portion of the earnings amount based on the estimated January 1, 2000 to June 1, 2000 earnings included in the corrective contribution equal to $759 ($6,325(.12)). (See Table 1.)

TABLE 1

CALCULATION AND ALLOCATION OF THE

CORRECTIVE AMOUNT ADJUSTED FOR EARNINGS

	Earnings Rate	Amount	Allocated to:
Corrective Contribution		$5,000	Employee X
First Partial Valuation Period Earnings	15%	750[1]	All 12/31/1997 Account Balances[4]
1999 Earnings	10%	575[2]	Employee X ($500)/ All 12/31/1998 Account Balances ($75)[4]
Second Partial Period Earnings	12%	759[3]	All 12/31/1999 Account Valuation Balances(including Employee X's $5,500)[4]
Total Amount Contributed		$7,084	

[1]$5,000 x 15%

[2]$5,750($5,000 +750) x 10%

[3]$6,325($5,000 +750 +575) x 12%

[4] After reduction for distributions during the year for which earning are being determined but without regard to contributions received during the year for which earnings are being determined.

Example 23: The facts are the same as in Example 22.

Earnings Adjustment on the Corrective Contribution: The earnings amount on the corrective contribution is the same as in Example 22, but the earnings amount is allocated using the specific employee allocation method. Thus, the entire earnings amount for all periods through June 1, 2000 (i.e., $750 for March 31, 1998 to December 31, 1998, $575 for 1999, and $759 for January 1, 2000 to June 1, 2000) is allocated to Employee X. Accordingly, Employer L makes a contribution on June 1, 2000 to the plan of $7,084 ($5,000(1.15)(1.10)(1.12)). Employee X's account balance as of December 31, 2000 is increased by $7,084. Alternatively, Employee X's account balance as of December 31, 1999 is increased by $6,325 ($5,000(1.15)(1.10)), which shares in the allocation of earnings for 2000, and Employee X's account balance as of December 31, 2000 is increased by the remaining $759. (See Table 2.)

TABLE 2

CALCULATION AND ALLOCATION OF THE
ADJUSTED CORRECTIVE AMOUNT FOR EARNINGS

	Earnings Rate	Amount	Allocated to:
Corrective Contribution		$5,000	Employee X
First Partial Valuation Period Earnings	15%	750[1]	Employee X
1999 Earnings	10%	575[2]	Employee X
Second Partial Valuation Period Earnings	12%	759[3]	Employee X
Total Amount Contributed		$7,084	

[1]$5,000 x 15%
[2]$5,750($5,000 +750) x 10%
[3]$6,325($5,000 +750 +575) x 12%

Example 24: The facts are the same as in Example 22.

Earnings Adjustment on the Corrective Contribution:

The earnings amount on the corrective contribution is the same as in Example 22, but the earnings amount is allocated using the bifurcated allocation method. Thus, the earnings for the first partial valuation period (March 31, 1998 to December 31, 1998) and the earnings for 1999 are allocated to Employee X. Accordingly, Employer L makes a contribution on June 1, 2000 to the plan of $7,084 ($5,000(1.15)(1.10)(1.12)). Employee X's account balance as of December 31, 1999 is increased by $6,325 ($5,000(1.15)(1.10)); and the December 31, 1999 account balances of employees (including Employee X's increased account balance) will share in estimated January 1, 2000 to June 1, 2000 earnings on the corrective contribution equal to $759 ($6,325(.12)). (See Table 3.)

TABLE 3

CALCULATION AND ALLOCATION OF THE
CORRECTIVE AMOUNT ADJUSTED FOR EARNINGS

	Earnings Rate	Amount	Allocated to:
Corrective Contribution		$5,000	Employee X
First Partial Valuation Period Earnings	15%	750[1]	Employee X
1999 Earnings	10%	575[2]	Employee X
Second Partial Valuation Period Earnings	12%	759[3]	12/31/99 Account Balances (including Employee X's $6,325)[4]
Total Amount Contributed		$7,084	

[1]$5,000 x 15%
[2]$5,750($5,000 +750) x 10%
[3]$6,325($5,000 +750 +575) x 12%
[4] After reduction for distributions during the 2000 year but without regard to contributions received during the 2000 year

Example 25: The facts are the same as in Example 22.

Earnings Adjustment on the Corrective Contribution:

The earnings amount on the corrective contribution is the same as in Example 22, but the earnings amount is allocated using the current period allocation method. Thus, the earnings for the first partial valuation period (March 31, 1998 to December 31, 1998) are allocated as 2000 earnings. Accordingly, Employer L makes a contribution on June 1, 2000 to the plan of $7,084 ($5,000 (1.15)(1.10)(1.12)). Employee X's account balance as of December 31, 1999 is increased by the sum of $5,500 ($5,000(1.10)) and the remaining 1999 earnings on the corrective contribution equal to $75 ($5,000(.15)(.10)). Further, both (1) the estimated March 31, 1998 to December 31, 1998 earnings on the corrective contribution equal to $750 ($5,000(.15)) and (2) the estimated January 1, 2000 to June 1, 2000 earnings on the corrective contribution equal to $759 ($6,325(.12)) are treated in the same manner as 2000 earnings by allocating these amounts to the December 31, 2000 account balances of employees in proportion to account balances as of December 31, 1999 (including Employee X's increased account balance). (See Table 4.) Thus, Employee X is allocated the earnings for the full valuation period during the period of the failure.

TABLE 4

CALCULATION AND ALLOCATION OF THE

CORRECTIVE AMOUNT ADJUSTED FOR EARNINGS

	Earnings Rate	Amount	Allocated to:
Corrective Contribution		$5,000	Employee X
First Partial Valuation Period Earnings	15%	750[1]	12/31/99 Account Balances (including Employee X's $5,575)[4]
1999 Earnings	10%	575[2]	Employee X
Second Partial Valuation Period Earnings	12%	759[3]	12/31/99 Account Balances (including Employee X's $5,575)[4]
Total Amount Contributed		$7,084	

[1] $5,000 x 15%

[2] $5,750($5,000 +750) x 10%

[3] $6,325($5,000 +750 +575) x 12%

[4] After reduction for distributions during the year for which earnings are being determined but without regard to contributions received during the year for which earnings are being determined.

APPENDIX C

VCR/SVP/WALK-IN CAP/TVC CHECKLIST
IS YOUR SUBMISSION COMPLETE?

INSTRUCTIONS

The Service will be able to respond more quickly to your VCR, SVP, Walk-in CAP or TVC request if it is carefully prepared and complete. To ensure that your request is in order, use this checklist. Answer each question in the checklist by inserting yes, no, or N/A, as appropriate, in the blank next to the item. **Sign and date the checklist (as taxpayer or authorized representative) and place it on top of your request.**

You must submit a completed copy of this checklist with your request. If a completed checklist is not submitted with your request, substantive consideration of your submission will be deferred until a completed checklist is received.

TAXPAYER'S NAME ____

TAXPAYER'S I.D. NO. ____

PLAN NAME & NO. ____

ATTORNEY/P.O.A. ____

The following items relate to all submissions:

______ 1. Have you included a complete description of the failure(s) and the years in which the failure(s) occurred (including the years for which the statutory period has expired)? **(See section 12.03(1) of Rev. Proc. 2000–16.) (Hereafter, all section references are to Rev. Proc. 2000–16.)**

______ 2. Have you included an explanation of how and why the failure(s) arose, including a description of the administrative procedures for the plan in effect at the time the failure(s) occurred? **(See section 12.03(2) and (3).)**

______ 3. Have you included a detailed description of the method for correcting the failure(s) identified in your submission? This description must include, for example, the number of employees affected and the expected cost of correction (both of which may be approximated if the exact number cannot be determined at the time of the request), the years involved, and calculations or assumptions the Plan Sponsor used to determine the amounts needed for correction. In lieu of providing correction calculations with respect to each employee affected by a failure, you may submit calculations with respect to a representative sample of affected employees. However, the representative sample calculations must be sufficient to demonstrate each aspect of the correction method proposed. Note that each step of the correction method must be described in narrative form. **(See section 12.03(4).)**

______ 4. Have you described the earnings or interest methodology (indicating computation period and basis for determining earnings or interest rates) that will be used to calculate earnings or interest on any corrective contributions or distributions? (As a general rule, the interest rate (or rates) earned by the plan during the applicable period(s) should be used in determining the earnings for corrective contributions or distributions.) **(See section 12.03(5).)**

If you inserted "N/A" for item 4, enter explanation:

____

____

____

______ 5. Have you submitted specific calculations for each affected employee or a representative sample of affected employees? **(See section 12.03(6).)**

______ 6. Have you described the method that will be used to locate and notify former employees or, if there are no former employees affected by the failure(s), provided an affirmative statement to that effect? **(See section 12.03(7).)**

______ 7. Have you provided a description of the administrative measures that have been or will be implemented to ensure that the same failure(s) do not recur? **(See section 12.03(8).)**

______ 8. Have you included a statement that, to the best of the Plan Sponsor's knowledge, the plan is not currently under an Employee Plans examination? **(See section 12.03(9).)**

______ 9. Have you included a statement that, to the best of the Plan Sponsor's knowledge, the Plan Sponsor is not under an Exempt Organizations examination? **(See section 12.03(9).)**

______ 10. If the plan is currently being considered in a determination letter application on a Form 5310, have you included a statement to that effect? **(See section 12.03(10).)**

______ 11. Have you included a copy of the portions of the plan document (and adoption agreement, if applicable) relevant to the failure(s) and method(s) of correction? **(See section 12.04(3).)**

______ 12. Have you included a copy of the plan's most recent Favorable Letter and/or the required applicable document(s)? **(See section 12.04(4).)**

______ 13. Have you included the appropriate voluntary compliance or correction fee? **(See section 12.05.)**

______ 14. Have you included the original signature of the sponsor or the sponsor's representative? **(See section 12.06.)**

______ 15. Have you included a Power of Attorney (Form 2848)? Note: (representation under the VCR/SVP, Walk-in CAP and TVC is limited to attorneys, certified public accountants, enrolled agents, and enrolled actuaries; unenrolled return preparers are not eligible to act as representatives under the VCR or TVC program). **(See section 12.07.)**

______ 16. Have you included a Penalty of Perjury Statement signed (original signature only) and dated by the Plan Sponsor? **(See section 12.08.)**

______ 17. Have you designated your submission as a VCR, SVP, Walk-in CAP, or TVC submission, as appropriate? **(See section 12.10.)**

The following items relate only to submissions under VCR (including SVP):

______ 18. Have you included a copy of the first page, the page containing employee census information (currently line 7f of the 1998 Form 5500), and the information relating to plan assets (currently line 31f of the 1998 Form 5500) of the most recently filed Form 5500 series return? Note: If a Form 5500 is not applicable, insert N/A and furnish the name of the plan, and the census information required of Form 5500 series filers. **(See section 12.04(1).)**

______ 19. Have you proposed a time period of correction that is limited to 150 days from the date the compliance statement is issued? **(See section 10.13.)**

The following items relate only to submissions under SVP:

______ 20. Have you included a statement identifying your request as an SVP request? **(See section 12.03(11).)**

______ 21. Are each of the failures you have identified eligible for correction under SVP? **(See Appendix A and Appendix B.)**

______ 22. Have you identified no more than two SVP failures? (If more than two failures were identified, SVP is not available, but you may make a submission under VCR.) **(See section 10.11(3).)**

______ 23. Have you proposed to correct the failure(s) identified in your request using the permitted correction method(s) set forth in Appendix A or Appendix B? **(See Appendix A and Appendix B.)**

The following item relates only to submissions under Walk-in CAP:

______ 24. Have you included a copy of the most recently filed Form 5500? **(See section 12.04(1).)**

______ 25. Have you submitted an application for a determination letter? **(See section 11.01(4).)**

____

Signature **Date**

____

Title or Authority

____

Typed or printed name of person signing checklist

26 CFR 601.201: Rulings and determination letters. (Also Part I, Sections 401, 403 and 501; 1.401–1, 1.403(a)–1, 1.501(a)–1.)

Rev. Proc. 2000–20

Table of Contents

SECTION 1. PURPOSE

.01 This revenue procedure revises and combines the Service's master and prototype (M&P) and regional prototype plan programs into a unified program for the pre-approval of pension, profit-sharing, and annuity plans. This revenue procedure opens this unified program, on April 7, 2000, for mass submitter plans and May 8, 2000, for non-mass submitter plans, to allow sponsors to obtain opinion letters relating to the qualification of their plans which take into account all of the changes in the qualification requirements made by the following:

1 The Uruguay Round Agreements Act, Pub. L. 103–465 (GATT);

2 The Small Business Job Protection Act of 1996, Pub. L. 104–188 (SBJPA) (including § 414(u) of the Internal Revenue Code (Code) and the Uniformed Services Employment and Reemployment Rights Act of 1994, Pub. L. 103–353 (USERRA));

3 The Taxpayer Relief Act of 1997, Pub. L. 105–34 (TRA '97); and

4 The Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. 105–206 (RRA).

These acts are hereinafter referred to collectively as GUST.

.02 This revenue procedure also opens the Service's volume submitter program on March 8, 2000, to allow practitioners to obtain GUST advisory letters for their volume submitter specimen plans.

.03 At the present time, employers may not obtain determination letters that consider all of the requirements of GUST. However, the Service expects to allow employers to obtain complete GUST letters in the near future.

SECTION 2. BACKGROUND AND GENERAL INFORMATION

.01 Rev. Proc. 89–9, 1989–1 C.B. 780, as modified by Rev. Proc. 90–21, 1990–1 C.B. 499, Rev. Proc. 91–66, 1991–2 C.B. 870, Rev. Proc. 92–41, 1992–21 I.R.B. 23, Rev. Proc. 93–9, 1993–1 C.B. 474, Rev. Proc. 93–10, 1993–1 C.B. 476, Rev. Proc. 93–12, 1993–1 C.B. 479, Rev. Proc. 94–13, 1994–1 C.B. 566, and Rev. Proc. 95–12, 1995–1 C.B. 508, sets forth the procedures of the Service on the issuance of opinion letters regarding the acceptability of the form of M&P plans.

.02 Rev. Proc. 89–13, 1989–1 C.B. 801, as modified by Rev. Proc. 90–21, Rev. Proc. 91–66, Rev. Proc. 92–41, Rev. Proc. 93–9, Rev. Proc. 93–10, Rev. Proc. 93–12, Rev. Proc. 94–13, Rev. Proc. 95–12, and Rev. Proc. 95–42, 1995–2 C.B. 411, sets forth the procedures of the Service on the issuance of notification letters regarding the acceptability of the form of regional prototype plans.

.03 Rev. Proc. 93–10 modified both Rev. Proc. 89–9 and Rev. Proc. 89–13 to provide for nonstandardized safe harbor plans.

.04 Rev. Proc. 97–41, 1997–2 C.B. 489, as modified by Rev. Proc. 98–14, 1998–4 I.R.B. 22, and Rev. Proc. 99–23, 1999–16 I.R.B. 5, provided a remedial amendment period under § 401(b) for amending plans for certain changes in the plan qualification requirements made by GUST. The GUST remedial amendment period ends on the last day of the first plan year beginning on or after January 1, 2000.

.05 Rev. Proc. 98–14, as modified by Rev. Proc. 98–53, 1998–53 I.R.B. 9, allowed employers, sponsors of M&P and regional prototype plans, and volume submitter practitioners to apply for determination, opinion, notification, and advisory letters that take into account most of the recent changes in law affecting plan qualification, but excluding changes under SBJPA that are effective after 1998 (that is, the safe harbors in § 401(k)(12) and § 401(m)(11) for satisfying the nondiscrimination requirements of §§ 401(k) and 401(m), and the repeal of the combined plan limitations under § 415(e)).

.06 Announcement 99–50, 1999–19 I.R.B. 1, announced that the Service was temporarily discontinuing acceptance of applications for opinion and notification letters for M&P and regional prototype plans until further notice.

.07 Rev. Proc. 2000–6, 2000–1 I.R.B. 187, contains the Service's general procedures for employee plan determination letter requests and requests for advisory letters for volume submitter specimen plans.

.08 Rev. Proc. 2000–8, 2000–1 I.R.B. 230, contains the Service's procedures regarding the payment of user fees for determination letter and similar requests.

SECTION 3. OVERVIEW OF THE REVENUE PROCEDURE

.01 In General - The Service believes that it is no longer necessary or practical for it to maintain separate prototype plan approval programs for the institutional sponsoring organizations, such as banks and insurance companies, that were eligible to sponsor M&P plans under Rev. Proc. 89–9, and the practitioner sponsors that were eligible to sponsor regional prototype plans under Rev. Proc. 89–13. Therefore, this revenue procedure revises and combines Rev. Proc. 89–9, Rev. Proc. 89–13, and Rev. Proc. 93–10 to establish a unified program that will be available to both institutional and practitioner sponsors that seek approval of master or prototype plans. Under this unified procedure, sponsors may request opinion letters that take into account all the requirements of GUST, including the requirements of SBJPA that are effective in plan years beginning on or after January 1, 1999.

.02 Organization of Revenue Procedure - This revenue procedure generally is patterned after and follows the organization of Rev. Proc. 89–9.

.03 Modifications to Rev. Proc. 89–9 and Rev. Proc. 89–13 Incorporated – Since Rev. Proc. 89–9 and Rev. Proc. 89–13 were published, they have been modified several times. Among the significant modifications were changes to the requirements for standardized plans that were needed to reflect the regulations under §§ 401(a)(4) and 410(b). In general, this revenue procedure incorporates these modifications.

.04 Unified Program - Under Rev. Proc. 89–9 and Rev. Proc. 89–13, different requirements applied to M&P plans and regional prototype plans. Under the unified program in this revenue procedure, one set of requirements and procedures will apply to all sponsors. In general, this revenue procedure provides that any options that were available to sponsors or employers under either Rev. Proc. 89–9 or Rev. Proc. 89–13 will now be available to all sponsors or employers under the new program. For example, under Rev. Proc. 89–9, M&P plan sponsors were allowed to sponsor paired defined benefit and defined contribution plans, while under Rev. Proc. 89–13, regional prototype plan sponsors could sponsor paired defined contribution plans but not defined benefit plans that were paired with a defined contribution plan. Under this revenue procedure, all sponsors may sponsor paired defined benefit and defined contribution plans.

.05 Retention of M&P Terminology - Because sponsors will continue to be eligible to sponsor both master plans and prototype plans, plans that may be sponsored under this revenue procedure are referred to as M&P plans. Where appropriate, references in this revenue procedure to M&P plans include plans that were regional prototype plans under Rev. Proc. 89–13. Likewise, where appropriate, references in this revenue procedure to opinion letters include notification letters that were issued under Rev. Proc. 89–13.

.06 New Sponsor Definition - Under Rev. Proc. 89–9, sponsoring organization was defined to include banks, insurance companies, and certain other institutions or associations. Rev. Proc. 89–9, as modified by Rev. Proc. 90–21, also included restrictions and additional requirements regarding the types of M&P plans that could be sponsored by trade or professional associations. Under Rev. Proc. 89–13, sponsor was defined as any person with an established place of business in the United States which could establish that at least 30 employers would adopt its approved regional prototype plan. In general, this revenue procedure defines sponsor using the definition in Rev. Proc. 89–13. Any person that would be eligible to sponsor a plan under Rev. Proc. 89–9 or Rev. Proc. 89–13 will be eligible to sponsor plans under this revenue procedure, provided at least 30 employers are reasonably expected to adopt a basic plan document of the sponsor within the 12-month period following its approval. In addition, any person with an established place of business in the United States may sponsor an M&P plan as a word-for-word identical adopter or minor modifier adopter of an M&P plan of a mass submitter, regardless of the number of employers that are expected to adopt the plan. As a result of this new sponsor definition, the restrictions and additional requirements that formerly applied to M&P plans sponsored by trade or professional associations have been eliminated.

.07 Sponsor Responsibilities - This revenue procedure provides that by filing an application for an opinion letter, or by having an application filed on its behalf by a mass submitter, a sponsor agrees to comply with the requirements that apply to sponsors under the procedure. For example, under this procedure, sponsors must make reasonable and diligent efforts to ensure that adopting employers amend their plans when necessary. Failure to comply with these requirements may result in the loss of eligibility to sponsor M&P plans and the revocation of opinion letters that have been issued to the sponsor. This revenue procedure simplifies the record keeping requirements that applied to regional prototype plan sponsors under Rev. Proc. 89–13 and applies these simplified requirements to all sponsors. Under this revenue procedure, every sponsor will be required to maintain or have maintained on its behalf, and to provide to the Service when requested, a list of the employers that have adopted its plan, but sponsors will not have to provide the annual notices that were required by Rev. Proc. 89–13. Finally, this revenue procedure provides that in cases where a sponsor reasonably concludes that an employer's M&P plan may no longer be a qualified plan and the sponsor does not or cannot submit a request to correct the qualification failure under the Service's Employee Plans Compliance Resolution System (EPCRS), it is incumbent on the sponsor to notify the employer that the plan may no longer be qualified, advise the employer that adverse tax consequences may result from loss of the plan's qualified status, and inform the employer about the availability of EPCRS.

.08 New Mass Submitter Definition - Both Rev. Proc. 89–9 and Rev. Proc. 89–13 provided procedures for simplified processing and expedited approval of mass submitter plans. Under Rev. Proc. 89–9, a mass submitter was defined as any person that submitted applications on behalf of at least 10 sponsoring organizations that were adopting the identical plan. Under Rev. Proc. 89–13, a mass submitter was defined as any person that could establish that at least 50 unaffiliated sponsors would adopt the identical plan.

In general, this revenue procedure requires that at least 30 unaffiliated adopting sponsors adopt a basic plan document of the mass submitter, but it also provides a grandfather rule so that any person that received an opinion letter as a mass submitter under Rev. Proc. 89–9 will generally qualify as a mass submitter under this revenue procedure.

.09 Changes to General M&P Plan Requirements - This revenue procedure makes several changes and clarifications to the requirements that apply to all M&P plans. Significant among these are the following:

1 Rev. Proc. 89–9 and Rev. Proc. 89–13 prohibited the issuance of opinion and notification letters for plans that contain or may contain multi-tiered benefit structures. This prohibition has been reformulated as a general requirement that the allocation or benefit formula in a nonstandardized M&P plan must satisfy the following uniformity requirements of the regulations under § 401(a)(4) pertaining to safe harbor plans. In the case of a nonstandardized defined contribution plan, the allocation formula must be a uniform allocation formula, within the meaning of § 1.401(a)(4)–2(b)(2) of the regulations, or a uniform points allocation formula, within the meaning of § 1.401(a)(4)–2(b)(3)(i)(A). In the case of a nonstandardized defined benefit plan, the benefit formula must satisfy each of the uniformity requirements of § 1.401(a)(4)–3(b)(2). In addition, each nonstandardized plan must give the employer the option to select total compensation as the compensation to be used in determining allocations or benefits and each nonstandardized defined benefit plan must automatically or by option allow the adopting employer to satisfy one of the design-based safe harbors described in § 1.401(a)(4)–3(b)(3), (4), and (5). (Of course, standardized plans and nonstandardized safe harbor plans continue to be required to satisfy design-based safe harbors described in the regulations under § 401(a)(4).) Thus, for example, an M&P plan, other than a uniform points defined contribution plan, may provide for disparity in the rates of employer contributions allocated to participants' accounts provided the plan satisfies § 401(l) in form. Exceptions to the uniformity requirements are provided for Davis-Bacon plans, plans that would fail to satisfy the requirement only because of the plans' top-heavy provisions, and plans that have continued to apply certain limitations under the Code that were repealed by GUST.

2 The procedure allows plans that include provisions designed to satisfy the safe harbor requirements of § 401(k)(12) to provide that the safe harbor matching or nonelective contribution requirement will be satisfied in another plan. However, this option is not available in standardized plans, other than paired defined contribution plans whose terms satisfy the requirements of Notice 98–52, 1998–46 I.R.B. 16, as modified by Notice 2000–3, 2000–4 I.R.B. 413.

3 The procedure clarifies the circumstances under which an adopting employer of an M&P plan must sign a new adoption agreement and provides that this requirement may be satisfied by an electronic signature.

.10 Changes to Standardized Plan Requirements and Employer Reliance - This revenue procedure makes several changes and clarifications with respect to employer reliance and to the requirements that apply to standardized plans. Significant among these are the following:

1 The procedure provides an exception from the requirement that a standardized plan benefit all nonexcludable employees of the employer. This exception will allow the employer to avail itself of the rule in § 410(b)(6)(C), relating to the minimum coverage requirements for a plan in the transition period following a merger, acquisition, or similar transaction;

2 The procedure provides that an employer may rely on an opinion letter for a standardized defined contribution plan even though the employer has maintained another defined contribution plan(s) covering some of the same participants, provided certain conditions are met; and

3 The procedure provides that an employer may rely on an opinion letter for a standardized defined contribution plan that is first effective on or after the effective date of the repeal of § 415(e) even though the employer has maintained a defined benefit plan(s) covering some of the same participants, provided the defined benefit plan(s) has been terminated prior to the effective date of the standardized defined contribution plan.

.11 Provisions Related to GUST - Several provisions in this revenue procedure relate specifically to the restatement of plans for GUST. They provide that:

1 Sponsors may submit requests for opinion letters that take into account all of the requirements of GUST beginning May 8, 2000. Prior to that time, the Service will not accept requests for opinion letters. However, mass submitters and national sponsors may request opinion letters that take into account all of the requirements of GUST beginning April 7, 2000. The Service will begin issuing advisory letters for volume submitter specimen plans which take into account all of the requirements of GUST beginning March 8, 2000;

2 In general, all M&P adoption agreements must contain elective provisions (with or without default provisions) that will allow adopting employers to conform the terms of their M&P plans to the manner in which the employers' plans were operated during the transition period between the earliest effective date under GUST and when the employers adopt their GUST-restated plans. These elective provisions may be contained in a separate "snap-off" section of the adoption agreement. The M&P plan sponsor may remove this snap-off section from the adoption agreements it provides to adopting employers that are not using the M&P plan to retroactively restate a plan for GUST;

3 In general, M&P plans must be restated for GUST and employers must sign new adoption agreements, in part so that they may conform their adoption agreement choices to the operation of their plans during the GUST transition period;

4 An M&P plan, including a standardized plan, may give an employer the option to elect to continue to apply the family aggregation rules of § 401(a)(17)(A) and § 414(q)(6) (both as in effect for plan years beginning before January 1, 1997) in plan years beginning after December 31, 1996, to the extent such election conforms to the plan's operation. Likewise, an M&P plan, including a standardized plan, may give an employer the option to elect to continue to apply the combined plan limit of § 415(e) (as in effect for limitation years beginning before January 1, 2000) in limitation years beginning after December 31, 1999, to the extent such

election conforms to the plan's operation. An M&P plan may not allow an employer to elect to continue to apply the pre-GUST family aggregation rules or the combined plan limit of § 415(e) in years beginning on or after the date the employer adopts its GUST-restated plan. An employer that makes either of these elections in a standardized plan will not be able to rely on the opinion letter without a determination letter with respect to the qualification of its plan for the years to which the election applies; and

5 An opinion letter will not be issued for an M&P plan that permits, in any plan year beginning on or after the date the employer adopts its GUST-restated plan, the use of a testing method (that is, prior year or current year) with respect to the ACP test under the plan that is different than the testing method with respect to the ADP test under the plan. This restriction does not apply with respect to plan years beginning before the date the employer adopts its GUST-restated plan.

.12 Remedial Amendment Period - This revenue procedure includes a procedure for extending the remedial amendment period for a plan so that employers will have sufficient time after the Service issues an opinion letter to adopt the approved M&P plan, provided the M&P plan is submitted for an opinion letter under this procedure by December 31, 2000. This procedure also applies to volume submitter specimen plans that are submitted by December 31, 2000, for advisory letters that take into account all of the requirements of GUST.

.13 Other Changes - This revenue procedure provides for reduced user fees for applications for advisory letters for volume submitter specimen plans in cases where at least 30 word-for-word identical specimen plans will be submitted.

SECTION 4. DEFINITIONS

.01 Master Plan - A "master plan" is a plan (including a plan covering self-employed individuals) that is made available by a sponsor (see section 4.09) for adoption by employers and for which a single funding medium (for example, a trust or custodial account) is established, as part of the plan, for the joint use of all adopting employers. A master plan consists of a basic plan document, an adoption agreement (see sections 4.03 and 4.04), and, unless included in the basic plan document, a trust or custodial account document (see section 4.05).

.02 Prototype Plan - A "prototype plan" is a plan (including a plan covering self-employed individuals) that is made available by a sponsor for adoption by employers and under which a separate funding medium is established for each adopting employer. A prototype plan consists of a basic plan document, an adoption agreement, and, unless the basic plan document incorporates a trust or custodial account agreement the provisions of which are applicable to all adopting employers, a trust or custodial account document.

.03 Basic Plan Document - A "basic plan document" is the portion of the plan containing all the non-elective provisions applicable to all adopting employers. No options (including blanks to be completed) may be provided in the basic plan document, except as provided in section 16.031 of this revenue procedure regarding flexible plans.

.04 Adoption Agreement - An "adoption agreement" is the portion of the plan containing all the options that may be selected by an adopting employer. (But see section 4.05.)

.05 Trust or Custodial Account Document (*Note: This definition does not apply if the basic plan document includes a trust or custodial account agreement the provisions of which apply to all adopting employers.*) - A "trust or custodial account document" is the portion of an M&P plan that contains the trust agreement or custodial account agreement and includes provisions covering such matters as the powers and duties of trustees, investment authority, and the kinds of investments that may be made. Except as provided in section 5.10 and below, all provisions of the trust or custodial account document must be applicable to all adopting employers and no options (including blanks to be completed) may be provided in the trust or custodial account document. With respect to prototype plans, a sponsor or mass submitter may provide up to five separate trust or custodial account documents that are intended for use with any single basic plan document. Thus, for example, several employers that adopt a sponsor's standardized M&P plan may have plans with different trust or custodial account documents. In addition, a sponsor or mass submitter may provide a trust or custodial account document, designated for use only by adopters of nonstandardized plans or nonstandardized safe harbor plans, which provides for blanks to be completed with respect to administrative provisions of the trust or custodial account agreement. Finally, an M&P plan may provide for the use of any other trust or custodial account document that has been approved by the Service for use with the plan as a qualified trust or as a custodial account treated as a qualified trust. Any trust or custodial account document (including one to be used by adopters of standardized plans) may provide for blanks to be completed that merely enable the adopting employer to specify the names of the plan, employer, trustee or custodian, plan administrator and other fiduciaries, the trust year, and the name of any pooled trust in which the plan's trust will participate.

.06 Opinion Letter - An "opinion letter" is a written statement issued by the Service to a sponsor or mass submitter under this revenue procedure (or, where appropriate in the context, to a sponsoring organization under Rev. Proc. 89–9) as to the acceptability of the form of an M&P plan and any related trust or custodial account under §§ 401(a), 403(a), and 501(a).

.07 Notification Letter - A "notification letter" is a written statement issued by the Service to a regional prototype plan sponsor or mass submitter under Rev. Proc. 89–13 as to the acceptability of the form of an M&P plan and any related trust or custodial account under §§ 401(a), 403(a), and 501(a).

.08 TRA '86 Opinion or Notification Letter - A "TRA '86 opinion or notification letter" is a favorable opinion or notification letter issued by the Service on or after January 4, 1990, under Rev. Proc. 89–9 or Rev. Proc. 89–13, which considers the effect of the Tax Reform Act of 1986, Pub. L. 99–514 (TRA '86).

.09 Sponsor - A "sponsor" is any person that (1) has an established place of business in the United States where it is accessible during every business day and (2) represents to the Service that it has at least 30 employer-clients each of which is reasonably expected to adopt the sponsor's basic plan document and one or more of the adoption agreements associated with that basic plan document within the 12-month period following the issuance of opinion letters under this revenue procedure.

A sponsor may submit any number of adoption agreements with the basic plan document provided at least 30 employers are reasonably expected to adopt the same basic plan document within the 12-month period following the issuance of opinion letters. After representing to the Service that at least 30 employers are reasonably expected to adopt a basic plan document, the sponsor may submit other basic plan documents and adoption agreements, regardless of the number of employers that are expected to adopt such other plans. The Service reserves the right at any time to request from the sponsor a list of the sponsor's clients that have adopted or are expected to adopt the sponsor's M&P plans, including the clients' business addresses and employer identification numbers.

Notwithstanding the above, any person that has an established place of business in the United States where it is accessible during every business day may sponsor a plan as a word-for-word identical adopter or minor modifier adopter of an M&P plan of a mass submitter, regardless of the number of employers that are expected to adopt such plan.

By submitting an application for an opinion letter for an M&P plan under this revenue procedure (or by having an application filed on its behalf by a mass submitter), a person represents to the Service that it is a sponsor, as defined above, and agrees to comply with the requirements imposed on sponsors by this revenue procedure. Failure to comply with these requirements may result in the loss of eligibility to sponsor M&P plans and the revocation of opinion letters that have been issued to the sponsor.

.10 Mass Submitter - A "mass submitter" is any person that (1) has an established place of business in the United States where it is accessible during every business day and (2) submits applications on behalf of at least 30 unaffiliated sponsors each of which is sponsoring, on a word-for-word identical basis, the same basic plan document and one or more of the adoption agreements associated with that basic plan document. A flexible plan (as defined in section 16.031) which is adopted by a sponsor will be considered a word-for-word identical plan. A mass submitter may submit an application on its own behalf as one of the 30 unaffiliated sponsors. For purposes of this definition, affiliation is determined under § 414(b) and (c). Additionally, the following will be considered to be affiliated: any law, accounting, consulting firm, etc., with its partners, members, associates, etc. Once the mass submitter has submitted applications on behalf of 30 unaffiliated sponsors with respect to any basic plan document, it will be treated as a mass submitter with respect to all the other basic plan documents and associated adoption agreements for which it requests opinion letters as a mass submitter under section 16.01, regardless of the number of identical adopters of such other plans.

Notwithstanding the above, any person that received a favorable TRA '86 opinion letter for a plan as a mass submitter under Rev. Proc. 89–9 will continue to be treated as a mass submitter if it submits applications on behalf of at least 10 sponsors (regardless of affiliation) each of which is sponsoring, on a word-for-word identical basis, the same basic plan document and one or more of the adoption agreements associated with that basic plan document. Once the mass submitter has submitted applications on behalf of 10 sponsors with respect to any basic plan document, it will be treated as a mass submitter with respect to all the other basic plan documents and associated adoption agreements for which it requests opinion letters as a mass submitter under section 16.01, regardless of the number of identical adopters of such other plans.

.11 National Sponsor - A "national sponsor" is a sponsor that has either (a) 30 or more adopting employers in each of 30 or more states (treating, for this purpose, the District of Columbia as a state) or (b) 3000 or more adopting employers. The determination as to whether there are 3000 or more adopting employers or 30 or more adopting employers in each of 30 or more states may be made on any one date during the 12 month period ending on the date that is 60 days after the effective date of this revenue procedure. For this purpose, an adopting employer is any employer that has adopted any plan of the sponsor that has a TRA '86 opinion or notification letter.

.12 Standardized Plan - A "standardized plan" is an M&P plan that meets the following requirements:

1 The provisions governing eligibility and participation are such that the plan by its terms must benefit all employees described in section 5.16 (regardless of whether any employer is treated as operating separate lines of business under § 414(r)) except those that may be excluded under § 410(a)(1) or (b)(3). The adoption agreement may provide options as to whether some or all of the employees described in § 410(a)(1) or (b)(3) are to be excluded, provided that the criteria for excluding employees described in § 410(a)(1) applies uniformly to all employees. A standardized plan generally may not deny an accrual or allocation to an employee eligible to participate merely because the employee is not an active employee on the last day of the plan year or has failed to complete a specified number of hours of service during the year. However, the plan may deny an allocation or accrual to an employee who is eligible to participate if the employee terminates service during the plan year with not more than 500 hours of service and is not an active employee on the last day of the plan year.

2 The eligibility requirements under the plan are not more favorable for highly compensated employees (as defined in § 414(q)) than for other employees.

3 Under the plan, allocations, in the case of a defined contribution plan (other than any cash or deferred arrangement part of the plan), or benefits, in the case of a defined benefit plan, are determined on the basis of total compensation. For this purpose, total compensation means a definition of compensation that includes all compensation within the meaning of § 415(c)(3) and excludes all other compensation or that otherwise satisfies § 414(s) under § 1.414(s)–1(c).

4 Unless the plan is a target benefit plan or a § 401(k) and\or § 401(m) plan, the plan must, by its terms, satisfy one of the design based safe harbors described in § 1.401(a)(4)–2(b)(2) (taking into account § 1.401(a)(4)–2(b)(4)) or § 1.401(a)(4)–3(b)(3), (4), or (5) (taking into account § 1.401(a)(4)–3(b)(6)). (See sections 5.18 and 8.03 for rules regarding § 401(k) and § 401(m) plans and target benefit plans.)

Notwithstanding this requirement, a standardized plan may give an employer the option to elect to continue to apply the family aggregation rules of § 401(a)(17)(A) and § 414(q)(6) (both as in effect for plan years beginning before January 1, 1997) in plan years beginning after December 31, 1996, to the extent such election conforms to the plan's operation. Likewise, a standardized plan may give an employer the option to elect to continue to apply the combined plan limit of § 415(e) (as in effect for limitation years beginning before January 1, 2000) in limitation years beginning after December 31, 1999, to the extent such election conforms to the plan's operation. However, a standardized plan may not give an employer the option to elect to continue to apply the pre-GUST family aggregation rules or the combined plan limit of § 415(e) in years beginning on or after the date the employer adopts its GUST-restated plan. In addition, a plan may not continue to apply the combined plan limit of § 415(e) to the extent such application would cause the plan to fail to satisfy § 401(a) (see Q&A 8 of Notice 99–44, 1999–35 I.R.B. 326). An employer that makes either of these elections will not be able to rely on the opinion letter without a determination letter with respect to the qualification of its plan for the years to which the election applies.

5 All benefits, rights, and features under the plan (other than those, if any, that have been prospectively eliminated) are currently available to all employees benefiting under the plan.

6 Any past service credit under the plan must meet the safe harbor in § 1.401(a)(4)–5(a)(3).

A plan will not fail to satisfy the coverage requirement of subsection .121 merely because the plan provides, either as the result of an elective provision or by default in the absence of an election to the contrary, that individuals who become employees, within the meaning of section 5.16, as the result of a "§ 410(b)(6)(C) transaction" will be excluded from eligibility to participate in the plan during the period beginning on the date of the transaction and ending on the last day of the first plan year beginning after the date of the transaction. A "§ 410(b)(6)(C) transaction" is an asset or stock acquisition, merger, or other similar transaction involving a change in the employer of the employees of a trade or business.

.13 Paired Plans - "Paired plans" are either a combination of two or more defined contribution standardized plans or a combination of one or more defined contribution standardized plans and one defined benefit standardized plan (for example, a money purchase pension plan, a profit-sharing plan and a unit benefit or flat benefit pension plan), so designed that if any single plan, or combination of plans, is adopted by an employer, each plan by itself, or the plans together, will meet the nondiscrimination rules set forth in § 401(a)(4), the contribution and benefit limitations set forth in § 415, and the top-heavy provisions set forth in § 416. Paired plans must have the same sponsor. In addition, only one of the paired plans that an employer adopts may provide for disparity in contributions or benefits that is permitted under § 401(l). If one of the paired plans is a defined benefit plan that includes a final pay limitation as described in § 401(a)(5)(D), then the paired defined contribution plan(s) may not provide for disparity in contributions.

.14 Nonstandardized Safe Harbor Plan - A "nonstandardized safe harbor plan" is an M&P plan that would be a standardized plan except that the plan:

1 is not required, by its terms, to benefit all nonexcludable employees and may, in the case of a defined contribution plan, condition allocations on employment on the last day of the plan year and/or the completion of up to 1000 hours of service during the plan year;

2 may use a § 414(s) definition of compensation for determining contributions or benefits that must be tested for nondiscrimination under § 1.414(s)–1(d); and

3 may provide past service credit that fails to meet the safe harbor in § 1.401(a)(4)–5(a)(3).

The opinion letter issued for the plan will state that the plan is a nonstandardized safe harbor plan.

.15 Nonstandardized Plan - A "nonstandardized plan" is an M&P plan that is neither a standardized plan nor a nonstandardized safe harbor plan.

.16 Volume Submitter Plan, Specimen Plan, and Advisory Letter - See section 9 of Rev. Proc. 2000–6.

SECTION 5. PROVISIONS REQUIRED IN EVERY M&P PLAN

.01 Sponsor Amendments - M&P plans must provide a procedure for sponsor amendment, so that changes in the Code, regulations, revenue rulings, other statements published by the Internal Revenue Service, or corrections of prior approved plans may be applied to all employers who have adopted the plan. Sponsors must make reasonable and dilligent efforts to ensure that adopting employers of the sponsor's M&P plan have actually received and are aware of all plan amendments and that such employers complete and sign new adoption agreements when necessary. See section 5.14. Failure to comply with this requirement may result in the loss of eligibility to sponsor M&P plans and the revocation of opinion letters that have been issued to the sponsor.

.02 Employer Amendments - An employer that amends any provision of an approved M&P plan including its adoption agreement (other than to change the choice of options, if the plan permits or contemplates such a change) or an employer that chooses to discontinue participation in a plan as amended by its sponsor and does not substitute another approved M&P plan is considered to have adopted an individually designed plan. However, this rule does not apply in the case of amendments permitted under section 5.07 and 5.11 and model amendments published by the Service which specifically provide that their adoption by an adopter of an M&P plan will not cause such plan to be treated as individually designed. An employer that amends an M&P plan because of a waiver of the minimum funding requirement under § 412(d) will also be considered to have an individually designed plan. The procedures stated in Rev. Proc. 2000–6 relating to the issuance of determination letters for individually designed plans will then apply to the plan as adopted by the employer.

.03 Uniform Allocation or Benefit Formula in Nonstandardized Plan - In general, the allocation or benefit formula in a nonstandardized M&P plan must satisfy the following uniformity requirements of the regulations under § 401(a)(4) pertaining to safe harbor plans. In the case of a nonstandardized defined contribution plan, the allocation formula must be a uniform allocation formula, within the meaning of § 1.401(a)(4)–2(b)(2), or a uniform points allocation formula, within the meaning of §

1.401(a)(4)–2(b)(3)(i)(A) (in each case taking into account § 1.401((a)(4)–2(b)(4)). In the case of a nonstandardized defined benefit plan, the benefit formula must satisfy each of the uniformity requirements of § 1.401(a)(4)–3(b)(2) (taking into account § 1.401(a)(4)–3(b)(6), except the requirement to satisfy §1.401(a)(4)–13(c)). (See sections 4.12, 4.14, and 8.03 for requirements that apply to standardized plans, nonstandardized safe harbor plans, and target benefit plans, respectively. See subsections .04 and .05 for additional requirements that apply to nonstandardized plans.) Thus, an M&P plan generally may not provide different allocation rates or different benefit formulas for different employees, such as two percent of compensation for salaried employees and one percent for hourly employees. However, an M&P plan, other than a uniform points defined contribution plan, may provide for disparity in the rates of employer contributions allocated to participants' accounts or in the rates of employer-provided benefits provided the plan satisfies § 401(l) in form. The uniformity requirements described in this paragraph do not apply to plans under which the amount of contributions or benefits is determined pursuant to requirements of the Davis-Bacon Act, 40 U.S.C. 276(a). In addition, the uniformity requirements do not apply to the extent that failure to satisfy the requirements results from the plan's top-heavy provisions or from the continued application under the plan of the pre-GUST family aggregation rules or the combined plan limit of § 415(e). However, an M&P plan may not continue to apply the pre-GUST family aggregation rules or the combined plan limit of § 415(e) in years beginning on or after the date the employer adopts its GUST-restated plan. In addition, a plan may not continue to apply the combined plan limit of § 415(e) to the extent such application would cause the plan to fail to satisfy § 401(a) (see Q&A 8 of Notice 99–44, 1999–35 I.R.B. 326).

.04 Compensation Requirements in Nonstandardized Plans - Each nonstandardized M&P plan must give the adopting employer the option to select total compensation as the compensation to be used in determining allocations or benefits. For this purpose, total compensation means a definition of compensation that includes all compensation within the meaning of § 415(c)(3) and excludes all other compensation or that otherwise satisfies § 414(s) under § 1.414(s)–1(c).

.05 Automatic or Optional Safe Harbor Provisions in Nonstandardized Defined Benefit Plans - Each nonstandardized M&P defined benefit plan must automatically or by option allow the adopting employer to satisfy one of the design-based safe harbors described in § 1.401(a)(4)–3(b)(3), (4), and (5) (taking into account § 1.401(a)(4)–3(b)(6)).

.06 Anti-Cutback Provisions - M&P plans must specifically provide for the protection provided under § 411(a)(10) and (d)(6), to the extent required, in the event that the employer amends the plan in any manner such as by revising the options selected in the adoption agreement or by adopting a new M&P plan. An M&P sponsor may not amend its plan in a manner that could result in the elimination of a benefit to the extent the benefit is required to be protected under § 411(d)(6) with respect to the plan of any adopting employer, unless permitted to do so under §§ 1.401(a)–4 and 1.411(d)–4. In addition, an M&P plan that does not contain vesting for all years which is at least as favorable to participants as that provided in § 416(b), must specifically provide that any vesting which occurs while the plan is top-heavy will not be cut back if the plan ceases to be top-heavy.

.07 Adopting Employer Modification to Satisfy §§ 415 and 416 - M&P plans must provide that the plan provisions may be amended by overriding plan language completed by the employer in the adoption agreement where such language is necessary to satisfy § 415 or 416 because of the required aggregation of multiple plans under these sections. In the event of such an amendment the adopting employer must obtain a determination letter in order to continue reliance on the plan's qualified status. Generally, a space should be provided in the adoption agreement with instructions for the employer to add such language as necessary to satisfy §§ 415 and 416. In addition, a space must be provided in the adoption agreement for the employer to specify the interest rate and mortality tables used for purposes of establishing the present value of accrued benefits in order to compute the top heavy ratio under § 416. Such a space must be included in both defined contribution plans and defined benefit plans.

.08 Defined Contribution § 415 Aggregation - Plan language must be incorporated that aggregates all defined contribution M&P plans to satisfy § 415(c) and (f). Sample language provided in the Listing of Required Modifications may be obtained by writing to the Internal Revenue Service, Employee Plans Rulings and Agreements, Washington, D.C. 20224, Attention T:EP:RA:T:ICU. Requests for sample language may also be faxed to (202) 622-6199 (not a toll-free call). As soon as possible after February 7, 2000, the sample language will also be available on the Internet at the following address: **http://www.irs.gov**. The Listing of Required Modifications can be found under "Tax Info for Business."

.09 Top-heavy Requirements - Except to the extent described in section 7.03, relating to paired plans, each plan must either provide that all the additional requirements applicable to top-heavy plans (described in § 416) apply at all times or provide that such requirements apply automatically if the plan is top-heavy regardless of how the adoption agreement is completed. In any case where the latter option is chosen, all the requirements for determining whether the plan is top-heavy must be included in the plan. (See Questions T-35 and T-36 of § 1.416-1.)

.10 Additional Top-Heavy Minimums to Satisfy § 415(e) - Each plan must provide automatically or by optional provisions, with respect to years beginning before January 1, 2000, the additional minimums described in § 416(h)(2)(A).

.11 Adopting Employer Modification of Trust or Custodial Account Document - An employer that adopts an M&P plan other than a standardized plan (or paired plans) will not be considered to have an individually designed plan merely because the employer amends administrative provisions of the trust or custodial account document (such as provisions relating to investments and the duties of trustees), provided the amended provisions are not in conflict with any other provision of the plan and do not cause the plan to fail to qualify under § 401(a). For this purpose, an amendment includes modification of the language of the trust or custodial account document and the addition of overriding language. An employer that adopts a standardized M&P plan may amend the trust or custodial account document provided such amendment merely involves the specification of the names of the plan, employer, trustee or custodian, plan administrator and other fiduciaries, the trust year, or the name of any pooled trust in which the plan's trust will participate.

.12 Effective Dates of M&P Plan Provisions Relating to GUST Changes - During the transition period between the effective dates of GUST and the date plans are amended for GUST, plans have in some cases been permitted, and in some cases required, to be operated in a manner that is inconsistent with the plans' terms but consistent with changes in the qualification requirements made by GUST. When the plans are amended for GUST, they must be amended retroactively and the retroactive amendments must conform to how the plans have been operated during the transition period. In order for a GUST-approved M&P plan to be available to be adopted by an employer to retroactively restate the employer's plan for GUST, the M&P plan must be able to accommodate whatever choices and elections have been made in the operation of the employer's plan during the transition period. For example, an employer with a § 401(k) plan may use either the current-year or the prior-year ADP testing method. During the transition period, an employer may have used the current-year method in 1997, the prior-year method in 1998, and the current-year method again in 1999 and 2000. If the employer adopts a GUST-approved M&P plan to retroactively restate the employer's plan for GUST, the terms of the M&P plan, as adopted by the employer, must reflect these specific year-by-year changes in the ADP testing method. This requirement will not be satisfied by provisions that state, for example, that they are effective as of the date that they have been made effective in operation where the actual date(s) is not specified in the plan. This requirement also will not be satisfied through incorporation by reference of documents outside the basic plan document and adoption agreement. In general, therefore, M&P adoption agreements must contain elective provisions (with or without default provisions) that will allow adopting employers to conform the terms of their M&P plans to the manner in which the employers' plans were operated during the transition period. These elective provisions may be contained in a separate "snap-off" section of the adoption agreement. The M&P plan sponsor may remove this snap-off section from the adoption agreements it provides to adopting employers that are not using the M&P plan to retroactively restate a plan for GUST.

.13 Provisions Required in Adoption Agreements Regarding Reliance - In order to avoid unnecessary confusion as to the scope of an opinion letter, sponsors must include in the adoption agreement of all M&P plans (other than standardized plans and paired plans), in close proximity to the signature blank, a statement that adopting employers may not rely on an opinion letter issued by the Service with respect to the qualification of that plan and should apply to Employee Plans Determinations for a determination letter in order to obtain reliance. Standardized plans and paired plans must also include a similar statement in the adoption agreement that the adopting employer may not rely on the opinion letter issued by the Service but must apply for a determination letter to have reliance under the circumstances described in section 6.

.14 Other Provisions Required in Adoption Agreements - Each M&P plan must contain a dated employer signature line. The employer must sign the adoption agreement when it first adopts the plan and must complete and sign a new adoption agreement if the plan has been restated. In addition, the employer must complete a new signature page if it modifies any prior elections or makes new elections in its adoption agreement. The signature requirement may be satisfied by an electronic signature that reliably authenticates and verifies the adoption of the adoption agreement, or restatement, amendment or modification thereof, by the employer. The adoption agreement must state that it is to be used with one and only one specific basic plan document. In addition, the adoption agreement must contain a cautionary statement to the effect that the failure to properly fill out the adoption agreement may result in failure of the plan to qualify. The adoption agreement must also contain a statement which provides that the sponsor will inform the adopting employer of any amendments made to the plan or of the discontinuance or abandonment of the plan.

.15 Sponsor Telephone Numbers - M&P plan adoption agreements must include the sponsor's address and telephone number (or a space for the address and telephone number of the sponsor's authorized representative) for inquiries by adopting employers regarding the adoption of the plan, the meaning of plan provisions, or the effect of the opinion letter.

.16 Definition of Employee / § 414(b), (c), (m), (n) and (o) - Each M&P plan must include a definition of employee as any employee of the employer maintaining the plan or any other employer aggregated under § 414(b), (c), (m) or (o) and the regulations thereunder. The definition of employee shall also include any individual deemed under § 414(n) (or under regulations under § 414(o)) to be an employee of any employer described in the previous sentence.

.17 Definition of Service / § 414(b), (c), (m), (n), and (o) - Each M&P plan must specifically credit all service with any employer aggregated under § 414(b), (c), (m) or (o) and the regulations thereunder as service with the employer maintaining the plan. In addition, in the case of an individual deemed under § 414(n) (or under regulations under § 414(o)) to be the employee of any employer described in the previous sentence, service with such employer must be credited to such individual.

.18 Additional Requirements for Plans That Include a CODA - An M&P plan may include a cash or deferred arrangement (CODA) only if the plan is a profit-sharing plan or a rural cooperative plan, as defined in § 401(k)(7), and the CODA is a qualified CODA, as defined in the regulations under § 401(k). In addition, the plan must satisfy the following requirements:

1 The plan may not incorporate the ADP test under § 401(k)(3) or the ACP test under § 401(m)(2) by reference;

2 The plan must use the same testing method (either current year or prior year) for both the ADP test under § 401(k)(3) and the ACP test under § 401(m)(2) in any plan year beginning on or after the date the employer adopts its GUST-restated M&P plan;

3 If the CODA provides for hardship distributions, it must adopt the safe harbor standards in the regulations under § 401(k);

4 The CODA may not be integrated with social security;

5 The plan must describe the method or methods for correcting contributions in excess of those allowed under the ADP or ACP test and for correcting multiple use of the alternative limitation (within the meaning of § 401(m)(9)), including the plan to be corrected; and

6 A plan that uses the safe harbor methods in §§ 401(k)(12) and 401(m)(11) (for plan years beginning after December 31, 1998) must satisfy the nonelective or matching contribution ("safe harbor contribution") requirement using one of the following options. First, the plan may provide that the safe harbor contributions will be made under the plan. Second, the plan may allow the employer to elect in the adoption agreement whether the safe harbor contributions will be made under the plan or under another specified defined contribution plan that satisfies the requirements of sections IX. and XI. of Notice 98–52, as modified by Notice 2000–3. However, the latter option is not available in standardized plans, other than paired defined contribution plans whose terms satisfy the requirements of sections IX. and XI. of Notice 98–52, as modified by Notice 2000–3. See section 7.04.

The requirements in 2 and 5 of this subsection .18 do not apply to a plan that does not use the ADP test under § 401(k)(3) and the ACP test under § 401(m)(2), but uses only the alternative ("SIMPLE") method of satisfying the nondiscrimination tests in §§ 401(k)(11) and 401(m)(10) (for plan years beginning after December 31, 1996) or the safe harbor methods in §§ 401(k)(12) and 401(m)(11) (for plan years beginning after December 31, 1998).

.19 Other requirements - In addition to any other substantive requirements, M&P plans must comply with the requirements of all revenue rulings, notices, legislation, and regulations, including:

1 Notice 97–45, relating to the definition of highly compensated employee under § 414(q);

2 Notice 97–75 and § 1.411(d)–4, Q&A 10, relating to the minimum distribution requirements of § 401(a)(9);

3 Notices 97–2, 98–1, 98–52, and 2000–3, Rev. Rul. 98–30, and Rev. Proc. 97–9, relating to the requirements for qualified cash or deferred arrangements under § 401(k), including SIMPLE § 401(k) plans and § 401(k) plan safe harbors;

4 Rev. Proc. 98–14 and Rev. Proc. 98–42, relating to the repeal of the family aggregation rules under former § 414(q)(6);

5 Rev. Rul. 94–76 and Rev. Proc. 96–55, relating to transfers and rollovers from money purchase pension plans to profit-sharing plans;

6 Rev. Rul. 98–1 and Notice 99–44, relating to the limitations of § 415;

7 Rev. Proc. 96–49, relating to the requirements of USERRA and § 414(u);

8 Section 1.417(e)–1(d), relating to the determination of present value and amounts of certain benefits; and

9 Notice 99–5, relating to the definition of eligible rollover distribution in § 402(c)(4) as amended by RRA.

SECTION 6. STANDARDIZED PLANS - EMPLOYER RELIANCE

.01 Reliance - An employer adopting a standardized plan or paired plans may rely on its opinion letter, except as provided in subsections .02, .03, and .04 below.

.02 Non-Reliance by Employer Maintaining More than One Plan - Except in the case of a combination of paired plans or as otherwise provided in this subsection, an employer may not rely on an opinion letter for a standardized plan, without obtaining a determination letter, if the employer maintains at any time, or has maintained at any time, another plan, including a standardized plan, that was qualified or determined to be qualified covering some of the same participants. For this purpose, a plan that has been properly replaced by the adoption of a standardized plan is not considered another plan. The plan that has been replaced and the standardized plan must be of the same type (e.g., both money purchase pension plans) in order for the employer to be able to rely on the standardized plan without obtaining a determination letter. In addition, an employer that adopts a standardized defined contribution plan will not be considered to have maintained another plan merely because the employer has maintained another defined contribution plan(s), provided such other plan(s) has been terminated prior to the effective date of the standardized plan and no annual additions have been credited to the account of any participant under such other plan(s) as of any date within a limitation year of the standardized plan. Likewise, an employer that adopts a standardized defined contribution plan that is first effective on or after the effective date of the repeal of § 415(e) will not be considered to have maintained another plan merely because the employer has maintained a defined benefit plan(s), provided the defined benefit plan(s) has been terminated prior to the effective date of the standardized defined contribution plan.

.03 Reliance by Employer Adopting a Standardized Defined Benefit Plan - An employer that has adopted a standardized defined benefit plan may rely on an opinion letter with respect to the requirements of § 401(a)(26) only if the plan satisfies the requirements of § 401(a)(26) with respect to its prior benefit structure or is deemed to satisfy § 401(a)(26) under the regulations. However, an employer may request a determination letter if the employer wishes to have reliance as to whether the plan satisfies § 401(a)(26) with respect to its prior benefit structure.

.04 No Automatic Reliance on Certain Issues - An employer that adopts a standardized plan may not rely on an opinion letter with respect to: (a) whether the timing of any amendment to the plan (or series of amendments) satisfies the nondiscrimination requirements of § 1.401(a)(4)–5(a), except with respect to plan amendments granting past service that meet the safe harbor described in § 1.401(a)(4)–5(a)(3) and are not part of a pattern of amendments that significantly discriminates in favor of highly compensated employees; or (b) whether the plan satisfies the effective availability requirement of § 1.401(a)(4)–4(c) with respect to any benefit, right, or feature. An employer that adopts a standardized plan as an amendment to a plan other than a standardized plan may not rely on an opinion letter with respect to whether a benefit, right, or feature that is prospectively eliminated satisfies the current availability requirements of § 1.401(a)–4 of the regulations. Such an employer may request a determination letter if the employer wishes to have reliance as to whether the prospectively eliminated benefit, right, or feature satisfies the current availability requirements. A standardized plan may give an employer the option to elect to continue to apply the pre-GUST family aggregation rules in years beginning after December 31, 1996, or the combined plan limit of § 415(e) in years beginning after December 31, 1999, to the extent such election(s) conforms to the plan's operation. However, an employer that elects to continue to apply the pre-GUST family aggregation rules or the combined plan limit of § 415(e) will not be able to rely on the opinion letter without a determination letter with respect to the qualification of its plan for the years to which the election applies.

.05 Effect of Termination of Paired Plan - If an employer maintains paired plans, the termination of one of the paired plans will not adversely affect the employer's ability to rely on the opinion letter with respect to the other paired plan(s).

.06 Sharing Basic Plan Document By Standardized, Nonstandardized, and Nonstandardized Safe Harbor Plans - A sponsor may establish a basic plan document that applies to a standardized plan, a nonstandardized plan, and a nonstandardized safe harbor plan. Such plans may differ only by the different adoption agreements. For example, the adoption agreement(s) for the nonstandardized plan and/or the nonstandardized safe harbor plan may have additional coverage options.

SECTION 7. ADDITIONAL REQUIREMENTS FOR PAIRED PLANS

.01 Limits of § 415(e) Must Be Provided in Defined Benefit Plan Only - For limitation years beginning before January 1, 2000, the benefits under a defined benefit plan in a combination of paired plans must be limited by the requirements of § 415(e), relating to the aggregation of defined benefit and defined contribution plans. Adjustments to satisfy the requirements of § 415(e) may only be provided in the defined benefit plan with respect to benefits thereunder.

.02 Section 416(h) Adjustment to § 415(e) Limits - For limitation years beginning before January 1, 2000, paired plans that include a defined benefit plan must compute the denominators of defined benefit and defined contribution fractions in a manner satisfying § 416(h)(1) unless the requirements of § 416(h)(2) (each as in effect for limitation years beginning before January 1, 2000) are satisfied. Paired plans providing the unreduced § 415(e) limits must provide, regardless of how the adoption agreement is completed, the additional top-heavy minimums described in § 416(h)(2)(A) and provide that the unreduced § 415(e) limits will not apply if the plan is super top-heavy as described in Question T-33 of § 1.416–1. In testing for super top-heavy, all the requirements of questions T-35 and T-36 of § 1.416–1 must be included in the plan.

.03 Coordination of Minimum Benefits and Contributions Under Top-Heavy Plans / Uniformity Requirements - Because paired plans are standardized plans that must continue to satisfy the uniform benefit or allocation formula requirements of § 1.401(a)(4)–2 and –3 when the plans are top-heavy, the plans must include provisions that comply with one of the following options:

1 each of the paired plans must provide the top-heavy minimum contribution or benefit (as applicable) without regard to whether a participant is covered under the other paired plan(s); or

2 any participant who benefits under any one of the paired plans must automatically benefit under the other paired plan(s).

If the second option is used, either each of the paired plans must provide the top-heavy minimum contribution or benefit (as applicable) or the paired plans may designate one of the plans to provide the top-heavy minimum contribution or benefit. That is, either the defined benefit plan must provide a 2% minimum benefit or the defined contribution plan must provide a 5% minimum contribution, or both plans may provide the top-heavy minimum. Also, if the second option is used and one of the paired plans has been designated to provide the top-heavy minimums, the plans must further provide that in the event the identical employees do not benefit under each paired plan, the plans will default to the first option (i.e., each plan provides the top-heavy minimum). In years beginning before January 1, 2000, if the unreduced § 415(e) limit is used, the 2% minimum benefit and the 5% minimum contribution are increased to 3% and 7 1/2%, respectively. If the paired plans designate one of the plans to provide the top-heavy minimum contribution or benefit, then, in the event of the termination of such plan, the remaining plan must provide the top-heavy minimum.

.04 Satisfaction of Safe Harbor Contribution Requirement in Paired Defined Contribution Plans that Include a § 401(k) Safe Harbor - In the case of paired defined contribution plans, if one of the plans uses the safe harbor method in § 401(k)(12) (for plan years beginning after December 31, 1998), the safe harbor contribution requirement must be satisfied using one of the following options. First, the paired plans may provide that the safe harbor contributions will be made under the plan that includes the CODA. Second, the paired plans may provide that the safe harbor contributions will be made under the other plan. However, the paired plans may provide for the latter option only if the terms of the paired plans will automatically satisfy the requirements of sections IX. and XI. of Notice 98–52, as modified by Notice 2000–3. If the paired plans provide that the safe harbor contributions will be made under the plan that does not include the CODA, then, in the event of the termination of such plan, the plan that includes the CODA must provide the safe harbor contributions.

.05 Pairing Provisions Must be in the Basic Plan Document - In the case of paired plans, all provisions necessary to coordinate the plans (other than the reliance statement required under section 5.13) must be set forth in the basic plan document and not in the adoption agreement. Paired plans may allow the employer to elect in the adoption agreement which of the two options described in subsection .03 and which of the two options described in subsection .04, if applicable, will apply to the employer's plans.

.06 Paired Plans Limited to Two Different Basic Plan Documents - While the sponsor is not limited in the number of sets of paired plans it may adopt, each set must be limited to two different basic plan documents: one for defined benefit plans and one for defined contribution plans. The pairing of defined contribution plans requires only one basic plan document such as a profit-sharing plan and a money purchase plan containing the identical basic plan document and two different adoption agreements. A sponsor may provide a pairing of defined benefit and defined contribution plans in such a manner that with two different basic plan documents and three adoption agreements, an adopting employer may adopt a profit-sharing plan, a money purchase plan, and a defined benefit plan.

SECTION 8. OPINION LETTERS - SCOPE

.01 General Limits on Opinion Letters - Opinion letters will be issued only to sponsors or mass submitters and do not constitute rulings or determinations as to either the qualification of the plans as adopted by particular employers, or, in the case of prototype plans, the exempt status of related trusts or custodial accounts.

.02 Nonapplicability of the Procedure to IRAs and SEPs - Opinion letters will not be issued under this revenue procedure for prototype plans intended to meet the requirements for individual savings programs or simplified employee pension programs under § 408 (see Rev. Proc. 87–50, 1987–2 C.B. 647, Rev. Proc. 97–29, 1997–1 C.B. 698, and Rev. Proc. 98–59, 1998–50 I.R.B. 8).

.03 Areas Not Covered by Opinion Letters - Opinion letters will not be issued for:

1 Multiemployer plans or multiple employer plans, within the meaning of § 413(b) and § 413(c) respectively;

2 Plans that have been negotiated pursuant to a collective bargaining agreement and submitted to the Service as a plan maintained pursuant to a collective bargaining agreement. This does not preclude an M&P plan from covering employees of the employer who are included in a unit covered by a collective bargaining agreement or the adoption of an M&P plan pursuant to such agreement as a single employer plan which covers only employees of the employer;

3 Stock bonus plans;

4 Employee stock ownership plans;

5 Pooled fund arrangements contemplated by Rev. Rul. 81–100, 1981–1 C.B. 326;

6 Annuity contracts under § 403(b);

7 Defined contribution plans (other than target benefit plans) under which the test for nondiscrimination under § 401(a)(4) is made by reference to benefits rather than contributions;

8 Cash balance or similar plans or defined benefit plans under which the test for nondiscrimination under § 401(a)(4) is made by reference to contributions rather than benefits;

9 Plans described in § 414(k) (relating to a defined benefit plan which provides a benefit derived from employer contributions which is based partly on the balance of the separate account of a participant);

10 Target benefit plans, other than plans which, by their terms, satisfy each of the safe harbor requirements described in § 1.401(a)(4)–8(b)(3)(i), as well as the additional rules in § 1.401(a)(4)–8(b)(3)(ii) through (vii);

11 Plans that provide for the disparity permitted under § 401(l), other than plans which use a definition of compensation that includes all compensation within the meaning of § 415(c)(3) and excludes all other compensation, or that otherwise satisfies § 414(s) under § 1.414(s)–(c);

12 Defined benefit plans that provide for employee contributions not allocated to separate accounts, other than plans that provide the minimum benefit described in § 1.401(a)(4)–6(b)(3)(ii);

13 Plans that would not satisfy the qualification requirements except as a governmental plan as described in § 414(d);

14 Church plans described in § 414(e) that have not made the election provided by § 410(d);

15 Plans under which the § 415 limitations are incorporated by reference;

16 Plans that do not contain a § 414(q) definition of highly compensated employee or under which the definition is incorporated by reference;

17 Fully-insured § 412(i) plans, other than plans that, by their terms, satisfy the safe harbor for § 412(i) plans in § 1.401(a)(4)–3(b)(5);

18 Plans that fail to contain a provision reflecting the requirements of § 414(u) (see Rev. Proc. 96–49).

.04 DOL Participant Loan Regulations not Addressed by Opinion Letter - M&P plans may adopt procedures to comply with the Department of Labor's (DOL) participant loan regulations under § 408(b)(1) of ERISA in the plan or in a document that is separate from the basic plan document, trust, and adoption agreement. The adoption of procedures outside of the plan document that are intended to comply with these regulations will not cause an M&P plan to be considered an individually designed plan. The Service will not review loan program procedures (whether in the plan or in a separate written document) to determine whether they comply with the requirements of the DOL regulations. Also, any opinion letter issued for an M&P plan will not consider whether loan program procedures may, in the operation of the plan, have an adverse effect on the qualified status of the plan. However, the loan program procedures under the plan may not be inconsistent with the qualification requirements of § 401(a).

.05 Nontransferability of Opinion Letters - An opinion letter issued to a sponsor is not transferable to any other entity. For this purpose, a change of employer identification number is deemed to be a change of entity.

SECTION 9. OPINION LETTERS - INSTRUCTIONS TO SPONSORS

.01 Employee Plans Rulings and Agreements Issues Opinion Letters - Employee Plans Rulings and Agreements will, upon the request of a sponsor, issue an opinion letter as to the acceptability of the form of the sponsor's M&P plan and any related trust or custodial account under §§ 401(a), 403(a), and 501(a). Review of the sponsor's application may be assigned to a field office**.**

.02 Forms and Address for Requesting Opinion Letters - A request for an opinion letter relating to an M&P plan must be submitted on the current version of Form 4461, Application for Approval of Master or Prototype Defined Contribution Plan, Form 4461-A, Application for Approval of Master or Prototype Defined Benefit Plan, or Form 4461-B, Application for Approval of Master or Prototype Plan Mass Submitter Adopting Sponsor, as appropriate. As soon as possible after February 7, 2000, these forms will be available for downloading from the Internet at the following address: **http://www.irs.gov**. All information on the first page of the application must be typed. The request, including the required user fee, is to be sent to the Internal Revenue Service, Employee Plans Rulings and Agreements, Attention:

T:EP:RA:T:ICU, P.O. Box 14073, Ben Franklin Station, Washington, D.C. 20044.

.03 Effect of Failure to Disclose Material Fact or to Accurately Provide Information - The Service may determine, based on the application form, the extent of review of the M&P plan. A failure to disclose a material fact or misrepresentation of a material fact on the application may adversely affect the reliance which would otherwise be obtained through issuance by the Service of a favorable opinion letter. Similarly, failure to accurately provide any of the information called for on any form required by this revenue procedure may result in no reliance.

.04 Expediting Review of Substantially Identical Plans - The Service reserves the right to review applications in any order which will expedite the processing of opinion letter applications. To expedite the review of substantially identical plans which are not described in section 16, relating to mass submitter plans, the Service encourages plan drafters and sponsors to include with each opinion letter application where it is appropriate a cover letter setting forth the following information:

1 The name and file folder number (if available) of the plan which, for review purposes, the plan drafter designates as the "lead plan" (including the name and EIN of the sponsor);

2 A list of all plans written by the plan drafter which are substantially identical to the lead plan (including the information described in 1);

3 A description of each place where the plan for which the application is being submitted is not word-for-word identical to the language of the lead plan, including an explanation of the purpose and effect of each such difference; and

4 A certification, made under penalty of perjury by the plan drafter, that the information described in 3 is true and complete.

If the sponsor or plan drafter is aware that a lead plan or any substantially identical plan has been assigned for review to a tax law specialist, the cover letter should also indicate the name of the tax law specialist, if possible. To the extent feasible, lead plans and substantially identical plans should be submitted together. The Service will regard the information and certification described in 3 and 4 above as a material representation for purposes of issuing an opinion letter.

.05 Separate Applications Required for Different Categories of M&P Plans / Use of Same Basic Plan Document by Multiple Plans - An M&P plan shall not contain any combination of profit-sharing, money purchase (other than target benefit), target benefit, non-integrated defined benefit, or integrated defined benefit plan features. However, separate defined contribution plans may have the same basic plan document and separate defined benefit plans may have the same basic plan document, but the provisions of the basic plan document must be identical for all plans using that document (that is, no elective or optional features). For example, a sponsor may submit six plans with respect to a given defined benefit basic plan document: integrated standardized, nonstandardized, and nonstandardized safe harbor plans; and nonintegrated standardized, nonstandardized, and nonstandardized safe harbor plans. A sponsor may also use one defined contribution basic plan document for a money purchase plan, a target benefit plan, and a profit-sharing plan. One basic plan document may not be used with respect to both defined benefit and defined contribution plans. A separate adoption agreement and completed application form must be submitted with respect to each defined benefit plan and each defined contribution plan. In the case of a simultaneous submission of plans using the same basic plan document, only one copy of the basic plan document need be provided. If the requests are not simultaneous, the sponsor must submit a copy of the basic plan document with each submission and include a cover letter identifying the original submission. The number of such basic plan document must remain the same as in the prior submission. Paired plans (as defined in section 4.13) must be submitted simultaneously.

.06 Sample Language - A Listing of Required Modifications (LRM) containing sample language to be used in drafting M&P plans is available from Employee Plans Rulings and Agreements. Such language is not automatically required in M&P plans but should be used as a guide in drafting such plans. An LRM may be obtained by writing to the Internal Revenue Service, Employee Plans Rulings and Agreements, Washington, D.C. 20224, Attention T:EP:RA:T:ICU. To expedite the review of their plans, sponsors are encouraged to use LRM language and to identify where such language is being used in their plan documents. Requests for LRMs may be faxed to (202) 622-6199 (not a toll-free call). As soon as possible after February 7, 2000, the LRMs will also be accessible on the Internet at the following address: **http://www.irs.gov**. The LRMs can be found under "Tax Info for Business."

.07 Additional Information May Be Requested - The Service may, at its discretion, require any additional information that it deems necessary. If a letter, requesting changes to plan documents, is sent to the plan's sponsor or authorized representative, the changes must be received no later than 30 days from the date of the letter. If the changes are not received within 30 days, the application may be considered withdrawn. An extension of the 30 day time limit will only be granted for good cause.

.08 Inadequate Submissions - The Service will return, without further action, plans that are not in substantial compliance with the qualification requirements or plans that are so deficient that they cannot be reviewed in a reasonable amount of time. A plan may be considered not to be in substantial compliance if, for example, it omits or merely incorporates qualification requirements by reference to the applicable Code section. The Service will not consider these plans until after they are revised, and they will be treated as new requests as of the date they are resubmitted. No additional user fee will be charged if an inadequate submission is amended to be in substantial compliance and is resubmitted to the Service within 30 days following the date the sponsor is notified of such inadequacy.

.09 Material Furnished to Adopting Employers - A sponsor must furnish each adopting employer with a copy of the approved plan, copies of any subsequent amendments, and the most recently issued Internal Revenue Service opinion letter.

.10 Nonidentification of Questionable Issues May Cause Delay - If the plan document submitted as part of an opinion letter request contains a provision that gives rise to an issue for which contrary published authorities exist, failure to disclose and address significant contrary authorities may result in requests for additional information, which will delay action on the request.

.11 Material Furnished to Employee Plans Determinations - Each mass submitter and each sponsor of a non-mass submitter plan must furnish a copy of the approved M&P plan and the Internal Revenue Service opinion letter to Employee Plans Determinations at the following address:

Internal Revenue Service
Employee Plans Determinations
P.O. Box 2508
Cincinnati, OH 45201
Attn: EP Determinations
VSC Coordinator
Room 4106

In addition, each mass submitter must submit a list to Employee Plans Determinations of all sponsors that have adopted a word-for-word identical plan of the mass submitter and a copy of any plan which contains minor modifications. Each mass submitter and sponsor of a non-mass submitter plan must also furnish Employee Plans Determinations with a copy of all amendments subsequently approved as to form by the Service. Copies of word-for-word identical plans of mass submitters, as described in section 4.10 of this revenue procedure, need not be submitted to Employee Plans Determinations.

SECTION 10. AMENDMENTS

.01 Opinion Letters for Sponsor Amendments - A sponsor may amend or restate its previously approved plan (including any related trust or custodial account) and EP Rulings and Agreements will entertain a request for a written opinion as to the acceptability, for purposes of §§ 401(a), 403(a), and 501(a), of the form of the plan as amended. If the sponsor is amending its plan, it must, except as provided in section 16.02 and 16.04, submit a Form 4461 or Form 4461-A, as applicable, to EP Rulings and Agreements, together with a copy of the amendment(s), a cover letter summarizing the changes to the plan effected by such amendment(s), and a copy of the plan which is being amended. As soon as possible after February 7, 2000, Form 4461 and Form 4461-A will be available for downloading from the Internet at the following address: **http:/www.irs.gov**. If the sponsor is restating its plan, it must, except as provided in sections 16.02 and 16.04, submit the restated plan, with the changes highlighted, along with a Form 4461 or 4461-A, as applicable. (The plan and application may be returned to the sponsor if the changes have not been highlighted.) No more than four consecutive amendments may be submitted without restating the plan. In addition, the Service may, at its discretion, require plan restatement at any time that it deems necessary to adequately review a plan. See section 18.05 regarding required restatement of M&P plans for GUST.

.02 No Opinion Letters for Certain Amendments - An M&P plan will not lose its qualified status and, except as provided in subsection .024 below, no opinion letter will be issued merely because amendments are made which solely cover the following:

1 Amendments to conform a plan to the requirements of § 402(a) of Title I of the Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. 93–406, 1974–3 C.B. 1, relating to named fiduciaries.

2 Amendments to conform a plan to requirements of § 503 of ERISA, relating to claims procedures.

3 Amendments that merely adjust the limitations under §§ 415, 402(g), 401(a)(17), and 414(q)(1)(B) to reflect annual cost-of-living increases, other than amendments that add an automatic cost-of-living adjustment provision to the plan.

4 Amendments that merely reflect a change of a sponsor's name. However, the sponsor must notify the Service, in writing, of the change in name and certify that it still meets the conditions for sponsorship described in section 4.09. No opinion letter will be issued and no user fee will be required for a mere change in name. However, if the sponsor wants a new opinion letter, it will have to submit a new Form 4461, 4461-A or 4461-B and pay the appropriate user fee. (Also see section 8.05 regarding changes in employer identification numbers.)

SECTION 11. DETERMINATION LETTERS AND INSTRUCTIONS TO ADOPTING EMPLOYERS

Except as provided in section 6, approval by the Service of the form of an M&P plan does not constitute a determination that an employer that adopts the plan will have a qualified plan. Therefore, such an adopting employer should request a determination letter in accordance with the procedures set forth in section 8 of Rev. Proc. 2000–6.

SECTION 12. APPROVED PLANS - MAINTENANCE OF APPROVED STATUS

.01 Revocation of Opinion Letter by the Service - An opinion letter found to be in error or not in accord with the current views of the Service may be revoked. However, except in rare or unusual circumstances, such revocation will not be applied retroactively if the conditions set forth in section 13.05 of Rev. Proc. 2000–4 are met. For this purpose, such opinion letters will be given the same effect as rulings. Revocation may be effected by a notice to the sponsor to which the letter was originally issued, or by a regulation, revenue ruling or other statement published in the Internal Revenue Bulletin. The sponsor should then notify each adopting employer of the revocation as soon as possible.

.02 Subsequent Required Amendments - An approved M&P plan must be amended by the sponsor and, if necessary, the employer, to retain its approved status if any provisions therein fail to meet the requirements of law, regulations, or other issuances and guidelines affecting qualification that become effective subsequent to the issuance of an opinion letter. Failure to so amend could result in the loss of a plan's qualified status. Sponsors are required to make reasonable and diligent efforts to ensure that each employer which, to the best of the sponsor's knowledge, continues to maintain the plan as an M&P plan amends its plan when necessary. Failure to comply with this or any other requirement imposed on sponsors by this revenue procedure may result in the loss of eligibility to sponsor M&P plans and the revocation of opinion letters that have been issued to the sponsor.

.03 Amendments Following Revenue Rulings - If an approved M&P plan is required to be amended to retain its approved status as a result of publication by the Service of a revenue ruling, notice or similar statement in the Internal Revenue Bulletin (I.R.B.), then, unless specifically stated otherwise in the revenue ruling, etc., the time by which the sponsor must amend its M&P plan to conform to the requirements of the revenue ruling, etc. and request a new opinion letter shall be the end of the one-year period after its publication in the I.R.B., and with respect to any adopting employer's plan the effective date of such amendment shall be the first day of the first plan year beginning within such one-year period.

.04 Loss of Qualified Status - If a sponsor reasonably concludes that an employer's M&P plan may no longer be a qualified plan and the sponsor does not or cannot submit a request to correct the qualification failure under EPCRS, it is incumbent on the sponsor to notify the employer that the plan may no longer be qualified, advise the employer that adverse tax consequences may result from loss of the plan's qualified status, and inform the employer about the availability of EPCRS. See Rev. Proc. 98–22, 1998–12 I.R.B. 11.

SECTION 13. WITHDRAWAL OF REQUESTS

.01 Notification and Effect - A sponsor may withdraw its request for an opinion letter at any time prior to the issuance of such letter by notifying EP Rulings and Agreements in writing of such withdrawal. The sponsor must also notify each employer who adopted the plan that the request has been withdrawn. Such an employer will be deemed to have an individually designed plan.

.02 Service Retains Information - Even though a request is withdrawn, EP Rulings and Agreements will retain all correspondence and documents associated with that request and will not return them to the sponsor. EP Rulings and Agreements may furnish its views concerning the qualified status of the plan to EP Examinations, which has audit jurisdiction over the returns of any employers that have adopted the plan.

SECTION 14. ABANDONED PLANS

.01 Notification to the Service - A sponsor should notify EP Rulings and Agreements in writing of an approved M&P plan that is no longer used by any employer and which the sponsor no longer intends to offer for adoption. Such written notification should be filed with EP Rulings and Agreements, Washington, D.C. 20224, Attention: T:EP:RA:T:ICU and should refer to the file folder number appearing on the latest opinion letter issued.

.02 Notification to Employers - A sponsor that intends to abandon an approved M&P plan that is in use by any adopting employer must inform each adopting employer that the form of the plan has been terminated, that the employer's plan will become an individually designed plan (unless the employer adopts another approved M&P plan), and that any employer with a determination letter may continue to rely on such letter (or if the plan is standardized, may continue to rely as if it had received a determination letter) on the date the form of the plan is terminated but only until a change in law or other change in the qualification requirements. After so informing all adopting employers, the sponsor should notify EP Rulings and Agreements in accordance with subsection .01 above.

SECTION 15. RECORD KEEPING REQUIREMENTS

.01 Filing of Opinion Letter Application Constitutes Agreement to Comply with Record Keeping Requirements - By submitting an application for an opinion letter under this revenue procedure (or by having an application filed on its behalf by a mass submitter), an M&P plan sponsor agrees, as provided in section 4.09, to comply with the requirements imposed on the sponsor by this revenue procedure, including the record keeping requirements of this section. Failure to comply with the requirements imposed on the sponsor by this revenue procedure may result in the loss of eligibility to sponsor M&P plans and the revocation of opinion letters that have been issued to the sponsor.

.02 Maintenance and Availability of Records of Adopting Employers - An M&P plan sponsor must maintain, or have maintained on its behalf, for each of its plans, a record of the names, business addresses, and taxpayer identification numbers of all employers that have adopted the plan. However, a sponsor need not maintain records with respect to employers that, to the best of the sponsor's knowledge, ceased to maintain the plan as an M&P plan more than three years earlier. Upon written request, a sponsor must provide to the Service a list of such adopting employers that indicates, to the best of the sponsor's knowledge, which of such employers continue to maintain the plan as an M&P plan and which of such employers have ceased to maintain the plan as an M&P plan within the preceding three years.

SECTION 16. MASS SUBMITTERS

.01 Opinion Letters Issued to Mass Submitters - EP Rulings and Agreements will, upon request by a mass submitter, as defined in section 4.10, issue an opinion letter as to the acceptability of the form of the mass submitter's M&P plan and any related trust or custodial account under §§ 401(a), 403(a), and 501(a). With respect to its plan, the mass submitter must submit a completed Form 4461 or 4461-A, as applicable, to EP Rulings and Agreements. As soon as possible after February 7, 2000, these forms will be available for downloading from the Internet at the following address: **http://www.irs.gov**. The first page of the Form 4461 or 4461- A must be typed. The application must include a copy of the plan (adoption agreement and basic plan document) and any separate trust or custodial account document(s). In the case of an initial submission of a basic plan document under this revenue procedure, the mass submitter's application must also be accompanied by applications for opinion letters filed on behalf of the requisite number of identical adopters (as determined under section 4.10), unless the mass submitter has already satisfied this requirement in connection with a previous application under this revenue procedure involving another basic plan document The application must also include the required user fee. A mass submitter may submit an application on its own behalf as one of the requisite number of adopting sponsors. After satisfying the requisite number of adopting sponsors requirement, the mass submitter may submit additional applications on behalf of other sponsors that wish to adopt a word-for-word identical plan or a plan that contains minor modifications from the mass submitter plan, as provided in section 16.032. In addition, the mass submitter may then submit requests for opinion letters under this section 16.01 for its other plans, regardless of the number of identical adopters of such other plans.

.02 Reduced Procedural Requirements for Sponsors That Use Mass Submitter Plans - A sponsor of an M&P plan of a mass submitter must obtain an opinion letter. For initial qualification, or where the sponsor's plan includes minor modifications, the mass submitter on behalf of the sponsor must submit to EP Rulings and Agreements a completed Form 4461-B which contains a declaration by the mass submitter under penalty of perjury that the sponsor has adopted an M&P plan that is word-for-word identical, within the meaning of this section, to a plan of the mass submitter, or an M&P plan that is a minor modification of the mass submitter's plan. As soon as possible after February 7, 2000, Form 4461-B will be available for downloading from the Internet at the following address: **http://www.irs.gov**. Form 4461-B must be typed. If the mass submitter's plan has been approved by the Service, the sponsor's request for an opinion letter must identify the letter serial number and date of the opinion letter issued to the mass submitter with respect to that plan. If the sponsor has previously received a letter with respect to a plan that is identical to the mass submitter's plan, the procedures described in sections 16.04 and 18.03, as applicable, should be followed. If the sponsor is sponsoring a word-for-word identical plan (including a flexible plan), a copy of the plan need not be submitted. If the mass submitter submits a plan with minor modifications, it must comply with the requirements of section 16.032. The application submitted on behalf of the sponsor must include the required user fee. Upon receipt of the request for an opinion letter, described above, the Service will, as soon as clerically feasible, issue an opinion letter to the sponsor.

.03 Definitions -

1 Flexible Plan -

(a) In general - A "flexible plan" is a plan submitted by a mass submitter which contains optional provisions (as defined in (b), below). Sponsors that adopt the flexible plan may include or delete any optional provision that is designated as such in the mass submitter's plan, provided the inclusion or deletion of specific optional provisions conforms to the mass submitter's written representation to the Service concerning the choices available to sponsors and the coordination of optional provisions. A mass submitter must bracket and identify the optional provisions when submitting such plan to EP Rulings and Agreements and must also provide the Service a written representation describing the choices available to sponsors and the coordination of optional provisions. Thus, such a representation must indicate whether a sponsor's plan may contain only one of a certain group of optional provisions, may contain only a specific combination of provisions, or may exclude the provisions entirely. Similarly, if the inclusion (or deletion) of a specific optional provision in a sponsor's plan will automatically result in the inclusion (or deletion) of any other optional provision, this must be set forth in the mass submitter's representation. A flexible plan may contain only optional provisions which meet the requirements of (b), below, and must be drafted so that the qualification of any sponsor's plan will not be affected by the inclusion or deletion of optional provisions. For example, if a sponsor's defined contribution plan contains an optional provision which allows a portion of a participant's account to be invested in life insurance, then under the terms of the sponsor's plan, the application of the proceeds must meet the requirements of §§ 401(a)(11) and 417. A flexible plan adopted by a sponsor which differs from the mass submitter plan only because the sponsor has deleted certain optional provisions from its plan in conformance with the mass submitter's representation described above will be treated as a word-for-word identical plan to the mass submitter plan. The Service encourages mass submitters to limit the number of optional provisions described in (b)(i) and (ii), below, which they provide under a flexible plan to six investment provisions and six administrative provisions.

(b) Optional Provisions - A flexible plan may contain only optional provisions that comply with the requirements set forth below. The optional provisions may be arranged as separate optional articles or as separate optional provisions within a single article. A flexible plan may also contain optional provisions in the adoption agreement. For example, if a mass submitter flexible plan basic plan document contains an optional provision which would allow for loans under a sponsor's M&P plan, the adoption agreement could also include an optional provision which would enable an adopting employer to elect whether loans will be available under the plan it adopts. If the sponsor does not wish to enable adopting employers to make loans available under their plans, both the basic plan document optional provision and the adoption agreement optional provision would be deleted from the sponsor's M&P plan. Sponsors may include or delete optional provisions of mass submitter plans, but once the sponsor has decided to include an optional provision, it must offer that provision to all adopting employers. Any optional provision which the Service determines does not meet the requirements of this section will have to be changed to a non-optional provision or deleted from the mass submitter's plan. The following is an exclusive list of the allowable optional provisions which a flexible plan may contain:

(i) Investment Provisions - A mass submitter may offer a variety of investment provisions in its plan for sponsors to include or delete from their version of the plan. However, the plan as adopted by the sponsor must provide some method for investing trust assets. Investment provisions are those provisions that describe the plan's methods of investing the trust or custodial funds, including provisions such as the availability of loans and investments in insurance contracts or other funding media, and self-directed investments. (Also see sections 4.05 and 5.11 regarding flexibility permitted in trust or custodial account documents.)

(ii) Administrative Provisions - A mass submitter may offer a variety of administrative provisions in its plan for sponsors to include or delete from their version of the plan. However, the plan as adopted by the sponsor must describe how the plan will be administered. Administrative provisions are those provisions that describe the administration of the plan, including the powers, duties, and responsibilities of a plan's custodian, trustee, administrator, employer, and other fiduciaries. Administrative provisions include the allocation of responsibilities among fiduciaries, the resignation or replacement of fiduciaries, claims procedures under the plan, and record keeping requirements. However, procedural provisions that are required for plan qualification are not administrative provisions under this section. For example, provisions that provide for the notice to participants required by § 417 and record keeping required by regulations under §§

401(k) and (m) are not administrative provisions for purposes of this revenue procedure, and may not be optional provisions.

(iii) Cash or Deferred Arrangement - A mass submitter may include a self-contained cash or deferred arrangement (as defined in § 401(k)) for sponsors to include or delete.

(c) Addition of Optional Provisions by the Mass Submitter - A mass submitter may add additional optional provisions to its plan after a favorable opinion letter is issued. Generally, the addition of such optional provisions will not be treated as a plan amendment for purposes of this revenue procedure, Rev. Proc. 2000–6, and Rev. Proc. 2000–8, and sponsors and adopting employers will not be required to obtain new opinion and determination letters in order to preserve reliance. (However, the addition of a cash or deferred arrangement or any change to the language of the adoption agreement subsequent to the issuance of an opinion letter will be treated as a plan amendment to the mass submitter's plan and the requirements of subsection .04 will then apply.) The mass submitter must submit such additional optional provisions to the Service, along with a completed Form 4461 or 4461-A, as applicable, and a check or money order in the amount specified in section 6.04(6) of Rev. Proc. 2000–8. No opinion letter will be issued to the mass submitter or any adopting sponsor with respect to the addition of these optional provisions. Instead, an advisory letter will be issued to the mass submitter notifying it that the addition of such optional provisions will not affect the status of favorable opinion and determination letters issued to sponsors and adopting employers.

(d) Notification to Employer - If a mass submitter adds optional provisions, as described in (c), above, all adopting sponsors who wish to include the additional optional provisions must furnish each adopting employer with a copy of the plan which includes such additional provisions in accordance with section 9.09. If a sponsor decides to include or delete an optional provision after it initially adopted the plan, it must also furnish each adopting employer with a copy of the new plan in accordance with section 9.09. However, if such inclusion or deletion results in a change to the language of the adoption agreement, such change will be treated as a plan amendment and the sponsor and its adopting employers may not continue to rely on previously issued opinion or determination letters.

2 Minor Modification - A "minor modification" is a minor change to an otherwise word-for-word identical plan of the mass submitter which does not require an in-depth technical review. For example, a change from 5 year 100% vesting to 3 year 100% vesting is a minor modification. On the other hand, a change in the method of accrual of benefits in a defined benefit plan would not be considered a minor modification. A minor modification must be submitted by the mass submitter on behalf of the sponsor that will adopt the modified plan. Such submissions will be reviewed on an expedited basis and opinion letters will be issued to the sponsor as soon as possible. However, the Service reserves the right to determine if such changes are actually minor. If it is determined that the changes are extensive or require an in-depth technical review, the plan will not be entitled to expedited review but will be treated as a non-mass submitter plan. (In such event, the Service will notify the mass submitter in writing of its determination. Within 30 days following the date of such communication, either the mass submitter may revise the plan so that the modifications are minor and resubmit the revised plan, or the sponsor may submit an additional user fee in an amount equal to the difference between a non-mass submitter plan application user fee and a minor modifier application user fee. If, after such 30 day period neither action has been taken, the application may be considered withdrawn.) To qualify for the expeditious review, the mass submitter must submit a completed Form 4461-B. Such form must be typed. In addition, the mass submitter must submit a copy of the mass submitter's plan with the minor modifications highlighted, as well as a statement indicating the location and effect of each change. The mass submitter must certify under penalty of perjury that the plan of the sponsor, except for the delineated changes, is word-for-word identical, within the meaning of this section, to the plan for which the mass submitter received a favorable opinion letter. If a mass submitter fails to identify each modification, such failure will be considered a material misrepresentation and an employer may not rely on any opinion or determination letter that may be issued with respect to the plan. If a mass submitter repeatedly fails to identify such modifications, the Service may deny permission to that mass submitter to submit additional minor modifications.

.04 Amendments of Mass Submitter Plans - Any plan submitted by a mass submitter must include language designating the mass submitter as agent for the sponsor for purposes of making plan amendments (see section 12.02). Any sponsor that does not wish to make the amendments made by a mass submitter may switch to another mass submitter or may submit an application for an opinion letter on its own behalf. If the mass submitter makes any change to the plan, other than the addition of optional provisions pursuant to section 16.031(c), an amendment described in section 10.02, or a model amendment published by the Service, it must comply with the requirements of section 10.01 of this revenue procedure. In addition, prior to submitting an amendment to EP Rulings and Agreements, the mass submitter must notify the Service of its intention to amend the plan. Such notification should be submitted, in writing, to EP Rulings and Agreements, Washington, D.C. 20224, Attention: T:EP:RA:T:ICU. The Service will then mail a list to the mass submitter showing all sponsors that have adopted plans that are identical to the mass submitter's plans, as well as the specific plans adopted by each sponsor. The mass submitter must then submit the amended plan to EP Rulings and Agreements for approval, along with a list identifying all adopting sponsors' plans that will be amended, a user fee form for each such sponsor, and the appropriate user fee required under section 6.04 of Rev. Proc. 2000–8. All sponsors that have adopted the mass submitter's plan, are identified on the list submitted to the Service, and for which a user fee has been submitted, will be considered to have made such amendments and will be issued opinion letters. In the case of minor modifier plans, separate Form 4461–B applications must be filed along with copies of the plans as amended, user fee forms, and the user fee required by section 6.04 of Rev. Proc. 2000–8 for minor modifier applications. Copies of the amended plan must be sent to adopting employers and EP Determinations in accordance with section 9.11. Any adopting sponsor that is not included on the list submitted to the Service (or in the case of a minor modifier, for which a Form 4461-B application has not been filed) or which notifies the Service of its desire not to adopt such amendment will no longer participate as a mass submitter plan but must apply for an opinion letter on its own behalf to retain its status as an M&P plan.

.05 Expeditious Processing Accorded Mass Submitter Plans - All mass submitter plans, including the adoption of approved mass submitter plans by sponsors, will be accorded more expeditious processing than M&P plans submitted by non-mass submitters, to the extent administratively feasible.

SECTION 17. USER FEES

.01 User Fees for Applications Filed Under This Revenue Procedure - Section 6.04 of Rev. Proc. 2000–8 sets forth the user fees for applications for opinion and advisory letters for M&P plans. The user fees in section 6.04 of Rev. Proc. 2000–8 apply to all applications for opinion and advisory letters for M&P plans that are filed under this revenue procedure.

.02 Reduced User Fees for Submission of Identical Volume Submitter Specimen Plans - Section 6.07 of Rev. Proc. 2000–8 sets forth the user fees for applications for advisory letters for volume submitter plans. Rev. Proc. 2000–8 is modified to provide reduced user fees for advisory letters in cases involving the submission of at least 30 identical volume submitter specimen plans under the following procedures:

1 A practitioner must submit an application for an advisory letter for a specimen plan (herafter referred to as the lead specimen plan). The application must include the plan and trust and all the other information required by section 9.07 of Rev. Proc. 2000–6. However, the cover letter for the application need not include a certification that at least 30 employers are expected to adopt similar plans; instead, the cover letter must state that at least 30 practitioners are submitting applications for advisory letters for identical specimen plans and must certify that each such plan is word-for-word identical to the lead specimen plan. The cover letter must provide the name, address, and EIN of each of the practitioners.

2 The application for the lead specimen plan must include a user fee in the amount of $3,000.

3 The application for the lead specimen plan must be accompanied by separate advisory letter applications filed by each of the practitioners listed in the cover letter for the lead specimen plan. The separate application should consist of a letter stating that the practitioner is requesting an advisory letter for a specimen plan that is word-for-word identical to the lead specimen plan and that the practitioner will maintain, and furnish to the Service on request, a list of adopting employers. The practitioner does not need to indicate that at least 30 employers are expected to adopt the plan. The practitioner should not submit a copy of the plan.

4 A user fee in the amount of $100 must be paid for each separate advisory letter application.

5 An application for an advisory letter for a specimen plan that has been filed under the general procedures in section 9.07 of Rev. Proc. 2000–6 can be amended at any time, even after the issuance of an advisory letter, to designate the plan as a lead specimen plan by payment of the required additional user fee and submission of the other information and fees described above.

6 After the initial submission of advisory letter applications by at least 30 practitioners, applications may be filed by other practitioners who will sponsor the word-for-word identical plan. The application must include the practitioner's agreement to maintain, and furnish to the Service on request, a list of adopting employers; a certification by the sponsor of the lead specimen plan that the practitioner's plan is word-for-word identical to the lead specimen plan; and a user fee in the amount of $100. A copy of the plan should not be submitted.

7 All of the above applications are to be sent to the address in section 9.07(1) of Rev. Proc. 2000–6.

SECTION 18. OPENING OF COMPLETE GUST PROGRAM FOR M&P PLANS AND VOLUME SUBMITTER SPECIMEN PLANS; OTHER PROCEDURES RELATED TO GUST

.01 Opening of Complete GUST Program for M&P Plans / Delayed Submissions - Applications for opinion letters for M&P plans that are filed on or after May 8, 2000, will be reviewed taking into account all requirements of GUST, including those that are effective in plan years beginning after December 31, 1998, as well as the requirements of this revenue procedure. In Announcement 99–50, the Service announced that as of May 10, 1999, it was temporarily discontinuing the acceptance of applications for opinion and notification letters for M&P and regional prototype plans. Effective May 10, 1999, therefore, and until May 8, 2000, no applications for the approval of M&P plans (other than those plans submitted pursuant to subsection .02) may be submitted. Any application received on or after May 10, 1999, and prior to May 8, 2000 (other than those submitted pursuant to subsection .02) will be returned.

.02 Early Submission Period for Mass Submitters and National Sponsors - Mass submitters (as defined in section 4.10) and national sponsors (as defined in section 4.11) may submit applications for approval of M&P plans beginning April 7, 2000, and will not be subject to the delayed submission requirement of subsection .01. In the case of a national sponsor, each application submitted during this early submission period must be accompanied by the sponsor's certification, made under penalty of perjury, that it maintains a list of adopting employers which establishes that the sponsor is a national sponsor as defined in section 4.11. The Service reserves the right to request a copy of such list in order to verify that these requirements have been met.

.03 Service to Mail Lists of Identical Adopters to Mass Submitters Approved Under Rev. Proc. 89–9 and Rev. Proc. 89–13 - Within 30 days after the effective date of this revenue procedure, the Service will mail to each person that was approved as a mass submitter under Rev. Proc. 89–9 or Rev. Proc. 89–13 a list of those sponsors that have previously adopted plans that are word-for-word identical to the mass submitter's plans along with such plans' file folder numbers. Mass submitters should use these lists, in accordance with the instructions provided with such lists, in applying for opinion letters under this procedure with respect to these sponsors' plans. These instructions will allow mass submitters to submit applications for opinion letters on behalf of the identical adopters without filing Form 4461-B.

.04 Treatment of In-Process Applications - As provided in Announcement 99–50, the Service will continue to process all M&P and regional prototype plan applications submitted before May 10, 1999, in accordance with the provisions of Rev. Procs. 89–9, 89–13, 98–14, and 98–53. Any letter issued to such a plan will not consider this revenue procedure or certain provisions of GUST that are effective after 1998. Alternatively, sponsors may withdraw any pending pre-May 10, 1999-application relating to an M&P or regional prototype plan. In this case, the user fee will not be refunded. However, if a new application pertaining to the same plan is subsequently filed on or before December 31, 2000, the user fee for the new application will be waived. The sponsor should indicate on the face of the application form that the user fee is being waived pursuant to Announcement 99–50 and this revenue procedure.

.05 Required Restatement of M&P Plans - M&P plans must be restated the first time they are submitted for GUST opinion letters under this revenue procedure. Amendments or working copies of plans in a restated format, in lieu of actual plan restatement, will not be accepted. However, restatement will not be required if the M&P plan was restated in connection with an application for an opinion letter under Rev. Proc. 98–14 and the plan received a favorable letter. Except as provided in section 16.04, the sponsor must highlight in the restated plan all changes that have been made to the last approved version of the plan.

.06 Completion of New Adoption Agreements for M&P Plans - Employers must complete new adoption agreements when M&P plans are restated for GUST. Part of the reason for this requirement is that employers must conform their adoption agreement choices to the operation of their plans during the GUST transition period. Except as provided in section 6, employers must also request new determination letters in order to have reliance as to the qualified status of their M&P plans.

.07 Opening of Complete GUST Program for Volume Submitter Specimen Plans - The Service will begin to issue advisory letters for volume submitter specimen plans that take into account all of the requirements of GUST beginning March 8, 2000.

SECTION 19. REMEDIAL AMENDMENT PERIOD

.01 Purpose - The purpose of this section is to ensure that employers will have 12 months after an M&P plan or volume submitter specimen plan is approved for GUST in which to adopt the approved plan as a timely GUST restatement. Employers will be eligible for this 12-month period if they are prior adopters of an M&P, regional prototype, or volume submitter specimen plan, or if they certify that they intend to restate their plan for GUST using an M&P or volume submitter specimen plan, and the M&P plan sponsor or volume submitter practitioner submits its plan for GUST-approval by December 31, 2000.

.02 Extension of Remedial Amendment Period - If the requirements in subsection .03 are satisfied, the remedial amendment period for an employer's plan will not expire before the time described in subsection .04. For purposes of this section, the remedial amendment period means the remedial amendment period determined under § 1.401(b)–1 and Rev. Proc. 97–41 and Rev. Proc. 98–14, both as modified by Rev. Proc. 99–23. As provided in section 3.05, where it is appropriate in this section (for example, in subsection .031), the term "M&P plan" includes regional prototype plans under Rev. Proc. 89–13, and the term "opinion letter" includes notification letters issued under Rev. Proc. 89–13.

.03 Requirements for Extension - The requirements of this subsection .03 are satisfied if:

1 before the end of the remedial amendment period (determined without regard to the extension provided by this section), the employer adopts an M&P plan or volume submitter specimen plan (regardless of whether such plan has a TRA '86 opinion or advisory letter); or

2 before the end of the remedial amendment period (determined without regard to the extension provided by this section), the employer and an M&P plan sponsor or volume submitter practitioner execute a written certification of the employer's intent to amend or restate its plan by adopting the sponsor's or practitioner's GUST-approved M&P or volume submitter specimen plan; and

3 by December 31, 2000, the sponsor or practitioner submits an application for a complete GUST opinion or advisory letter for the M&P plan or volume submitter specimen plan referred to in 1 or 2 (even if the M&P plan is an identical adoption of a mass submitter plan).

.04 Period of Extension - If the preceding requirements are satisfied, the remedial amendment period for the employer's plan will not expire before the end of the twelfth month beginning after the date on which a GUST opinion or advisory letter is issued for the M&P or volume submitter specimen plan referred to in subsection .03 or the opinion or advisory letter application for the plan is withdrawn. Within this period, the employer must amend or restate its plan by adopting the GUST-approved M&P or volume submitter specimen plan (or another GUST-approved M&P or volume submitter specimen plan, or individually designed GUST amendments) and, if required for reliance, request a determination letter.

.05 Prior Adopters Deemed to Have Adopted Other Plans of Sponsor or Practitioner for Purposes of This Section - An employer that adopts, before the end of the remedial amendment period (determined without regard to the extension provided by this section), any M&P plan or volume submitter specimen plan of a sponsor or practitioner will, for purposes of this section, be deemed to have adopted each other M&P plan or volume submitter specimen plan of that sponsor or practitioner. Likewise, an employer that certifies, before the end of the remedial amendment period (determined without regard to the extension provided by this section), its intent to adopt any M&P plan or volume submitter specimen plan of a sponsor or practitioner will, for purposes of this section, be deemed to have made such a certification with respect to each other M&P plan or volume submitter specimen plan of that sponsor or practitioner.

.06 Certain Employer Amendments Disregarded for Purposes of This Section - An employer that has adopted an

M&P plan or a volume submitter specimen plan may have modified the plan in a such a way that the plan, as adopted by the employer, would not be considered an M&P plan or a volume submitter plan. Nevertheless, for purposes of this section, such a plan will be treated as an M&P or volume submitter plan and will be eligible for the remedial amendment period extension provided by this section. For example, an employer may have adopted an individually designed GUST-related amendment to an M&P plan that would have caused the plan to be considered an individually designed plan under section 5.02 of Rev. Proc. 89–9. Despite the individually designed amendment, the plan will be treated as an M&P plan for purposes of this section.

.07 No Extension Where M&P Plan Sponsor or Volume Submitter Practitioner Fails to Make Timely Request for GUST Opinion or Advisory Letter - If an employer's plan would otherwise be eligible for the extension described in subsection .04, but the M&P sponsor or volume submitter practitioner fails to submit an application for a GUST opinion or advisory letter by December 31, 2000, the remedial amendment period for the employer's plan will not be extended.

.08 Information To Be Submitted with Determination Letter Application - An employer that avails itself of the extension provided by this section must include with its determination letter application either evidence of adoption, before the expiration of the remedial amendment period (determined without regard to this section), of an M&P or volume submitter specimen plan or a copy of the certification described in subsection .032.

.09 Discretionary Extensions - If an M&P sponsor or volume submitter practitioner determines that the extension of the remedial amendment period provided by this section does not allow sufficient time for employers to adopt the sponsor's or practitioner's GUST-approved M&P or volume submitter specimen plan and, if required for reliance, request determination letters, the sponsor or practitioner may request a further extension. At its discretion, the Service may grant such a further extension. Among the factors that the Service will consider in determining whether a further extension will be granted are whether the sponsor or practitioner has taken reasonable steps to ensure that the process of restating employers' plans for GUST is completed as promptly as possible, whether substantial hardship to employers or the sponsor or practitioner would result if such an extension were not granted, whether such an extension is in the best interests of plan participants, and whether the granting of the extension is adverse to the interests of the Government. Requests for a further extension should be addressed to the Commissioner, Tax Exempt and Government Entities Division, P.O. Box 14073, Ben Franklin Station, Washington, D.C. 20224, Attention: T:EP:RA:T:ICU. However, the Service will not accept requests for a further extension before the later of December 31, 2000, or the date of issuance of a GUST opinion or advisory letter with respect to the sponsor's or practitioner's M&P or volume submitter specimen plan.

.10 Required Amendments for Plans with Extended Reliance on TRA '86 Letters - Under Rev. Proc. 89–9, Rev. Proc. 89–13 (both as modified by Rev. Proc. 93–9, 1993–1 C.B. 474), Rev. Proc. 93–39, 1993–2 C.B. 513, Announcement 94–85, 1994–26 I.R.B. 23, and Rev. Proc. 95–12, 1995–1 C.B. 508, plans that were submitted to the Service within certain deadlines for determination, opinion, or notification letters under TRA '86 and received favorable letters were entitled to extended reliance. During the extended reliance period, a plan generally was not required to comply in operation with or be amended for regulations or administrative guidance of general applicability issued after the date of the plan's letter which interpret the qualification requirements in effect when the letter was issued. As modified by Rev. Proc. 99–23, the extended reliance period continued until the earlier of the last day of the last plan year commencing prior to January 1, 2000, or the date established for plan amendment by any legislation effective after the date of the plan's letter. As further provided in Rev. Proc. 99–23, a plan with extended reliance must be amended by the last day of the first plan year beginning on or after January 1, 2000, to the extent necessary to comply with regulations or administrative guidance of general applicability which has been issued since the date of the plan's favorable TRA '86 letter. For this purpose, plan amendments will be deemed to have been adopted on the last day of the first plan year beginning on or after January 1, 2000, if they are in fact adopted after that date but within the plan's remedial amendment period as extended by this section. The amendments must be made effective no later than the first day of the first plan year beginning on or after January 1, 2000. If the plan's remedial amendment period has been extended by this section, the amendments may be made effective earlier than the first day of the plan year in which the amendments are adopted to the extent necessary to comply with this requirement.

SECTION 20. EFFECT ON OTHER DOCUMENTS

.01 The following revenue procedures are superseded: Rev. Procs. 89–9, 89–13, 90–21, 92–41, 93–10, and 95–42.

.02 Section 8.03 through 8.08 of Rev. Proc. 91–66 is superseded. The balance of Rev. Proc. 91–66 was previously superseded; therefore, Rev. Proc. 91–66 is now superseded in full.

.03 Section 4 of Rev. Proc. 93–9 is superseded. The balance of Rev. Proc. 93–9 was previously superseded; therefore, Rev. Proc. 93–9 is now superseded in full.

.04 Section 8.05 of Rev. Proc. 2000–6 is modified as follows:

1 subsection (2) is modified to provide that whether an employer may rely on an opinion letter for a standardized plan without requesting a determination letter will be determined under section 6 of this revenue procedure; and

2 subsection (3) is deleted.

.05 Rev. Proc. 2000–8 is modified as provided in section 17.

.06 Announcement 99–50 is modified.

SECTION 21. EFFECTIVE DATE

This revenue procedure is effective February 7, 2000.

SECTION 22. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1674.

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

The collections of information in this revenue procedure are in sections 5.14, 9.11, 12.02, 12.03, 15.02, 17.02, 18.06, 19.02 and 19.09. This information is required in connection with the determination of plan qualification. This information will be used to determine whether a plan is entitled to favorable tax treatment. The collections of information are mandatory. The likely respondents are banks, insurance companies, other financial institutions, law, actuarial and consulting firms, employee benefit practitioners and employers.

The estimated total annual reporting and/or record keeping burden is 408,563 hours.

The estimated annual burden per respondent/record-keeper varies from 10 minutes to 2000 hours, depending on individual circumstances, with an estimated average of 1.53 hours. The estimated number of respondents and/or record-keepers is 266,530.

The estimated annual frequency of responses (used for reporting requirements only) is once every three years.

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 revenue procedure is James Flannery of the Tax Exempt and Government Entities Division. For further information regarding this revenue procedure, contact the Employee Plans telephone assistance service between the hours of 1:30 and 3:30 p.m. Eastern time, Monday through Thursday, on (202) 622-6074/75 (These telephone numbers are not toll-free.)

Safe Harbor Explanation—Certain Qualified Plan Distributions

Notice 2000–11

PURPOSE

This notice contains a "Safe Harbor Explanation" that plan administrators may provide to recipients of eligible rollover distributions from qualified plans in order to satisfy § 402(f) of the Internal Revenue Code. It is an updated version of the Safe Harbor Explanation that was published in Notice 92–48, 1992–2 C.B. 377.

BACKGROUND

Section 402(f) requires a plan administrator to provide a written explanation to any recipient of a payment that could be rolled over (an "eligible rollover distribution") to an individual retirement arrangement described in Code § 408(a) or (b) ("traditional IRA") or to a qualified employer plan described in Code § 401(a) or an annuity described in Code § 403(a) ("qualified employer plan"). The written explanation must cover the direct rollover rules, the mandatory income tax withholding on distributions not directly rolled over, and the tax treatment of distributions not rolled over (including the special tax treatment available for certain lump sum distributions). Section 402(f) provides that this explanation must be given within a reasonable period of time before the plan makes an eligible rollover distribution.

Section 521(d) of the Unemployment Compensation Amendments of 1992, P.L. 102–318 (UCA) directed the Secretary of the Treasury to develop a model explanation that could be used to satisfy the requirements of § 402(f) of the Code, as amended. The model explanation was originally published as Notice 92–48 and is referred to in that Notice as a Safe Harbor Explanation.

This updated notice is being issued to reflect changes made to the Code and Income Tax Regulations that affect the information provided in the Safe Harbor Explanation. The Small Business Job Protection Act of 1996, P.L. 104–188, section 1401(a), amended Code § 401(a)(9) to alter the rules relating to the commencement of minimum required distributions and also amended Code § 402(d) to eliminate the special five-year averaging tax treatment for lump sum distributions (although transition rules retain ten-year special averaging for individuals who satisfy certain requirements). The Internal Revenue Service Restructuring and Reform Act of 1998 ("RRA"), P.L. 105-206, section 3436, amended Code § 72(t) to provide an additional exception to the early withdrawal tax for tax levies on qualified plans. RRA, section 6005(c)(2)(A), also amended Code § 402(c)(4) to provide that certain hardship distributions are not eligible for rollover.

Temporary and Proposed Income Tax Regulations under Code §§ 401(a)(31), 402(f), 403(b) and 3405(c), which were published in conjunction with Notice 92–48, have since been finalized. Final regulations under Code §§ 402(c) and 3405(c) now address withholding on employer securities and the treatment of plan loan offset amounts, and new regulations have been published under Code § 401(a)(31), and also under § 402(f) (relating to paperless technologies).

SAFE HARBOR AND ALTERNATIVE EXPLANATION

This notice contains an updated model written explanation ("Safe Harbor Explanation") that meets the requirements of Code § 402(f) if it is provided to the recipient of an eligible rollover distribution within a reasonable period of time before the distribution is made. In general, under § 1.402(f)–1 of the regulations, a reasonable period of time for providing an explanation is no less than 30 days and no more than 90 days before the date on which a distribution is made.

In using the Safe Harbor Explanation, a plan administrator may "customize" the Safe Harbor Explanation by omitting any portion that could not apply to the plan. For example, if the plan does not hold after-tax employee contributions, the paragraph headed "Non-taxable Payments" could be eliminated. Similarly, if the plan does not provide for distributions of employer stock or other employer securities, the paragraph headed “Employer Stock or Securities” could be eliminated. Other paragraphs that may not be relevant to a particular plan include, for example, “Payments Spread Over Long Periods,” “Direct Rollover of a Series of Payments,” “Special Tax Treatment,” “Hardship Distributions,” and “Repayment of Plan Loans.” In addition, a plan administrator may provide additional information with the Safe Harbor Explanation, if the information is not inconsistent with the Safe Harbor Explanation.

Alternatively, a plan administrator can satisfy § 402(f) by providing distributees with an explanation that is different from the Safe Harbor Explanation. Any explanation must contain the information required by § 402(f) and must be written in a manner designed to be easily understood.

If the law governing the tax treatment of distributions or the other provisions covered by the Safe Harbor Explanation is amended after publication of this notice, the Safe Harbor Explanation will not satisfy § 402(f) to the extent that the Safe Harbor Explanation no longer accurately describes the relevant law.

EFFECT ON OTHER DOCUMENT

Notice 92–48 is obsoleted.

REQUEST FOR COMMENTS

The preamble to the proposed regulations under § 402(f) that were issued in December 1998 included an example of a summary § 402(f) notice that the Service and Treasury believe satisfies the requirements for a summary notice set forth in those proposed regulations. See 63 Fed. Reg. 70071, 70074 (December 18, 1998). The example was not intended as a model summary or as the exclusive form for such a summary. However, the Service and the Treasury believe that additional guidance providing one or more additional examples of summary notices may be appropriate. Accordingly, the Service and Treasury invite comments and suggestions from interested parties concerning the development of additional examples for use in the circumstances described in those proposed regulations. We encourage interested parties to submit examples of summary notices that may be used in the development of further guidance.

Comments related to this notice, including comments with respect to summary § 402(f) notices, can be addressed to CC:DOM:CORP:R (Notice 2000–11), 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 2000–11), Courier’s Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may transmit comments electronically via the IRS Internet site at: http://www.irs.gov/tax_regs/regslist.html.

DRAFTING INFORMATION

The principal authors of this notice are Steven Linder of the Tax Exempt and Government Entities Division (T:EP) and Amy L. Speetjens of the Office of Chief Counsel (EBEO). For further information regarding this notice, contact the Employee Plans taxpayer assistance telephone service between the hours of 1:30 and 3:30 P.M. Eastern time, Monday through Thursday by calling (202) 622-6074. Mr. Linder can be reached at (202) 622-6214. Ms. Speetjens can be reached at (202) 622-6090. (These telephone numbers are not toll-free numbers.)

TEXT OF THE SAFE HARBOR EXPLANATION

SPECIAL TAX NOTICE REGARDING PLAN PAYMENTS

This notice contains important information you will need before you decide how to receive your Plan benefits.

This notice is provided to you by [INSERT NAME OF PLAN ADMINISTRATOR] (your “Plan Administrator”) because all or part of the payment that you will soon receive from the [INSERT NAME OF PLAN] (the “Plan”) may be eligible for rollover by you or your Plan Administrator to a traditional IRA or another qualified employer plan. A “traditional IRA” does not include a Roth IRA, SIMPLE IRA, or education IRA.

If you have additional questions after reading this notice, you can contact your plan administrator at [INSERT PHONE NUMBER OR OTHER CONTACT INFORMATION]

SUMMARY

There are two ways you may be able to receive a Plan payment that is eligible for rollover:

(1) certain payments can be made directly to a traditional IRA or, if you choose, another qualified employer plan that will accept it (“DIRECT ROLLOVER”), or

(2) the payment can be PAID TO YOU.

If you choose a *DIRECT ROLLOVER*

◦ Your payment will not be taxed in the current year and no income tax will be withheld.

◦ Your payment will be made directly to your traditional IRA or, if you choose, to another qualified employer plan that accepts your rollover. Your Plan payment cannot be rolled over to a Roth IRA, a SIMPLE IRA, or an education IRA because these are not traditional IRAs.

◦ Your payment will be taxed later when you take it out of the traditional IRA or the qualified employer plan.

If you choose to have a Plan payment that is eligible for rollover *PAID TO YOU*

◦ You will receive only 80% of the payment, because the Plan Administrator is required to withhold 20% of the payment and send it to the IRS as income tax withholding to be credited against your taxes.

◦ Your payment will be taxed in the current year unless you roll it over. Under limited circumstances, you may be able to use special tax rules that could reduce the tax you owe. However, if you receive the payment before age 59-1/2, you also may have to pay an additional 10% tax.

◦ You can roll over the payment by paying it to your traditional IRA or to another qualified employer plan that accepts your rollover within 60 days after you receive the payment. The amount rolled over will not be taxed until you take it out of the traditional IRA, or the qualified employer plan.

◦ If you want to roll over 100% of the payment to a traditional IRA or another qualified employer plan, *you must find other money to replace the 20% that was withheld*. If you roll over only the 80% that you received, you will be taxed on the 20% that was withheld and that is not rolled over.

MORE INFORMATION

I. PAYMENTS THAT CAN AND CANNOT BE ROLLED OVER

Payments from the Plan may be "eligible rollover distributions." This means that they can be rolled over to an IRA or to another employer plan that accepts rollovers. Payments from a plan cannot be rolled over to a Roth IRA, a SIMPLE IRA, or an education IRA. Your Plan administrator should be able to tell you what portion of your payment is an eligible rollover distribution.

The following types of payments *cannot* be rolled over:

Non-taxable Payments. In general, only the "taxable portion" of your payment can be rolled over. If you have made "after-tax" employee contributions to the Plan, these contributions will be non-taxable when they are paid to you, and they cannot be rolled over. (After-tax employee contributions generally are contributions you made from your own pay that were already taxed.) Your Plan Administrator should be able to tell you how much of your payment is the taxable portion and how much is the after-tax employee contribution portion.

Payments Spread over Long Periods. You cannot roll over a payment if it is part of a series of equal (or almost equal) payments that are made at least once a year and that will last for

◦ your lifetime (or your life expectancy), or

◦ your lifetime and your beneficiary's lifetime (or life expectancies), or

◦ a period of ten years or more.

Required Minimum Payments. Beginning when you reach age 70-1/2 or retire, whichever is later, a certain portion of your payment cannot be rolled over because it is a "required minimum payment" that must be paid to you. Special rules apply if you own 5% or more of your employer.

Hardship Distributions. A hardship distribution from your employer's 401(k) plan may not be eligible for rollover. Your Plan Administrator should be able to tell you if your payment includes amounts which cannot be rolled over.

II. DIRECT ROLLOVER

A DIRECT ROLLOVER is a direct payment of the amount of your Plan benefits to a traditional IRA or another qualified employer plan that will accept it. You can choose a DIRECT ROLLOVER of all or any portion of your payment that is an eligible rollover distribution, as described in Part I above. You are not taxed on any portion of your payment for which you choose a DIRECT ROLLOVER until you later take it out of the traditional IRA or qualified employer plan. In addition, no income tax withholding is required for any portion of your Plan benefits for which you choose a DIRECT ROLLOVER.

DIRECT ROLLOVER to a Traditional IRA. You can open a traditional IRA to receive the direct rollover. If you choose to have your payment made directly to a traditional IRA, contact an IRA sponsor (usually a financial institution) to find out how to have your payment made in a direct rollover to a traditional IRA at that institution. If you are unsure of how to invest your money, you can temporarily establish a traditional IRA to receive the payment. However, in choosing a traditional IRA, you may wish to consider whether the traditional IRA you choose will allow you to move all or a part of your payment to another traditional IRA at a later date, without penalties or other limitations. See IRS Publication 590, *Individual Retirement Arrangements*, for more information on traditional IRAs (including limits on how often you can roll over between IRAs).

DIRECT ROLLOVER to a Plan. If you are employed by a new employer that has a qualified employer plan, and you want a direct rollover to that plan, ask the Plan Administrator of that plan whether it will accept your rollover. A qualified employer plan is not legally required to accept a rollover. If your new employer's plan does not accept a rollover, you can choose a DIRECT ROLLOVER to a traditional IRA.

DIRECT ROLLOVER of a Series of Payments. If you receive a payment that can be rolled over to a traditional IRA or another qualified employer plan that will accept it, and it is paid in a series for less than ten years, your choice to make or not make a DIRECT ROLLOVER for a payment will apply to all later payments in the series until you change your election. You are free to change your election for any later payment in the series.

III. PAYMENT PAID TO YOU

If your payment can be rolled over under Part I above and the payment is made to you in cash, it is subject to 20% income tax withholding. The payment is taxed in the year you receive it unless, within 60 days, you roll it over to a traditional IRA or another qualified employer plan that accepts rollovers. If you do not roll it over, special tax rules may apply.

Income Tax Withholding:

Mandatory Withholding. If any portion of your payment can be rolled over under Part I above and you do not elect to make a DIRECT ROLLOVER, the Plan is required by law to withhold 20% of that amount. This amount is sent to the IRS as income tax withholding. For example, if you can roll over a payment of $10,000, only $8,000 will be paid to you because the Plan must withhold $2,000 as income tax. However, when you prepare your income tax return for the year, you must report the full $10,000 as a payment from the Plan. You must report the $2,000 as tax withheld, and it will be credited against any income tax you owe for the year.

Voluntary Withholding. If any portion of your payment is taxable but cannot be rolled over under Part I above, the mandatory withholding rules described above do not apply. In this case, you may elect not to have withholding apply to that portion. To elect out of withholding, ask the Plan Administrator for the election form and related information.

Sixty-Day Rollover Option. If you receive a payment that can be rolled over under Part I above, you can still decide to roll over all or part of it to a traditional IRA or another qualified employer plan that accepts rollovers. If you decide to roll over, *you must contribute the amount of the payment you received to a traditional IRA or another qualified plan* *within 60 days after you receive the payment*. The portion of your payment that is rolled over will not be taxed until you take it out of the traditional IRA or the qualified employer plan.

You can roll over up to 100% of your payment that can be rolled over under Part I above, including an amount equal to the 20% that was withheld. If you choose to roll over 100%, you must find other money within the 60-day period to contribute to the traditional IRA or the qualified employer plan, to replace the 20% that was withheld. On the other hand, if you roll over only the 80% that you received, you will be taxed on the 20% that was withheld.

Example: The portion of your payment that can be rolled over under Part I above is $10,000, and you choose to have it paid to you. You will receive $8,000, and $2,000 will be sent to the IRS as income tax withholding. Within 60 days after receiving the $8,000, you may roll over the entire $10,000 to a traditional IRA or a qualified employer plan. To do this, you roll over the $8,000 you received from the Plan, and you will have to find $2,000 from other sources (your savings, a loan, etc.). In this case, the entire $10,000 is not taxed until you take it out of the traditional IRA or the qualified employer plan. If you roll over the entire $10,000, when you file your income tax return you may get a refund of part or all of the $2,000 withheld.

If, on the other hand, you roll over only $8,000, the $2,000 you did not roll over is taxed in the year it was withheld. When you file your income tax return you may get a refund of part of the $2,000 withheld. (However, any refund is likely to be larger if you roll over the entire $10,000.)

Additional 10% Tax If You Are under Age 59-1/2. If you receive a payment before you reach age 59-1/2 and you do not roll it over, then, in addition to the regular income tax, you may have to pay an extra tax equal to 10% of the taxable portion of the payment. The additional 10% tax generally does not apply to (1) payments that are paid after you separate from service with your employer during or after the year you reach age 55, (2) payments that are paid because you retire due to disability, (3) payments that are paid as equal (or almost equal) payments over your life or life expectancy (or your and your beneficiary's lives or life expectancies), (4) dividends paid with respect to stock by an employee stock ownership plan (ESOP) as described in Code section 404(k), (5) payments that are paid directly to the government to satisfy a federal tax levy, (6) payments that are paid to an alternate payee under a qualified domestic relations order, or (7) payments that do not exceed the amount of your deductible medical expenses. See IRS Form 5329 for more information on the additional 10% tax.

Special Tax Treatment If You Were Born before January 1, 1936. If you receive a payment that can be rolled over under Part I and you do not roll it over to a traditional IRA or other qualified employer plan that will accept it, the payment will be taxed in the year you receive it. However, if the payment qualifies as a "lump sum distribution," it may be eligible for special tax treatment. (See also "Employer Stock or Securities", below.) A lump sum distribution is a payment, within one year, of your entire balance under the Plan (and certain other similar plans of the employer) that is payable to you <u>after</u> you have reached age 59-1/2 or because you have separated from service with your employer (or, in the case of a self-employed individual, after you have reached age 59-1/2 or have become disabled). For a payment to be treated as a lump sum distribution, you must have been a participant in the plan for at least five years before the year in which you received the distribution. The special tax treatment for lump sum distributions that may be available to you is described below.

Ten-Year Averaging. If you receive a lump sum distribution and you were born before January 1, 1936, you can make a one-time election to figure the tax on the payment by using "10-year averaging" (using 1986 tax rates). Ten-year averaging often reduces the tax you owe.

Capital Gain Treatment. If you receive a lump sum distribution and you were born before January 1, 1936 and if you were a participant in the Plan before 1974, you may elect to have the part of your payment that is attributable to your pre-1974 participation in the Plan taxed as long-term capital gain at a rate of 20%.

There are other limits on the special tax treatment for lump sum distributions. For example, you can generally elect this special tax treatment only once in your lifetime, and the election applies to all lump sum distributions that you receive in that same year. If you have previously rolled over a distribution from the Plan (or certain other similar plans of the employer), you cannot use this special averaging treatment for later payments from the Plan. If you roll over your payment to a traditional IRA, you will not be able to use special tax treatment for later payments from the traditional IRA. Also, if you roll over only a portion of your payment to a traditional IRA, this special tax treatment is not available for the rest of the payment. See IRS Form 4972 for additional information on lump sum distributions and how you elect the special tax treatment.

Employer Stock or Securities. There is a special rule for a payment from the Plan that includes employer stock (or other employer securities). To use this special rule, 1) the payment must qualify as a lump sum distribution, as described above, except that you do not need five years of plan participation, or 2) the employer stock included in the payment must be attributable to "after-tax" employee contributions, if any. Under this special rule, you may have the option of not paying tax on the "net unrealized appreciation" of the stock until you sell the stock. Net unrealized appreciation generally is the increase in the value of the employer stock while it was held by the Plan. For example, if employer stock was contributed to your Plan account when the stock was worth $1,000 but the stock was worth $1,200 when you received it, you would not have to pay tax on the $200 increase in value until you later sold the stock.

You may instead elect not to have the special rule apply to the net unrealized appreciation. In this case, your net unrealized appreciation will be taxed in the year you receive the stock, unless you roll over the stock. The stock (including any net unrealized appreciation) can be rolled over to a traditional IRA or another qualified employer plan, either in a direct rollover or a rollover that you make yourself.

If you receive only employer stock in a payment that can be rolled over, no amount will be withheld from the payment. If you receive cash or property other than employer stock, as well as employer stock, in a payment that can be rolled over, the 20% withholding amount will be based on the entire amount paid to you (including the employer stock but excluding the net unrealized appreciation). However, the amount withheld will be limited to the cash or property (excluding employer stock) paid to you.

If you receive employer stock in a payment that qualifies as a lump sum distribution, the special tax treatment for lump sum distributions described above (such as 10-year averaging) also may apply. See IRS Form 4972 for additional information on these rules.

Repayment of Plan Loans. If you end your employment and have an outstanding loan from your Plan, your employer may reduce (or "offset") your balance in the Plan by the amount of the loan you have not repaid. The amount of your loan offset is treated as a distribution to you at the time of the offset and will be taxed unless you roll over an amount equal to the amount of your loan offset to another qualified employer plan or a traditional IRA within 60 days of the date of the offset. If the amount of your loan offset is the only amount you receive or are treated as having received, no amount will be withheld from it. If you receive other payments of cash or property from the Plan, the 20% withholding amount will be based on the entire amount paid to you, including the amount of the loan repayment. The amount withheld will be limited to the amount of other cash or property paid to you (other than any employer securities).

IV. SURVIVING SPOUSES, ALTERNATE PAYEES, AND OTHER BENEFICIARIES

In general, the rules summarized above that apply to payments to employees also apply to payments to surviving spouses of employees and to spouses or former spouses who are "alternate payees." You are an alternate payee if your interest in the Plan results from a "qualified domestic relations order," which is an order issued by a court, usually in connection with a divorce or legal separation. Some of the rules summarized above also apply to a deceased employee's beneficiary who is not a spouse. However, there are some exceptions for payments to surviving spouses, alternate payees, and other beneficiaries that should be mentioned.

If you are a surviving spouse, you may choose to have a payment that can be rolled over, as described in Part I above, paid in a DIRECT ROLLOVER to a traditional IRA or paid to you. If you have the payment paid to you, you can keep it or roll it over yourself to a traditional IRA but you cannot roll it over to a qualified employer plan. If you are an alternate payee, you have the same choices as the employee. Thus, you can have the payment paid as a direct rollover or paid to you. If you have it paid to you, you can keep it or roll it over yourself to a traditional IRA or to another qualified employer plan that accepts rollovers.

If you are a beneficiary other than the surviving spouse, you *cannot* choose a direct rollover, and you *cannot* roll over the payment yourself.

If you are a surviving spouse, an alternate payee, or another beneficiary, your payment is generally not subject to the additional 10% tax described in section III above, even if you are younger than age 59-1/2.

If you are a surviving spouse, an alternate payee, or another beneficiary, you may be able to use the special tax treatment for lump sum distributions and the special rule for payments that include employer stock, as described in section III above. If you receive a payment because of the employee's death, you may be able to treat the payment as a lump sum distribution if the employee met the appropriate age requirements, whether or not the employee had 5 years of participation in the Plan.

HOW TO OBTAIN ADDITIONAL INFORMATION

This notice summarizes only the federal (not state or local) tax rules that might apply to your payment. The rules described above are complex and contain many conditions and exceptions that are not included in this notice. Therefore, you may want to consult with the Plan Administrator or a professional tax advisor *before* you take a payment of your benefits from your Plan. Also, you can find more specific information on the tax treatment of payments from qualified retirement plans in IRS Publication 575, *Pension and Annuity Income*, and IRS Publication 590, *Individual Retirement Arrangements*. These publications are available from your local IRS office, on the IRS's Internet Web Site at *www.irs.gov*,or by calling 1-800-TAX- FORMS.

Part IV. Items of General Interest

Notice of Proposed Rulemaking and Notice of Public Hearing

Source of Compensation for Labor or Personal Services

REG–208254–90

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains a proposed Income Tax Regulation describing the appropriate basis for determining the source of income from labor or personal services performed partly within and partly without the United States. This proposed regulation would modify the existing final regulation under section 861 of the Internal Revenue Code (Code). This regulation would affect foreign and United States persons that perform services partly within and partly without the United States during the taxable year. This document also provides a notice of a public hearing on this proposed regulation.

DATES: Written and electronic comments and outlines of topics to be discussed at the public hearing scheduled for April 19, 2000, must be received by March 29, 2000.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–208254–90), 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–208254–90), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Reg" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.gov/tax_regs/regslist.html. The public hearing will be held at 10 a.m. in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulation, David Bergkuist of the Office of Associate Chief Counsel (International), within the Office of Chief Counsel, (202) 622-3850; concerning submission of comments, the hearing, and/or to be placed on the building access list to attend the hearing, LaNita Van Dyke (202) 622-7180 (not toll free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR Part 1) under section 861 of the Internal Revenue Code (Code). These amendments modify the application of the existing final regulation relating to the determination of the source of income from the performance of labor or personal services when such labor or personal services are performed partly within and partly without the United States.

Explanation of Provisions

Section 861(a)(3) of the Code provides, in general, that compensation for the performance of labor or personal services within the United States is treated as gross income from sources within the United States. Generally, under current §1.861–4(b)(1)(i) of the Income Tax Regulations, if a specific amount is paid for labor or personal services performed in the United States, that amount shall be included in United States source gross income. If no accurate allocation or segregation of amounts paid as compensation for labor or personal services performed in the United States can be made, or when such compensation is paid for labor or personal service performed partly within and partly without the United States, this regulation provides that the amount to be included in gross income from sources within the United States shall be determined on the basis that most correctly reflects the proper source of income under the facts and circumstances of the particular case. In many cases, the facts and circumstances will be such that an apportionment on a time basis will be acceptable; that is, the amount to be included in gross income from sources within the United States will be that amount that bears the same relation to the total compensation as the number of days of performance of the labor or service within the United States bears to the total number of days of performance of labor or services for which the payment is made. In other cases, the facts and circumstances will be such that another method of apportionment will be acceptable.

The IRS understands that, under the current regulations, U.S. individuals posted overseas and foreign individuals posted to the United States generally apportion compensation on a time basis. However, the IRS has become aware that under the facts and circumstances test of the current regulations, U.S. individuals are taking the position that certain fringe benefits associated with an overseas posting by their employer should be considered compensation for labor or personal services performed outside the United States and treated entirely as foreign source income even though some services are performed within the United States during the time of the overseas posting. Conversely, foreign individuals posted to the United States are taking the position that fringe benefits associated with their U.S. posting should be apportioned between compensation for labor or personal services performed within and without the United States based upon the amount of time spent in each jurisdiction and would be partly U.S. and partly foreign source income. In addition, under the current regulations, similarly situated taxpayers may be treated differently depending upon how their employers account for any foreign posting fringe benefits. Where an employer separately states the value of a fringe benefit, a U.S. individual posted overseas may argue that the fringe benefit is entirely compensation for labor or personal services performed outside the United States and foreign source. However, another employee receiving the same amount of additional compensation as part of a foreign posting, but where that benefit is not separately stated, will often be required to apportion this benefit on the basis of time. Finally, the current regulations may allow U.S. individuals to take an inconsistent position for U.S. and foreign tax purposes with respect to the source of fringe benefits associated with an overseas posting and avoid all tax on such compensation.

Treasury and the IRS have determined that an individual who performs labor or personal services partly within and partly without the United States during a specific time period should apportion the services income, including any income in the nature of fringe benefits, between compensation for labor or personal services performed within and without the United States on a time basis. The amount of compensation paid for labor or personal services performed in the United States, as determined under proposed §1.861–4(b), will constitute United States source income unless an exception applies under §1.861–4(a). A time basis test for individuals will provide certainty as well as ease of administration for both taxpayers and the IRS. A time basis test will also prevent the possibility of in-bound taxpayers taking a time basis apportionment position to apportion a portion of their United States posting fringe benefits back to their home country while similarly situated out-bound taxpayers take a facts and circumstances position to allocate all of their fringe benefits to foreign sources. This rule will also eliminate any disparate treatment of similarly situated taxpayers that might occur due to their employer's method of wage accounting. Finally, Treasury and the IRS believe that this rule will limit the potential for individuals to take inconsistent positions for U.S. and foreign tax purposes with respect to the source of their fringe benefits and avoid all tax.

Treasury and the IRS have further determined that, with respect to persons other than an individual, an apportionment based upon all of the facts and circumstances available, for example, an apportionment based upon payroll expenses or capital and intangibles employed, may better reflect the proper source of such compensation. In many situations, an apportionment on a time basis may be acceptable.

The proposed regulation would delete as obsolete current §1.861–4(b)(2), containing rules applicable to taxable years beginning before January 1, 1976.

Proposed Effective Date

These regulations are proposed to be applicable for taxable years beginning on or after the date they are published in the **Federal Register** as final regulations.

Special Analyses

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

Comments and Public Hearing

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

A public hearing has been scheduled for April 19, 2000, beginning at 10 a.m. in room 2615 of the 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 comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by March 29, 2000. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of this regulation is David Bergkuist of the Office of Associate Chief Counsel (International), within the Office of Chief Counsel, Internal Revenue Service. However, other personnel from the IRS and Treasury Department participated in its development.

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Proposed Amendments to the Regulations

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

PART 1—INCOME TAX

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

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

Par. 2. Section 1.861–4 is amended as follows:

1. The heading for paragraph (a)(1) is revised.

2. A new sentence is added at the beginning of paragraph (a)(1).

3. Paragraphs (b) and (d) are revised.

The addition and revisions read as follows:

§1.861–4 Compensation for labor or personal services.

(a) *Compensation for labor or personal services performed within the United States*. (1) Generally, a specific amount paid for labor or personal services performed in the United States is gross income from sources within the United States. * * *

* * * * *

(b) *Compensation for labor or personal services performed partly within and partly without the United States*—(l) *Persons other than individuals*. If a taxpayer other than an individual receives compensation for a specific time period for labor or personal services performed partly within and partly without the United States, the amount of compensation for labor or personal services performed in the United States shall be determined on the basis that most correctly reflects the proper source of the income under the facts and circumstances of the particular case. To the extent that a determination is made on a time basis, the time period to which the compensation for services relates is presumed to be the taxable year of the taxpayer in which the services are performed unless the taxpayer establishes to the satisfaction of the Commissioner, or the Commissioner determines, a change in circumstances that establishes a distinct, separate, and continuous period of time.

(2) *Individuals*. If an individual receives compensation, including fringe benefits, for a specific time period for labor or personal services that are performed partly within and partly without the United States, the amount of compensation for labor or personal services performed within the United States shall be determined on a time basis. An amount of compensation for labor or personal services performed in the United States determined on a time basis is an amount that bears the same relation to the total compensation as the number of days of performance of the labor or services within the United States bears to the total number of days of performance of labor or services for which the compensation payment is made. The time period to which the compensation for services relates is presumed to be the calendar year in which the services are performed, unless the taxpayer establishes to the satisfaction of the Commissioner, or the Commissioner determines, a change in circumstances that establishes a distinct, separate, and continuous period of time. For example, a transfer from a position in the United States to a foreign posting during the year would generally establish two separate time periods. However, a foreign posting that requires short-term returns to the United States to perform services for the employer would not be sufficient to establish a distinct, separate, and continuous time period within the foreign posting time period. Short-term returns to the United States during the separate time period of the foreign posting would be relevant to the apportionment of compensation relating to such time period.

(3) *Examples*. The following examples illustrate the application of this paragraph (b):

Example 1. Corp X, a United States corporation, receives compensation of $15,000 under a contract for services to be performed concurrently in the United States and in several foreign countries at differing rates of compensation by numerous Corp X employees during the taxable year. The employees performing services under this contract perform their services exclusively in one jurisdiction and do not work both within and without the United States during the taxable year. The payroll costs for employees performing services in the United States associated with these contract services is $2,000 out of a total contract payroll cost of $3,000. Since the employees add relatively different amounts of value to the product, a time basis test is not the best test under the facts and circumstances of this particular case. An apportionment of the income received under the contract based upon relative payroll costs would be the basis that most correctly reflects the proper source of the income. Thus, $10,000 of the compensation received under this contract will be compensation for labor or personal services performed in the United States ($15,000 x $2,000/$3,000).

Example 2. Corp X, a United States corporation, receives compensation of $15,000 under a contract for services. Corp X is able to perform the services necessary to fulfill its obligation under the contract by assigning only three of its employees, each with the same rate of compensation, to render services both within and without the United States during the taxable year. Since the rate of compensation is the same, it can be assumed that all employees are adding the same value to the product. The total number of employee-days necessary to complete the contract is 30 days of which 10 days were spent performing services within the United States. Under these facts and circumstances, an apportionment on a time basis would be the basis that most correctly reflects the proper source of the income. The amount of compensation for labor or personal services performed in the United States will be that amount that bears the same relation to the total compensation as the number of days of performance of the labor or services within the United States bears to the total number of days of performance of labor or services for which the payment is made. Thus, $5,000 will be compensation from labor or personal services performed in the United States ($15,000 x 10/30).

Example 3. B, a nonresident alien individual, was employed by M, a domestic corporation, from March 1 to June 12 of the taxable year, a total of 104 days, for which B received compensation in the amount of $12,240. Under the contract, B was subject to call at all times by M and was in a payment status on a 7-day week basis. Pursuant to the contract, B performed services within the United States for 59 days and performed services without the United States for 45 days. Under subparagraph (b)(2) of this section, the amount of compensation from labor or personal services performed in the United States will be determined on a time basis and equal to $6,943.85 ($12,240 x 59/104).

Example 4. (i) A, a United States citizen, is employed by a domestic corporation. A earns an annual salary of $100,000. During the first quarter of the calendar year, A's post of duty is in the United States and A performs services entirely within the United States during this period. A is transferred to Country X for the remaining three-quarters of the year, and, in addition to A's annual salary, receives $75,000 in fringe benefits that relate to the foreign posting. These fringe benefits are paid separately from A's annual salary and are specifically stated to be a housing allowance and an allowance for family home leave. Under A's employment contract, A is required to work on a 5-day week basis, Monday through Friday. During the last three quarters of the year, A performs services 30 days in the United States and 150 days abroad.

(ii) A has $175,000 gross income for the taxable year from the performance of services. A is able to clearly establish that A's transfer created two distinct, separate, and continuous time periods within the calendar year. Accordingly, $25,000 of the income designated as salary is attributable to the first quarter of the year (one quarter of $100,000). This amount is allocated entirely to compensation for labor or personal services performed in the United States. The balance of A's adjusted gross income, $150,000 (which includes the $75,000 in fringe benefits that relate to the foreign posting), is compensation allocated to services performed for the final three quarters of his taxable year. During the last three quarters of the year, A's periodic performance of services in the United States does not constitute distinct, separate, and continuous periods of time. Of this $150,000 amount, $125,000 (150/180 x $150,000) is apportioned to compensation for labor or personal services performed outside the United States, and $25,000 (30/180 x $150,000) is apportioned to compensation for labor or personal services performed in the United States.

* * * * *

(d) *Effective date*. Paragraphs (a) and (c) of this section apply with respect to taxable years beginning after December 31, 1966, however, the first sentence of paragraph (a)(1) applies to taxable years beginning on or after final regulations are published in the **Federal Register**. Paragraph (b) of this section applies to taxable years beginning on or after final regulations are published in the **Federal Register**. For paragraph (b) of this section and corresponding rules applicable to taxable years beginning after December 31, 1966, and before the date final regulations are published in the **Federal Register**, see §1.861– 4(b) in effect prior to the date final regulations are published in the Federal Register (26 CFR part 1 revised April 1, 1999). For corresponding rules applicable to taxable years beginning before January 1, 1967, see §1.861–4 in effect prior to October 2, 1975 (26 CFR part 1 revised April 1, 1975).

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on January 20, 2000, 8:45 a.m., and published in the issue of the Federal Register for January 21, 2000, 65 F.R. 3401)

Notice of Proposed Rulemaking and Notice of Public Hearing

Guidance Under Section 356 Relating to the Treatment of Nonqualified Preferred Stock and Other in Certain Exchanges and Distributions

REG–105089–99

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations providing guidance relating to nonqualified preferred stock. The proposed regulations address the effective date of the definition of nonqualified preferred stock and the treatment of nonqualified preferred stock and similar preferred stock received by shareholders in certain reorganizations and distributions. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments and requests to speak (with outlines of oral comments) at a public hearing scheduled for 10 a.m., May 31, 2000, must be received by May 10, 2000.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–105089–99), 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–105089–99), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/tax_regs/regslist.html. The public hearing will be held in the NYU Classroom, Room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Richard E. Coss, (202) 622-7790; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, LaNita Van Dyke, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) under sections 354, 355, 356, and 1036 of the Internal Revenue Code (the Code). Section 1014 of the Taxpayer Relief Act of 1997 (TRA of 1997), Public Law 105-34, enacted on August 5, 1997, amended sections 351, 354, 355, 356, and 1036 of the Code. As amended, these sections, in general, provide that nonqualified preferred stock (as defined in section 351(g)(2)) (NQPS) received in an exchange or distribution will not be treated as stock or securities but, instead, will be treated as "other property" or "boot." As a result, the receipt of NQPS in a transaction occurring after the NQPS provisions are effective will, unless a specified exception applies, result in gain (or, in some instances, loss) recognition. Section 351(g)(4) provides authority to issue regulations to carry out the purposes of these provisions.

Section 351(g)(2)(A) defines NQPS as preferred stock if (1) the holder has the right to require the issuer or a related person to redeem or purchase the stock, (2) the issuer or a related person is required to redeem or purchase the stock, (3) the issuer or a related person has the right to redeem or purchase the stock and, as of the issue date, it is more likely than not that such right will be exercised, or (4) the dividend rate on the stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or other similar indices. Factors (1), (2), and (3) above will cause an instrument to be NQPS only if the right or obligation may be exercised within 20 years of the date the instrument is issued and such right or obligation is not subject to a contingency which, as of the issue date, makes remote the likelihood of the redemption or purchase.

These rights or obligations do not cause preferred stock to be NQPS in certain circumstances described in section 351(g)(2)(C). In one such exception, contained in section 351(g)(2)(C)(i)(II), a redemption or purchase right shall not cause stock to be NQPS if the stock containing the right is transferred in connection with the performance of services for the issuer or a related person (and represents reasonable compensation), and the right may be exercised only upon the holder's separation from service.

The NQPS provisions also provide certain exceptions to the treatment of NQPS as boot. Under sections 354(a)(2)(C), 355(a)(3)(D), and 356(e)(2), NQPS is treated as stock, and not other property, in cases where the NQPS is received in exchange for, or in a distribution with respect to, NQPS. As a result, the receipt of NQPS in exchange for NQPS will not result in gain or loss recognition.

Under prior law, preferred stock generally did not constitute boot in a reorganization or in a distribution under section 355 of the Code. The legislative history of the NQPS provisions indicates that Congress was concerned about nonrecognition transactions in which a secure preferred stock instrument is received in exchange for common stock or riskier preferred stock. The committee reports state that "[c]ertain preferred stocks have been widely used in corporate transactions to afford taxpayers non-recognition treatment, even though the taxpayers may receive relatively secure instruments in exchange for relatively risky investments," and that "[t]he Committee believes that when such preferred stock instruments are received in certain transactions, it is appropriate to view such instruments as taxable consideration, since the investor has often obtained a more secure form of investment." H.R. Rep. No. 148, 105th Cong., 1st Sess. 472 (1997); S. Rep. 33, 105th Cong., 1st Sess. (1997).

The NQPS provisions apply to transactions after June 8, 1997, but will not apply to any transaction (1) made pursuant to a written agreement which was binding on such date and at all times thereafter, (2) described in a ruling request submitted to the IRS on or before such date, or (3) described in a public announcement or filing with the Securities and Exchange Commission on or before such date. Section 1014(f) of TRA of 1997.

A temporary regulation published as T.D. 8753 (1999–9 I.R.B. 6) in the **Federal Register** on January 6, 1998, provides that, notwithstanding contemporaneously issued final regulations treating certain rights to acquire stock as securities that can be received tax-free in reorganizations and section 355 distributions, a right to acquire NQPS received in exchange for stock other than NQPS (or for a right to acquire stock other than NQPS) will not be treated as a security, and that NQPS received in exchange for stock other than NQPS (or for a right to acquire stock other than NQPS) will not be treated as stock or a security. The temporary regulation added §1.356–6T, and applies to NQPS (or a right to acquire such stock) received in connection with a transaction occurring on or after March 9, 1998 (other than transactions described in section 1014(f)(2) of TRA of 1997).

Explanation of Provisions

The proposed regulations address three technical issues relating to the question of whether certain preferred stock instruments qualify as NQPS.

The first issue addressed by the proposed regulations is whether stock described in section 351(g)(2) that was issued in a transaction on or before June 8, 1997, qualifies as NQPS (even though the receipt of such stock would not have been boot because the transaction in which it was received occurred prior to the NQPS provisions' effective date). Although the NQPS provisions generally are effective with respect to transactions occurring after June 8, 1997, neither the effective date provisions of section 1014(f) of TRA of 1997 nor the legislative history of the NQPS provisions addresses this issue.

The proposed regulations provide that stock described in section 351(g)(2) is NQPS regardless of the date on which the stock is issued. The IRS and Treasury believe that this represents the proper interpretation of the NQPS provisions; a contrary interpretation would give rise to results that are inconsistent with other NQPS provisions and their underlying policy.

For example, assume that corporation (T) issues preferred stock described in section 351(g)(2) to shareholder (X) in 1996, and that X surrenders the T stock and receives NQPS of acquiring corporation (P) in a reorganization occurring after June 8, 1997 (when the NQPS provisions are effective). If the T preferred stock received in 1996 is not NQPS, X will recognize gain (if any) on the exchange. This result is unwarranted, because X is not receiving a more secure type of investment for a relatively risky type of investment, and exchanges of NQPS for NQPS are otherwise governed by the nonrecognition rules of sections 354, 355, and 356.

The second issue addressed by the proposed regulations is the treatment of NQPS received in a reorganization in exchange for (or in a distribution with respect to) preferred stock that is not NQPS solely because, at the time the original stock was issued, a redemption or purchase right was not exercisable until after a 20-year period beginning on the issue date, or a redemption or purchase right was exercisable within a 20-year period but was subject to a contingency which made remote the likelihood of the redemption or purchase, or, in the case of an issuer's right to redeem or purchase stock described in section 351(g)(2)(A)(iii), was unlikely to be exercised within a 20-year period beginning on the issue date (or because of any combination of these reasons). To illustrate, assume that after June 8, 1997, T issues preferred stock to X that permits the holder to require T to redeem the stock on demand, but not before the stock is held for 22 years. Assume that seven years later, the T stock is exchanged in a reorganization for P preferred stock with substantially identical terms that permits the holder to require P to redeem the stock after 15 years.

Technically, this transaction could be viewed as a taxable exchange because X is receiving P stock that meets the definition of NQPS in exchange for T stock that is not NQPS (QPS). However, the IRS and Treasury believe that nonrecognition treatment is appropriate because the P stock represents a continuation of the original investment in the T stock.

The proposed regulations provide a rule that treats the P stock received in such transactions as QPS if the P stock is substantially identical to the T preferred stock surrendered (or the T stock on which a distribution is made). The substantially identical requirement is necessary to ensure that this rule does not permit the NQPS provisions to be circumvented through exchanges of QPS for more secure NQPS. The P stock is considered to be substantially identical to the T stock if two conditions are met. The first condition is that the P stock does not contain any terms which, in relation to the terms of the T stock, decrease the period in which a redemption or purchase right will be exercised, increase the likelihood that such a right will be exercised, or accelerate the timing of the returns from the stock instrument (including the receipt of dividends or other distributions). The second condition is that, as a result of the receipt of P stock in the transaction, the exercise of the right or obligation does not become more likely than not to occur within a 20-year period beginning on the issue date of the T stock. To illustrate the two conditions, if the P stock contains a term that permits the stock to be redeemed before the date on which the T stock could be redeemed, or if, at the time of the transaction, the T stock is not more likely than not to be redeemed within a 20-year period beginning on the issue date of the T stock but the P stock is more likely than not to be redeemed within a 20-year period beginning on the issue date of the T stock, the P stock is not substantially identical to the T stock.

Under this rule, the P stock received will continue to be treated as QPS in subsequent transactions, and similar principles will apply to those transactions. For example, if the P stock is later exchanged in a reorganization for substantially identical stock of another acquiring corporation, the acquiring corporation stock will also be treated as QPS. However, if the P stock is later exchanged for stock described in section 351(g)(2) that is not substantially identical, the receipt of the stock will be treated as boot.

The third issue addressed by the proposed regulations is how to interpret the provision that exempts from the definition of NQPS certain preferred stock containing a purchase or redemption right that may only be exercised on the holder's separation from service (compensation stock). To be exempted from the definition of NQPS under this provision, stock must be "transferred in connection with the performance of services" and must represent "reasonable compensation." A commentator has questioned how these requirements apply in the context of a reorganization or distribution. The concern is that, when an employee of T receives P preferred stock in a reorganization in exchange for T stock of equal value, the P stock received could be considered transferred in exchange for stock (rather than for services), or could be considered not to represent reasonable compensation (because the P stock received in the equal value exchange represents no additional compensation to the employee). The legislative history of the NQPS provisions does not address these ambiguities.

The IRS and Treasury believe that the exemption for compensation stock is intended to apply in situations where an employee previously received compensation stock and then surrenders that stock in a reorganization in exchange for new compensation stock containing a similar purchase or redemption right that can only be exercised upon separation from service. The proposed regulations provide a rule that treats the P preferred stock received in such transactions as satisfying the "transferred in connection with the performance of services" and the "reasonable compensation" requirements if the T stock surrendered (or the T stock on which a distribution is made) was originally transferred to the T employee in connection with the performance of services and represented reasonable compensation at the time of the transfer. This rule applies regardless of whether the T stock is common or preferred stock. No inference is intended regarding the meaning of the phrases "transferred in connection with the performance of services" and "reasonable compensation" for purposes other than the exemption from the definition of NQPS in section 351(g)(2)(C)(i)(II).

The proposed regulations also provide that the principles of the rules described above apply to transactions involving rights to acquire NQPS that are subject to §1.356–6T.

Proposed Effective Date

The proposed regulations are proposed to be effective for transactions on the date that final regulations are published in the **Federal Register**. Notwithstanding the prospective effective date of the proposed regulations, the IRS and Treasury believe that the regulations prescribe the proper treatment of the transactions they address, and the IRS generally will not challenge return positions consistent with the regulations. However, a transaction involving rights to acquire NQPS that occurs before the effective date of §1.356–6T will be treated in accordance with the law governing rights to acquire stock in effect at that time.

Special Analyses

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

Comments and 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, if written) that are submitted timely (in the manner described in the ADDRESSES portion of this preamble) to the IRS. The IRS and Treasury specifically request comments on the clarity of the proposed regulations and how the regulations may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for May 31, 2000, beginning at 10 a.m., in the NYU Classroom, Room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, D.C. 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 hearing 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 request to speak, and submit written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by May 10, 2000. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is Richard E. Coss, Office of Assistant Chief Counsel (Corporate). However, other personnel from the IRS and Treasury 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 is amended by adding the following entries in numerical order to read in part as follows:

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

Section 1.354–1 also issued under 26 U.S.C. 351(g)(4).

Section 1.355–1 also issued under 26 U.S.C. 351(g)(4). * * *

Section 1.356–7 also issued under 26 U.S.C. 351(g)(4). * * *

Section 1.1036–1 also issued under 26 U.S.C. 351(g)(4). * * *

Par. 2. Section 1.354–1 is amended by adding paragraph (f) as follows:

§1.354–1 Exchanges of stock and securities in certain reorganizations.

* * * * *

(f) *Nonqualified preferred stock*. See §1.356–7(a) and (b) for the treatment of nonqualified preferred stock (as defined in section 351(g)(2)) received in certain exchanges for nonqualified preferred stock or preferred stock. See §1.356–7(c) for the treatment of preferred stock received in certain exchanges for common or preferred stock described in section 351(g)(2)(C)(i)(II).

Par. 3. Section 1.355–1 is amended by adding paragraph (d) as follows:

§1.355–1 Distributions of stock and securities of a controlled corporation.

* * * * *

(d) *Nonqualified preferred stock.* See §1.356–7(a) and (b) for the treatment of nonqualified preferred stock (as defined in section 351(g)(2)) received in certain exchanges for (or in certain distributions with respect to) nonqualified preferred stock or preferred stock. See §1.356–7(c) for the treatment of the receipt of preferred stock in certain exchanges for (or in certain distributions with respect to) common or preferred stock described in section 351(g)(2)(C)(i)(II).

Par. 4. Section 1.356–7 is added to read as follows:

§ 1.356–7 Rules for treatment of nonqualified preferred stock and other preferred stock received in certain transactions.

(a) *Stock issued prior to effective date*. Stock described in section 351(g)(2) is nonqualified preferred stock (NQPS) regardless of the date on which the stock is issued. However, sections 351(g), 354(a)(2)(C), 355(a)(3)(D), 356(e), and 1036(b) do not apply to any transaction occurring prior to June 9, 1997, or to any transaction occurring after June 8, 1997, that is described in section 1014(f)(2) of the Taxpayer Relief Act of 1997, Public Law 105–34, 111 Stat. 788, 921.

(b) *Receipt of preferred stock in exchange for (or distribution on) substantially identical preferred stock* —- (1) *General rule.* For purposes of sections 354(a)(2)(C)(i), 355(a)(3)(D), and 356(e)(2), preferred stock is not NQPS, even though it is described in section 351(g)(2), if it is received in exchange for (or in a distribution with respect to) preferred stock (the original preferred stock) that is not NQPS (QPS), provided —-

(i) The original preferred stock is QPS solely because, on its issue date, a right or obligation described in clause (i), (ii), or (iii) of section 351(g)(2)(A) was not exercisable until after a 20-year period beginning on the issue date, the right or obligation was exercisable within the 20-year period beginning on the issue date but was subject to a contingency which made remote the likelihood of the redemption or purchase, or the issuer's (or a related party's) right to redeem or purchase the stock was not more likely than not to be exercised within a 20-year period beginning on the issue date, or because of any combination of these reasons; and

(ii) the stock received is substantially identical to the original preferred stock.

(2) *Substantially identical.* The stock received is substantially identical to the original preferred stock if —

(i) the stock received does not contain any term or terms which, in relation to any term or terms of the original preferred stock, decrease the period in which a right or obligation described in clause (i), (ii), or (iii) of section 351(g)(2)(A) may be exercised, increase the likelihood that such a right or obligation may be exercised, or accelerate the timing of the returns from the stock instrument, including the timing of actual or deemed dividends or other distributions received on the stock; and

(ii) as a result of the exchange or distribution, exercise of the right or obligation does not become more likely than not to occur within a 20-year period beginning on the issue date of the original preferred stock.

(3) *Treatment of stock received*. The stock received will continue to be treated as QPS in subsequent transactions involving such stock, and the principles of this paragraph (b) apply to such transactions as though the stock received is the original preferred stock issued on the same date as the original preferred stock.

(c) *Stock transferred for services.* For purposes of sections 354(a)(2)(C)(i), 355(a)(3)(D), and 356(e)(2), preferred stock containing a right or obligation described in clause (i), (ii) or (iii) of section 351(g)(2)(A) that is exercisable only upon the holder's separation from service from the issuer or a related person (as described in section 351(g)(3)(B)) will be treated as transferred in connection with the performance of services (and representing reasonable compensation) within the meaning of section 351(g)(2)(C)(i)(II), if such preferred stock is received in exchange for (or in a distribution with respect to) existing stock containing a similar right or obligation (exercisable only upon separation from service) and the existing stock was transferred in connection with the performance of services for the issuer or a related person (and represented reasonable compensation when transferred). In applying the rules relating to NQPS, the preferred stock received will continue to be treated as transferred in connection with the performance of services (and representing reasonable compensation) in subsequent transactions involving such stock, and the principles of this paragraph (c) apply to such transactions.

(d) *Rights to acquire stock.* For purposes of §1.356–6T, the principles of paragraphs (a), (b), and (c) of this section apply.

(e) *Examples*. The following examples illustrate paragraphs (a), (b), and (c) of this section. For purposes of the examples in this paragraph (e), T and P are corporations, A is a shareholder of T, and, except for in *Example 1*, A surrenders and receives (in addition to the stock exchanged in the examples) common stock in the reorganizations described.

Example 1. In 1995, A transfers property to T and receives T preferred stock that is described in section 351(g)(2) in a transaction under section 351. In 2002, pursuant to a reorganization under section 368(a)(1)(B), A surrenders the T preferred stock in exchange for P NQPS. Under paragraph (a) of this section, the T preferred stock issued to A in 1995 is NQPS. However, because section 351(g) does not apply to transactions occurring before June 9, 1997, the T NQPS was not "other property" within the meaning of section 351(b) when issued in 1995. Under sections 354(a)(2)(C) and 356(e)(2), the P NQPS received by A in 2002 is not "other property" within the meaning of section 356(a)(1)(B) because it is received in exchange for NQPS.

Example 2. T issues QPS to A on January 1, 2000 that is not NQPS solely because the holder cannot require T to redeem the stock until January 1, 2022. In 2007, pursuant to a reorganization under section 368(a)(1)(A) in which T merges into P, A surrenders the T preferred stock in exchange for P preferred stock with terms that are identical to the terms of the T preferred stock, including the term that the holder cannot require the redemption of the stock until January 1, 2022. Because the P stock and the T stock have identical terms, and because the redemption did not become more likely than not to occur within the 20-year period that begins on January 1, 2000 (which is the issue date of the T preferred stock) as a result of the exchange, under paragraph (b) of this section, the P preferred stock received by A is treated as QPS. Thus, the P preferred stock received is not "other property" within the meaning of section 356(a)(1)(B).

Example 3. The facts are the same as in *Example 2*, except that, in addition, in 2010, pursuant to a recapitalization of P under section 368(a)(1)(E), A exchanges the P preferred stock above for P NQPS that permits the holder to require P to redeem the stock in 2020. Under paragraph (b) of this section, the P preferred stock surrendered by A is treated as QPS. Because the P preferred stock received by A in the recapitalization is not substantially identical to the P preferred stock surrendered, the P preferred stock received by A is not treated as QPS. Thus, the P preferred stock received is "other property" within the meaning of section 356(a)(1)(B).

Example 4. T issues preferred stock to A on January 1, 2000 that permits the holder to require T to redeem the stock on January 1, 2018, or at any time thereafter, but which is not NQPS solely because, as of the issue date, the holder's right to redeem is subject to a contingency which makes remote the likelihood of redemption on or before January 1, 2020. In 2007, pursuant to a reorganization under section 368(a)(1)(A) in which T merges into P, A surrenders the T preferred stock in exchange for P preferred stock with terms that are identical to the terms of the T preferred stock. Immediately before the exchange, the contingency to which the holder's right to cause redemption of the T stock is subject makes remote the likelihood of redemption before January 1, 2020, but the P stock, although subject to the same contingency, is more likely than not to be redeemed before January 1, 2020. Because, as a result of the exchange of T stock for P stock, the exercise of the redemption right became more likely than not to occur within the 20-year period beginning on the issue date of the T preferred stock, the P preferred stock received by A is not substantially identical to the T stock surrendered, and is not treated as QPS. Thus, the P preferred stock received is "other property" within the meaning of section 356(a)(1)(B).

Example 5. The facts are the same as in *Example 4*, except that, immediately before the merger of T into P in 2007, the contingency to which the holder's right to cause redemption of the T stock is subject makes it more likely than not that the T stock will be redeemed before January 1, 2020. Because exercise of the redemption right did not become more likely than not to occur within the 20-year period beginning on the issue date of the T preferred stock as a result of the exchange, the P preferred stock received by A is substantially identical to the T stock surrendered, and is treated as QPS. Thus, the P preferred stock received is not "other property" within the meaning of section 356(a)(1)(B).

Example 6. A is an employee of T. In connection with A's performance of services for T, T transfers to A in 2000 an amount of T common stock that represents reasonable compensation. The T common stock contains a term granting A the right to require T to redeem the common stock, but only upon A's separation from service from T. In 2005, pursuant to a reorganization under section 368(a)(1)(A) in which T merges into P, A receives, in exchange for A's T common stock, P preferred stock granting a similar redemption right upon A's separation from P's service. Under paragraph (c) of this section, the P preferred stock received by A is treated as transferred in connection with the performance of services (and representing reasonable compensation) within the meaning of section 351(g)(2)(C)(i)(II). Thus, the P preferred stock received by A is QPS.

(f) *Effective dates*. This section applies to transactions occurring on or after the date these regulations are published as final regulations in the **Federal Register**.

Par. 5. Section 1.1036–1 is amended by adding paragraph (d) as follows:

§1.1036–1 Stock for stock of the same corporation.

* * * * *

(d) *Nonqualified preferred stock*. See §1.356–7(a) for the applicability of the definition of nonqualified preferred stock in section 351(g)(2) for stock issued prior to June 9, 1997, and for stock issued in transactions occurring after June 8, 1997, that are described in section 1014(f) of the Taxpayer Relief Act of 1997, Public Law 105–34, 111 Stat. 788, 921.

Robert E. Wenzel,
Deputy Commissioner
of Internal Revenue.

(Filed by the Office of the Federal Register on January 21, 2000, 8:45 a.m., and published in the issue of the Federal Register for January 26, 2000, 65 F.R. 4203)

Notice of Proposed Rulemaking and Notice of Public Hearing

Stock Transfer Rules: Supplemental Rules

REG–116048–99

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document proposes, by cross-reference to temporary regulations, amendments to the final regulations concerning the Federal tax treatment of certain exchanges subject to section 367(b) of the Internal Revenue Code (Code). The temporary regulations, T.D. 8863, provide an election for certain taxpayers engaged in certain exchanges described in section 367(b). The temporary regulations provide guidance for taxpayers that make the specified election in order to determine the extent to which income must be included and certain corresponding adjustments must be made. The text of the temporary regulations also serves as the text of the proposed regulations. This document also provides notice of a public hearing on the proposed regulations.

DATES: Written comments must be received by April 24, 2000. Requests to speak (with outlines of oral comments) at the public hearing scheduled for April 20, 2000, must be submitted by March 31, 2000.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–116048–99), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG–116048–99), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option of the IRS Home Page, or by submitting comments directly to the IRS Internet site at: http://www.irs.ustreas.gov/prod/tax_regs/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 regulations, Mark D. Harris, (202) 622-3860 (not a toll-free number); concerning submissions and the hearing, Guy Traynor, (202) 622-7180 (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 24, 2000. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the **Internal Revenue Service**, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of service to provide information.

The collection of information in this proposed regulation is in §1.367(b)–3(b)(4). This information is required to properly make an election to include an amount in income that is different than the inclusion currently required under §1.367(b)–3 of the final regulations. This information will be used to verify proper compliance with the section 367(b) regulations, including that the election provided herein was made and that the required adjustments will be made by all parties to the section 367(b) transaction. The collection of information is mandatory. The likely respondents are businesses or other for-profit institutions.

Estimated total annual reporting burden: 85 hours.

Estimated average annual burden hours per respondent: 4 hours, 15 minutes.

Estimated number of respondents: 20

Estimated annual frequency of responses: once

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

T.D. 8863 on page 488 amends the Income Tax Regulations (26 CFR part 1) relating to section 367(b). The temporary regulations contain rules that provide an election for certain taxpayers engaged in certain exchanges described in section 367(b).

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

Proposed Effective Date

Except as otherwise specified, these regulations are proposed to apply to section 367(b) exchanges that occur on or after January 24, 2000.

Special Analyses

It has been determined that these regulations are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. 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 upon the fact that the number of section 367(b) exchanges that require reporting under these regulations is estimated to be only 20 per year. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required.

Pursuant to section 7805(f) of the Code, these proposed regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact.

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) that are submitted timely to the IRS. The IRS and Treasury request comments on the clarity of the proposed regulation and how it may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for April 20, 2000, beginning at 10 a.m., in room 2615, Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit timely written comments and an outline of the topics to be discussed and the time to be devoted to each topic by (preferably a signed original and eight (8) copies) March 31, 2000. However, comments not to be presented at the hearing must be submitted by April 24, 2000.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

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

* * * * *

Proposed Amendments to the Regulations

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

Income taxes, Reporting and recordkeeping requirements.

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.367(b)–3 is amended by adding paragraph (b)(4) to read as follows:

§1.367(b)–3 Repatriation of foreign corporate assets in certain nonrecognition transactions.

* * * * *

(b) * * *

(4) [The text of this proposed addition is the same as the text of §1.367(b)–3T(b)(4) published in T.D.8863].

* * * * *

John M. Dalrymple,
Acting Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on January 21, 2000, 8:45 a.m., and published in the issue of the Federal Register for January 24, 2000, 65 F.R. 3629)

Update of Mortality Tables

Announcement 2000–7

The Internal Revenue Service and the Treasury Department are undertaking a review of the mortality table in effect under § 412(*l*)(7)(C) of the Internal Revenue Code (the Code) and section 302(d)(7)(C) of the Employee Retirement Income Security Act of 1974 (ERISA).

Background

Section 412(*l*) of the Code and section 302(d) of ERISA provide additional funding requirements for certain defined benefit pension plans. The additional funding requirements for a plan are in part based upon the current liability under a plan as defined in § 412(*l*)(7) of the Code and section 302(d)(7) of ERISA. Section 412(*l*)(7)(C) of the Code and section 302(d)(7)(C) of ERISA provide for the interest rate and mortality table to be used to determine the current liability of a plan.

Section 412(*l*)(7)(C) of the Code and section 302(d)(7)(C) of ERISA provide that the mortality table used in determining current liability shall be prescribed by the Secretary of the Treasury. Section 412(*l*)(7)(C)(ii)(I) of the Code and section 302(d)(7)(C)(ii)(I) of ERISA provide that the initial mortality table is to be based on the prevailing commissioners' standard table (described in § 807(d)(5)(A) of the Code) used to determine reserves for group annuity contracts issued on January 1, 1993.

Section 412(*l*)(7)(C)(iii) of the Code and section 302(d)(7)(C)(iii) of ERISA provide that, in the case of plan years beginning after December 31, 1995, the Secretary shall establish mortality tables which may be used (in lieu of the tables under§ 412(*l*)(7)(C)(ii) of the Code and section 302(d)(7)(C)(ii) of ERISA) to determine current liability for individuals who are entitled to benefits under the plan on account of disability. The Secretary was to establish separate tables for individuals whose disabilities occur in plan years beginning before January 1, 1995, and for individuals whose disabilities occur in plan years beginning on or after such date.

Except as provided in section 412(*l*)(7)(C)(iii) of the Code and section 302(d)(7)(C)(iii) of ERISA, relating to disabled lives, Rev. Rul. 95–28, 1995–1 C.B. 74, sets forth the mortality table to be used under Section 412(*l*)(7)(C)(ii)(I) of the Code and section 302(d)(7)(C)(ii)(I) of ERISA for plan years beginning after December 31, 1994. Rev. Rul. 95–28 also requested written comments concerning the mortality table to be used for determining current liability for plan years beginning after December 31, 1999, and information on existing or upcoming independent studies of mortality of individuals covered by pension plans.

Rev. Rul. 96–7, 1996–1 C.B. 59, sets forth the alternative mortality tables that may be used under § 412(*l*)(7)(C)(iii) of the Code and section 302(d)(7)(C)(iii) of ERISA to determine a plan's current liability for individuals who are entitled to benefits under the plan on account of disability.

Section 412(*l*)(7)(C)(ii)(III) of the Code and section 302(d)(7)(C)(ii)(III) of ERISA provide that the Secretary shall periodically (at least every 5 years) review any tables in effect under these sections and, to the extent the Secretary determines necessary, by regulation update the mortality tables used to determine current liability. Section 412(*l*)(7)(C)(ii)(II) of the Code and section 302(d)(7)(C)(ii)(II) of ERISA provide that the updated tables are to be based upon the actual experience of pension plans and projected trends in such experience, and that in prescribing such tables, the Secretary is to take into account results of available independent studies of mortality of individuals covered by pension plans. Section 412(*l*)(7)(C)(ii)(II) of the Code and section 302(d)(7)(C)(ii)(II) of ERISA also provide that the updated tables may not be effective until the first plan year beginning after December 31, 1999.

Review

As required by § 412(*l*)(7)(C)(ii)(III) of the Code and section 302(d)(7)(C)(ii)(III) of ERISA, the Internal Revenue Service and the Treasury Department are undertaking a review of the mortality tables used to determine current liability under § 412(*l*)(7)(C) of the Code and section 302(d)(7)(C) of ERISA. As part of the review, the Service and the Treasury Department will take into account studies of mortality of individuals covered by defined benefit pension plans. The review also includes an analysis of projected trends in mortality of individuals covered by defined benefit pension plans.

Accordingly, interested parties are invited to submit any studies of mortality, any studies of trends in mortality, or any information with respect to such studies that they believe to be relevant to individuals covered by defined benefit pension plans. Furthermore, interested parties are invited to submit written comments concerning the mortality table or tables to be used for determining current liability for plan years beginning after December 31, 1999. The studies, information, or comments should be sent to Commissioner of Internal Revenue, Attention: T:EP:RA:T:A1, Washington, D.C. 20224.

If the review indicates that a change in mortality tables is appropriate, the Service and the Treasury Department will propose regulations. The Service and the Treasury Department anticipate that in no event would there be any change in the mortality tables for plan years beginning before January 1, 2001.

Foundations Status of Certain Orgainzations

Announcement 2000–8

The following organizations have failed to establish or have been unable to maintain their status as public charities or as operating foundations. Accordingly, grantors and contributors may not, after this date, rely on previous rulings or designations in the Cumulative List of Organizations (Publication 78), or on the presumption arising from the filing of notices under section 508(b) of the Code. This listing does *not* indicate that the organizations have lost their status as organizations described in section 501(c)(3), eligible to receive deductible contributions.

Former Public Charities. The following organizations (which have been treated as organizations that are not private foundations described in section 509(a) of the Code) are now classified as private foundations:

1-12 Club, Baton Rouge, LA
Abounding Love Christian Ministries, Brown Deer, WI
Affirming Life, Inc., Oklahoma City, OK
Affordable Housing Corporation, Chicago, IL
Agape Community Arts Center, Cayce, SC
A.L. Brown Outreach Foundation, Jackson, MS
Alexandria Outreach Inc., Pineville, LA
Amazing Grace Ministries, Youngstown, OH
American Institute of Mathematics, Palo Alto, Ca
Amesbury Youth Music Supporters, Amesbury, MA
Another Way, Inc., Acme, PA
Arts for Hearts, Inc., Sacramento, CA
Bees Incorporated, New York, NY
Black Research Organization, Inc., Milwaukee, WI
Blast Intermediate Unit 17 Educational Enhancement Foundation, Williamsport, PA
Board of Trustees for People with Developmental Disabilities Inc., Bronx, NY
Bondservant Ministries, Inc., Katy, TX
Build and Design for Charities, Inc. A Delaware Corporation, Glendora CA
Capital City Transit Coalition, Gahanna, OH
Carlos Mantilla Ortega Foundation, Inc., Baltimore, MD
Causa-Peru, East Hartford, CT
Center for Alcohol Policy and Prevention, Syracuse, NY
Challenger Space Education Foundation, Santa Clara, CA
Christian Buddies, Wyoming, MI
City of Tolleson Community Development Block Grant Corporation, Tolleson, AZ
Clowns on Rounds, Inc., Albany, NY
Coalition for the Advancement of Regional Transportation, Inc., Louisville, KY
Coastal Villages Investment Fund, Anchorage, AK
Columbia-Marion County Development Foundation, Inc., Columbia, MS
Community Recovery House of Kansas, Kansas City, MO
Comtemporary Music Forum, Inc., Takoma Park, MD
Covington County Art Association, Seminary, MS
The D & N Institute, Oakland, CA
Danville Lions Foundation, Inc., Danville, VA
Dialogue Toward Change, Inc., Framingham, MA
Dr. Morris Smoller Social Service Fund, New York, NY
Eastern Virginia Breastfeeding Taskforce, Norfolk, VA
Elkhorn American Legion Baseball Association, Elkhorn, NE
Eugene/Springfield/Bethel Education Foundation, Eugene, OR
Flipper Temple Institutional Outreach Ministry, Inc., Atlanta, GA
Fort Dale Pioneer Settlement, Inc., Greenville, AL
Foundation of the Burns Archive, Inc., New York, NY
Foundation of the Interreligious Council of Central New York, Syracuse, NY
Fowler Center for Wildlife Education, Inc.
New Canaan, CT
Frends/Funding Resources in Education Needs and Directional Solutions, Inc., Tucson, AZ
Friends of Francis W. Gregory Jr. High School Foundation, New Orleans, LA
Friends of Luke, Glendale, AZ
Greenwood Stop the Violence Committee, Greenwood, SC
Healing Institute for Jobs Recovery Academics and Housing, Mt. View, CA
Heartbeat Enterprises, Prescott, AZ
Heavenbound, Inc., Reno, NV
Holden Youth Sports, Inc., Worchester, MA
Home Street Home, Clayton, NC
ILC Industries Foundation, Inc., Bohemia, NY
International Children Care, Houston, TX
The Jamani/Tanawake Project, Fairfield, CA
J & L Center Stage Incorporated, Danville, CA
Koanig Educational Foundation, Anchorage, AK
Latin American Educational Association for Health Care, Boston, MA
Lincoln Crawford, Cincinnati, Oh
Living Potential, Inc., Binghampton, NY
Local 144 Hospital & Health Facilities Education Fund, New York, NY
Los Angeles County Bomberos, Inc., Monterey Park, CA
Madison Rotary Club Foundation, Inc., Roseland, NJ
MAK Foundation, Inc., Montebello, CA
Marshall County Sheriff's Posse, Plymouth, IN
M & M Community Development, Inc., Nashville, TN
Multicultural Journalism Consortium, Inc., Schererville, IN
My Iran, Inc., Beaverton, OR
My Sisters Keeper, Seagoville, TX
National Hispanic Youth Organization, San Antonio, TX
New Day, Inc., Des Moines, IA
New Direction Outreach, Mound Bayou, MS
New Federalist Foundation, Salt Lake City, UT
New Life for All, Inc., Eustis, FL
New Life Praise Temple Ministries, Inc., Savannah, GA
New Mexico Foundation for Educational Excellence, Albuquerque, NM
New York Kunsthalle, Inc., New York, NY
Operation One Warm Coat Plus—Children of Shelters, San Francisco, CA
OSHO Neeraj Meditation Center, Inc., Niskayuna, NY
Outreach Ministry for Singles, Inc., Newark, NY
Philadelphia Center for Complementary Medicine, Philadelphia, PA
Pioneer Civic Services, Inc. Peoria, IL
Project Scivias Hildegardis, San Francisco, CA
Promotion of Education in Pakistan Foundation, Inc., Staten Island, NY
Ra'Hel House, Columbus, OH
Reaching Out to Others Through Services, Washington, DC
RNC, Inc., Dallas, TX
Salon De Fleurus, Inc., New York, NY
Sandwich Islands Mission Outreach, Honolulu, HI
Seawind Initiative, Inc., Cotuit, MA
Serving Christ Ministry, St. Paul, MN
Shamrock Foundation, Portland, OR
Shofar Broadcasting Corp c/o James R. Jenkins, Charleston, WV
Shree Kapilaben Ramanlal Patel Foundation, Medinah, IL
Snadpiper Medical Foundation, Palo Alto, CA
Sons of the American Revolution Patriotic and Educational Foundation, Inc., Atlanta, GA
Sullivan Center Foundation for Children, Fresno, CA

Texas Medical Assistance and Development, Houston, TX
Tullywinney Arts and Education Fund, Inc., Helena, MT
United Interfaith Council, Chicago, IL
University Community Hospital Specialty Care, Inc., Tampa, FL
Village Oaks Community Association, Eugene, OR
Wayne Group Home Corporation, Hackensack, NJ
We Stop the Tears, Sun City, AZ
Wooster Family Housing Corporation, Akron, OH
Yonose Foundation, Tucson, AZ

If an organization listed above submits information that warrants the renewal of its classification as a public charity or as a private operating foundation, the Internal Revenue Service will issue a ruling or determination letter with the revised classification as to foundation status. Grantors and contributors may thereafter rely upon such ruling or determination letter as provided in section 1.509(a)–7 of the Income Tax Regulations. It is not the practice of the Service to announce such revised classification of foundation status in the Internal Revenue Bulletin.

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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The abbreviation and number in parenthesis following the index entry refer to the specific item; numbers in roman and italic type following the parenthesis refer to the Internal Revenue Bulletin in which the item may be found and the page number on which it appears.

Key to Abbreviations:

RR	Revenue Ruling
RP	Revenue Procedure
TD	Treasury Decision
CD	Court Decision
PL	Public Law
EO	Executive Order
DO	Delegation Order
TDO	Treasury Department Order
TC	Tax Convention
SPR	Statement of Procedural Rules
PTE	Prohibited Transaction Exemption

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