Internal Revenue
bulletin

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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.

SPECIAL ANNOUNCEMENT

Announcement 2002–101, page 800.
This announcement solicts applications from potential partners to participate in the 2003 IRS Individual *e-file* Partnership Program. The partnership opportunities are a result of RRA 98, which requires the IRS to receive 80 percent of all returns electronically by 2007. RRA 98 authorized the IRS Commissioner to promote the benefits of and encourage the use of *e-file* services through partnerships with various entities that offer low cost tax preparation and electronic filing of income tax returns for qualified taxpayers. Those applicants that are accepted as partners will have a link(s) and description(s) of their services placed on the IRS website at *www.irs.gov* (IRS *e-file* Partners Page).

INCOME TAX

Rev. Rul. 2002–69, page 760.
Business expenses; interest; lease-in/lease-out transactions. A taxpayer may not deduct currently, under sections 162 and 163 of the Code, rent and interest paid or incurred in connection with a lease-in/lease-out (LILO) transaction that properly is characterized as conferring only a future interest in property. Rev. Rul. 99–14 modified and superseded.

Rev. Rul. 2002–71, page 763.
Notional principal contract (NPC). This ruling provides guidance on the timing of recognition of gain or loss on the termination of a notional principal contract that hedges a portion of the term of a debt instrument issued by the taxpayer.

Rev. Rul. 2002–72, page 759.
Low-income housing credit; satisfactory bond; "bond factor" amounts for the period October through December 2002. This ruling announces the monthly bond factor amounts to be used by taxpayers who dispose of qualified low-income buildings or interests therein during the period October through December 2002. This ruling also provides a summary of the bond factor amounts for dispositions occurring during the period January through September 2002.

REG–112306–00, page 767.
Proposed regulations under section 1296 of the Code contain procedures for certain United States persons holding marketable stock in a passive foreign investment company (PFIC) to elect mark to market treatment for that stock. A public hearing is scheduled for November 6, 2002.

REG–150313–01, page 777.
Proposed regulations under sections 302, 304, and other sections of the Code provide guidance regarding the treatment of the basis of redeemed stock when a distribution in redemption of such stock is treated as a dividend. The regulations also provide guidance regarding certain acquisitions of stock by related corporations that are treated as distributions in redemption of stock. A public hearing is scheduled for February 20, 2003.

Notice 2002–70, page 765.
This notice alerts taxpayers and their representatives about certain reinsurance transactions intended to shift income to offshore related companies purported to be insurance companies that are subject to little or no U.S. federal income tax. These transactions often do not generate the federal tax benefits that taxpayers claim are allowable for federal income tax purposes. This notice also alerts taxpayers, their representatives, and promoters of these transactions, to certain reporting and record keeping obligations and penalties that they may be subject to with respect to these transactions.

Announcement 2002–100, page 799.
This document contains corrections to proposed regulations under section 1503(d) of the Code (REG–106879–00, 2002–34 I.R.B. 402) relating to the events that require the recapture of dual consolidated losses.

Finding Lists begin on page ii.
Index for July through October begins on page v.

Department of the Treasury
Internal Revenue Service

Announcement 2002–102, page 802.
This document changes the date of a scheduled public hearing and extends the public comment period on proposed regulations (REG–136311–01, 2002–36 I.R.B. 485) that relate to when a foreign corporation engaged in the international operation of ships or aircraft may exclude its U.S. source income from gross income for U.S. federal income tax purposes. The hearing is rescheduled from November 12, 2002, to November 25, 2002.

EMPLOYEE PLANS

REG–124667–02, page 791.
Proposed regulations under section 417 of the Code would consolidate the content requirements applicable to explanations of qualified joint and survivor annuities and qualified preretirement survivor annuities payable from certain retirement plans. In addition, these regulations would specify requirements for disclosing the relative value of optional forms of benefit that are payable from certain retirement plans in lieu of a qualified joint and survivor annuity. A public hearing is scheduled for January 14, 2003.

The IRS Mission

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

Introduction

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

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

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

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

The Bulletin is divided into four parts as follows:

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

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

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

Part IV.—Items of General Interest.
This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

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

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

Low-income housing credit; satisfactory bond; "bond factor" amounts for the period October through December 2002. This ruling announces the monthly bond factor amounts to be used by taxpayers who dispose of qualified low-income buildings or interests therein during the period October through December 2002. This ruling also provides a summary of the bond factor amounts for dispositions occuring during the period January through September 2002.

Rev. Rul. 2002–72

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

Rev. Proc. 99–11, 1999–1 C.B. 275, established a collateral program as an alternative to providing a surety bond for taxpayers to avoid or defer recapture of the low-income housing tax credits under § 42(j)(6). Under this program, taxpayers may establish a Treasury Direct Account and pledge certain United States Treasury securities to the Internal Revenue Service as security.

This revenue ruling provides in Table 1 the bond factor amounts for calculating the amount of bond considered satisfactory under § 42(j)(6) or the amount of United States Treasury securities to pledge in a Treasury Direct Account under Rev. Proc. 99–11 for dispositions of qualified low-income buildings or interests therein during the period October through December 2002. Table 1 also provides a summary of the bond factor amounts for dispositions occurring during the period January through September 2002.

Table 1
Rev. Rul. 2002–72
Monthly Bond Factor Amounts for Dispositions Expressed
As a Percentage of Total Credits

	Calendar Year Building Placed in Service or, if Section 42(f)(1) Election Was Made, the Succeeding Calendar Year										
Month of Disposition	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
Jan '02	17.76	32.73	45.44	56.24	65.46	65.92	66.46	66.99	67.63	68.35	69.24
Feb '02	17.76	32.73	45.44	56.24	65.46	65.75	66.28	66.80	67.44	68.16	69.05
Mar '02	17.76	32.73	45.44	56.24	65.46	65.57	66.10	66.62	67.26	67.98	68.86
Apr '02	17.76	32.73	45.44	56.24	65.46	65.40	65.93	66.45	67.08	67.80	68.68
May '02	17.76	32.73	45.44	56.24	65.46	65.23	65.76	66.27	66.91	67.62	68.50
Jun '02	17.76	32.73	45.44	56.24	65.46	65.06	65.59	66.11	66.74	67.46	68.33
Jul '02	17.76	32.73	45.44	56.24	65.46	64.90	65.42	65.94	66.58	67.29	68.17
Aug '02	17.76	32.73	45.44	56.24	65.46	64.74	65.26	65.78	66.42	67.13	68.01
Sep '02	17.76	32.73	45.44	56.24	65.46	64.58	65.10	65.62	66.26	66.98	67.86
Oct '02	17.76	32.73	45.44	56.24	65.46	64.43	64.95	65.47	66.11	66.83	67.72
Nov '02	17.76	32.73	45.44	56.24	65.46	64.27	64.80	65.32	65.96	66.68	67.58
Dec '02	17.76	32.73	45.44	56.24	65.46	64.12	64.65	65.17	65.81	66.54	67.44

Table 1 (cont'd)
Rev. Rul. 2002–72
Monthly Bond Factor Amounts for Dispositions Expressed
As a Percentage of Total Credits

Month of Disposition	Calendar Year Building Placed in Service or, if Section 42(f)(1) Election Was Made, the Succeeding Calendar Year			
	1999	2000	2001	2002
Jan '02	70.13	70.98	72.28	72.55
Feb '02	69.92	70.77	72.05	72.55
Mar '02	69.73	70.58	71.84	72.55
Apr '02	69.55	70.40	71.67	72.55
May '02	69.38	70.24	71.51	72.55
Jun '02	69.21	70.09	71.37	72.55
Jul '02	69.05	69.94	71.25	72.55
Aug '02	68.90	69.81	71.14	72.55
Sep '02	68.76	69.68	71.04	72.55
Oct '02	68.62	69.57	70.94	72.55
Nov '02	68.49	69.45	70.86	72.55
Dec '02	68.37	69.35	70.78	72.55

For a list of bond factor amounts applicable to dispositions occurring during other calendar years, see: Rev. Rul. 98–3, 1998–1 C.B. 248; Rev. Rul. 2001–2, 2001–1 C.B. 255; and Rev. Rul. 2001–53, 2001–2 C.B. 488.

DRAFTING INFORMATION

The principal author of this revenue ruling is Gregory N. Doran of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling, contact Mr. Doran at (202) 622–3040 (not a toll-free call).

Section 162.—Trade or Business Expenses

26 CFR 1.162–11: Rentals.
(Also § 163; 1.163–1.)

Business expenses; interest; lease-in/lease-out transactions. A taxpayer may not deduct currently, under sections 162 and 163 of the Code, rent or interest paid or incurred in connection with a lease-in/lease-out (LILO) transaction that properly is characterized as conferring only a future interest in property.

Rev. Rul. 2002–69

ISSUE

May a taxpayer deduct currently, under §§ 162 and 163 of the Internal Revenue Code, rent and interest paid or incurred in connection with a "lease-in/lease-out" ("LILO") transaction?

FACTS

X is a U.S. corporation. *FM* is a foreign municipality that has historically owned and used certain property. As of 1997, it is estimated that the property has a remaining useful life of 50 years and a fair market value of $100 million. *BK1* and *BK2* are banks. None of these four parties is related to any of the others.

On January 1, 1997, *X* and *FM* entered into a LILO transaction under which *FM* leased the property to *X* under a "Headlease," and *X* immediately leased the property back to *FM* under a "Sublease." The term of the Headlease is 40 years. The primary term of the Sublease is 20 years. Moreover, as described below, the Sublease also may be renewed for a term of 10 years ("put renewal term") at the option of *X*. *X*'s right to possess the property under the Headlease for the first 20 years is substantially the same as *FM*'s right to possession under the Sublease for the primary term.

The Headlease requires *X* to make two rental payments to *FM* during its 40-year term: (1) an $89 million prepayment at the beginning of year 1; and (2) a postpayment at the end of year 40 that has a discounted present value of $8 million. For federal income tax purposes, *X* and *FM* allocate the prepayment ratably to the first 6 years of the Headlease and the future value of the postpayment ratably to the remaining 34 years of the Headlease.

The Sublease requires *FM* to make fixed, annual rental payments over both the primary term and, if exercised, the put renewal term. The fixed, annual payments during the put renewal term are equal to 90 percent of the amounts that (as of January 1, 1997) are projected to be the fair market value rental amounts for that term.

To partially fund the $89 million Headlease prepayment, *X* borrows $54 million from *BK1* and $6 million from *BK2*. Both loans are nonrecourse, have fixed interest rates, and provide for annual debt service payments that fully amortize the loans over the 20-year primary term of the Sublease. The amount and timing of the debt ser-

vice payments mirror the amount and timing of the Sublease payments due during the primary term of the Sublease. The remaining $29 million of the Headlease prepayment is provided by *X*.

Upon receiving the $89 million Headlease prepayment, *FM* deposits $54 million into a deposit account with an affiliate of *BK1* and $6 million into a deposit account with an affiliate of *BK2*. The deposits with the affiliates of *BK1* and *BK2* earn interest at the same rates as the loans from *BK1* and *BK2*. *FM* directs the affiliate of *BK1* to pay *BK1* annual amounts equal to 90 percent of *FM*'s annual rent obligation under the Sublease (that is, amounts sufficient to satisfy *X*'s debt service obligation to *BK1*). The parties treat these amounts as having been paid from the affiliate to *FM*, then from *FM* to *X* as rental payments, and finally from *X* to *BK1* as debt service payments. In addition, *FM* pledges the deposit account to *X* as security for *FM*'s obligations under the Sublease, while *X*, in turn, pledges its interest in *FM*'s pledge to *BK1* as security for *X*'s obligations under the loan from *BK1*. Similarly, *FM* directs the affiliate of *BK2* to pay *BK2* annual amounts equal to 10 percent of *FM*'s annual rent obligation under the Sublease (that is, amounts sufficient to satisfy *X*'s debt service obligation to *BK2*). The parties treat these amounts as having been paid from the affiliate to *FM*, then from *FM* to *X* as rental payments, and finally from *X* to *BK2* as debt service payments. Although *FM*'s deposit with the *BK2* affiliate is not pledged, the parties understand that *FM* will use the account to pay the remaining 10 percent of *FM*'s annual rent obligation under the Sublease.

As a result of the foregoing arrangement, *X*'s obligation to make the property available under the 20-year primary term of the Sublease is completely offset by *X*'s right to use the property under the Headlease. *X*'s obligation to make debt service payments on the loans from *BK1* and *BK2* is completely offset by *X*'s right to receive Sublease rentals from *FM*. Moreover, *X*'s exposure to the risk that *FM* will not make the rent payments is further limited by the arrangements with the affiliates of *BK1* and *BK2*. In the case of the loan from *BK1*, *X*'s economic risk is eliminated through the defeasance arrangement. In the case of the $6 million loan from *BK2*, *X*'s economic risk, although not eliminated, is substantially reduced through the deposit arrangement. As a result, neither bank requires an independent source of funds to make the loans, or bears significant risk of nonpayment. In short, during the primary Sublease term, the transaction is characterized by reciprocal and circular obligations that offset one another.

At the end of the Sublease primary term, *FM* has a fixed-payment option to purchase from *X* the Headlease residual (the right to use the property beyond the Sublease primary term subject to the obligation to make the rent postpayment) for a fixed exercise price equal to 105 percent of the amount that (as of January 1, 1997) is projected to be the future fair market value of the Headlease residual. If *FM* exercises the option, the transaction is terminated at that point, and *X* receives the exercise price of the option and is not required to make any portion of the postpayment due under the Headlease. If *FM* does not exercise the option, *X* may elect to (1) use the property itself for the remaining term of the Headlease, (2) lease the property to another person for the remaining term of the Headlease, or (3) compel *FM* to lease the property for the 10-year put renewal term of the Sublease. If *FM* does not exercise the fixed-payment option and *X* exercises its put renewal option, *X* will receive rents that are equal to 90 percent of the amounts that are (as of January 1, 1997) projected to be the fair market rents for that term. If the actual fair market rents in 20 years turn out to be less than the amount specified in the put renewal option and *FM* does not exercise the fixed-payment option, *X* will be able to compel *FM* to lease the property for rents that are greater than the then fair market rental value. Thus, as a practical matter, the fixed-payment option and put renewal option operate to "collar" the value of the Headlease residual during the primary term.

In addition, *X* has nominal exposure to *FM*'s credit under the fixed-payment option and, if exercised, the put renewal term. At the inception of the transaction, *X* requires *FM* to invest $15 million of the Headlease prepayment in highly-rated debt securities that will mature in an amount sufficient to fund the fixed amount due under the fixed-payment option, and to pledge these debt securities to *X*. This arrangement ensures that *FM* is able to make the payment under the fixed-payment option. Having economically defeased both its rental obligations under the Sublease and its fixed-payment under the fixed-payment option, *FM* keeps the remaining portion of the Headlease prepayment as its return on the transaction. If *FM* does not exercise the fixed-payment option and *X* exercises the put renewal option, *X* can require *FM* to purchase a letter of credit guaranteeing the put renewal rents. If *FM* does not obtain the letter of credit, *FM* must exercise the fixed-payment option.

For tax purposes, *X* claims deductions for interest on the loans and for the allocated rents on the Headlease. *X* includes in gross income the rents received on the Sublease. If the fixed-payment option is exercised, *X* also includes the option price and recaptures rent deductions taken during the primary Sublease term that are attributable to the postpayment it is no longer required to make.

LAW AND ANALYSIS

X and *FM*'s allocations of the prepayment and the postpayment for federal income tax purposes meet the uneven rent test contained in proposed § 467 regulations (§ 1.467–3(c)(2)(i)), and under those regulations the Headlease would not be treated as a disqualified leaseback or long-term agreement subject to constant rental accrual. Because this LILO transaction was entered into after June 3, 1996, and on or before May 18, 1999, the provisions of the proposed regulations are available. *See* § 1.467–9(c). For later years, however, final § 467 regulations effective May 18, 1999, treat the prepayment of rent as resulting in a deemed loan from *X* to *FM* and require the imputation of interest income to *X*. § 1.467–4. Moreover, *X*'s rent deduction would be subject to proportional rent rules that reflect the time value of money concept. *See* § 1.467–2(c).

The substance of a transaction, not its form, governs its tax treatment. *Gregory v. Helvering*, 293 U.S. 465 (1935). In *Frank Lyon Co. v. United States*, 435 U.S. 561, 573 (1978), the United States Supreme Court stated, "In applying the doctrine of substance over form, the Court has looked to the objective economic realities of a transaction rather than to the particular form the parties employed." The Court evaluated the substance of the transaction in *Frank Lyon* to determine that it was indeed a sale/leaseback, as it was structured,

rather than a financing. The Court subsequently relied on its approach in *Frank Lyon* to recharacterize a sale and repurchase of federal securities as a loan, finding that the economic realities of the transaction did not support the form chosen by the taxpayer. *Nebraska Dep't of Revenue v. Loewenstein*, 513 U.S. 123 (1994).

Where parties have in form entered into two separate transactions that result in offsetting obligations, the courts often have collapsed the offsetting obligations and recharacterized the two transactions as a single transaction. In *Rogers v. United States*, 281 F.3d 1108 (10th Cir. 2002), the part-owner (Fogelman) of a professional baseball team that was organized as an S corporation borrowed money from the S corporation. The nonrecourse loan was secured by Fogelman's ownership interest in the corporation and his existing option to purchase the rest of the shares from the taxpayer (Kauffman), the other owner of the team. Fogelman also granted the corporation an option to purchase both his shares and his existing option to buy Kauffman's shares. The option price was an amount equal to the outstanding loan balance. The corporation exercised its option immediately but deferred closing until the due date of Fogelman's loan, five months later. On that date, Fogelman transferred his shares in the corporation to the corporation in lieu of its foreclosure on the loan. The corporation claimed that the shares had no value at that time and deducted the loan amount as a bad debt, which was passed through to Kauffman.

The court in *Rogers* applied the substance over form doctrine to collapse the loan and the option transaction into a redemption of Fogelman's stock in exchange for cash. Fogelman had no incentive to repay the loan because any reduction in the loan balance would reduce the option price. The immediate exercise of the option precluded any attempt by Fogelman to repay the loan and keep the stock. On the basis of those facts, among others, the court held that the substance of the transaction was a sale of Fogelman's stock to the corporation.

In *Bussing v. Commissioner*, 88 T.C. 449, *reconsideration denied*, 89 T.C. 1050 (1987), a Swiss subsidiary of a computer leasing company (AG) purchased computer equipment in a sale/leaseback transaction involving a five-year lease. Subsequently, AG purportedly sold the equipment to a domestic corporation (Sutton), which in turn purportedly sold interests in the equipment to the taxpayer (Bussing) and four other individual investors. Bussing acquired his interest in the computer equipment subject to the underlying lease by paying cash, short-term promissory notes, and a long-term promissory note to Sutton. Bussing then leased his interest in the equipment back to AG for nine years. The rents due Bussing from AG equaled Bussing's annual payments on the long-term promissory note to Sutton for the first three years and were supposed to generate nominal annual cash flow thereafter.

The court first disregarded Sutton's participation in the transactions on substance over form grounds. It then held that Bussing's long-term indebtedness also must be disregarded because it was completely offset by AG's rent payments in a "purported sale-leaseback pursuant to which the respective lease and debt obligations flow between only two parties." *Id.* at 458. The court stated,

> The respective obligations between AG and Bussing cancel each other out. Any possible claim by AG with respect to the note is fully offset by AG's rental obligation to Bussing. . . . Bussing, effectively, will never be required to make any payments on his debt obligation, a feature of the transaction that we believe the parties intended to achieve.

Id. After collapsing the offsetting loan and lease, the court concluded that Bussing had acquired an interest in a joint venture with AG and the other investors to the extent of his cash payment only.

Courts have similarly disregarded the parties' obligations in purported installment sales where the taxpayer received an installment note that was offset by some other arrangement between the two parties, indicating that the maker of the note would not be called upon to pay the installment obligation. *See Rickey v. Commissioner*, 502 F.2d 748 (9th Cir. 1974), *aff'g* 54 T.C. 680 (1970). Although taxpayers are entitled to arrange the terms of a sale in order to qualify for the installment method, "the arrangements must have substance and must reflect the true situation rather than being merely the formal documentation of the terms of the sale." *Id.* at 752–53, quoting 54 T.C. 680 at 694. *See also United States v. Ingalls*, 399 F.2d 143 (5th Cir. 1968); *Blue Flame Gas Co. v. Commissioner*, 54 T.C. 584 (1970); *Greenfield v. Commissioner*, T.C. Memo. 1982–617; *Big "D" Development Corp. v. Commissioner*, T.C. Memo. 1971–148, *aff'd per curiam*, 453 F.2d 1365 (5th Cir.1972).

Similarly, the Headlease and Sublease impose offsetting obligations that must be disregarded, regardless of whether other components of the LILO transaction are respected. During the first 20 years of its term, the Headlease confers to X a right to use the property that is immediately reversed by the Sublease grant to FM of substantially the same right to use property. In the LILO transaction, the Sublease interest retained by *FM* is of the same nature as the Headlease interest conveyed to *X*. Because the transfer and retransfer of the right to possess the property for the first 20 years are disregarded as offsetting obligations, the transaction that remains is, at best, a transfer of funds from *X* to *FM* in exchange for *FM*'s obligation to repay those funds and provide *X* the right to begin to lease the property in 20 years.

An analogous situation occurs when the conveyance of property is accompanied by the retention of some interest in the same property. If the interest retained is of substantially the same nature as the interest conveyed, only a future interest is conveyed. In *McCully Ashlock v. Commissioner*, 18 T.C. 405 (1952), *acq.*, 1952–2 C.B. 1, taxpayer had acquired property through a deed dated June 6, 1945. The seller, however, had retained the right to possession and rentals through August 15, 1947. The court found that taxpayer had acquired only a future interest in the property because "the trustees [sellers] not only retained the rents legally but they also retained control and benefits of ownership." *Id.* at 411. Consequently, rentals from the property were income to the seller.

Similarly, in *Kruesel v. United States*, 63–2 U.S. Tax Cas. (CCH) ¶ 9714 (D. Minn. 1963), the court concluded that taxpayer had transferred only a future, remainder interest in property and reserved a life estate. The government had unsuccessfully argued that taxpayer had sold its entire interest in the property and the taxpayer's amount realized on the sale included the value of a right to occupancy provided to the taxpayer by the buyer.

In contrast, in *Alstores Realty Corp. v. Commissioner*, 46 T.C. 363 (1966), *acq.*, 1967–2 C.B.1, the court held that a sale of property accompanied by the reservation of a right of occupancy did not result in the transfer of only a future interest because the seller's right of occupancy was in the nature of a leasehold interest, because the purchaser acquired the benefits and burdens of ownership of the property.

Alstores can be distinguished from *McCully Ashlock* and *Kruesel*. *McCully Ashlock* and *Kruesel* conclude that where a retained interest is of the same nature as the interest conveyed, only a future interest has been transferred. In *Alstores*, the interests were not of the same nature.

Similarly, the LILO transaction is distinguishable from the transaction involved in *Comdisco, Inc. v. Commissioner*, 756 F.2d 569 (7th Cir. 1985). In that case, equipment was subject to end user leases, and the lessor of that equipment assigned an interest to taxpayer in a transaction designed to give the taxpayer investment tax credits. The taxpayer's entitlement to the credits depended on whether it had the status of lessee/sublessor. In concluding that it did, the court noted a number of factors that supported taxpayer's claim that it had acquired a leasehold interest. The taxpayer was obligated to the lessor in the event of a default by the sublessee. The taxpayer relet certain equipment after one sublease had expired. In connection with another sublease, the taxpayer was responsible for rent to its assignor in excess of amounts paid by the sublessee directly to the assignor. The court also emphasized the regulatory restrictions on direct leases between the assignor and the end users. *Id.* at 576–77. Unlike *Comdisco*, in the LILO transaction the headlessor and the sublessee are the same party. Further, in the LILO transaction the headlessee/sublessor is not materially exposed to the risk that the sublessee will fail to make rent payments.

Section 162(a)(3) permits a deduction for rentals and other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property. Because *X* does not acquire a current leasehold interest in the property, it is not entitled to current deductions for rent. The $29 million "equity" portion of the Headlease prepayment is, effectively, a payment for at most *X*'s right under the Headlease to lease the property 20 years hence for a term of 20 years. (Economically, $29 million is an overpayment for the value of any right that *X* obtains to lease the property in the future. *X* was willing to overpay in this manner, however, in order to induce *FM* to participate in the transaction.). In accordance with § 467, the $29 million "equity" portion of the Headlease prepayment is deductible over the 20-year residual term of the Headlease (the 10-year put renewal term and the 10-year "shirttail" period). Alternatively, in the event *FM* exercises its fixed-price option at the end of the primary term of the Sublease, *X* will have gain or loss equal to the difference between the option price and *X*'s cost of acquiring a right to the Headlease residual term. Section 1001.

The remainder of the Headlease prepayment, $60 million, must be disregarded, because the "loans" that purportedly finance this portion of the Headlease prepayment are without substance. In *Bridges v. Commissioner*, 39 T.C. 1064, *aff'd* 325 F.2d 180 (4th Cir. 1963), taxpayer "borrowed" funds from banks and used the funds to purchase Treasury notes, which the banks held as collateral and ultimately sold to satisfy taxpayer's debts. The court's rationale for disallowing taxpayer's deductions of prepaid interest is equally applicable here:

> [P]etitioner at no time had the uncontrolled use of any additional money, of the bonds, or of the interest on the bonds. He assumed no risk of a rise or fall in the market price of the bonds and could not take advantage of such. His payment to the bank was not for the use or forbearance of money; it was for the purchase of a rigged sales price for the bonds and for a tax deduction. Petitioner incurred no genuine indebtedness, within the meaning of the statute, and as a payment of interest, this transaction was also a sham.

Id. at 1078–79. Neither *X* nor *FM* obtain use of the "borrowed" funds. The "loans" purportedly are made to finance *X*'s acquisition of the Headlease interest. But that leasehold interest is substantially offset by an interdependent Sublease with the Headlessor. What remains can only be enjoyed after 20 years and after the loans have been "repaid" using "rents" from a Sublease that itself lacks substance. Under the circumstances, the loans are disregarded.

Although this ruling refers to a foreign municipality and its property, the analysis and holding apply as well to LILO transactions that involve or include domestic tax-exempt or tax-indifferent entities.

HOLDING

A taxpayer may not deduct currently, under §§ 162 and 163, rent or interest paid or incurred in connection with a LILO transaction that properly is characterized as conferring only a future interest in property.

Where appropriate, the Service will continue to disallow the tax benefits claimed in connection with LILO transactions upon other grounds, including that the substance over form doctrine requires their recharacterization as financing arrangements and that they are to be disregarded for lack of economic substance.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 99–14, 1999–1 C.B. 835, is modified and superseded.

DRAFTING INFORMATION

The principal author of this revenue ruling is John Aramburu of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this revenue ruling, contact Mr. Aramburu at (202) 622–4960 (not a toll-free call).

Section 163.—Interest

26 CFR 1.162–17: Interest deduction in general.

May a taxpayer deduct currently, under § 163, interest paid or incurred in connection with a lease-in/lease-out (LILO) transaction that properly is characterized as conferring only a future interest in property. See Rev. Rul. 2002–69, page 760.

Section 446.—General Rule for Methods of Accounting

(Also 26 CFR 1.446–4)

Notional principal contract (NPC). This ruling provides guidance on the timing of recognition of gain or loss on the termination of a notional principal contract that hedges a portion of the term of a debt instrument issued by the taxpayer.

ISSUE

When should a taxpayer take into account gain or loss on the termination of a notional principal contract (NPC) that hedges a portion of the term of a debt instrument issued by the taxpayer?

FACTS

Situation 1

Taxpayer *TP* uses the calendar year as its taxable year. On the first day of Year 1, *TP* issues a debt instrument. The debt instrument has a 10-year term and provides for interest to be paid annually at a fixed rate. Contemporaneously with the issuance of the debt instrument, *TP* also enters into an NPC with a 5-year term that converts the fixed rate payments under the debt instrument into floating rate payments. That is, the NPC provides for *TP* to receive payments equal to the product of the fixed rate on the debt instrument and a notional amount equal to the principal amount of the debt instrument in exchange for payments by *TP* equal to the product of a floating rate and the same notional amount. Pursuant to § 1.1221–2(f), *TP* properly identifies the NPC as a hedging transaction covering Year 1 through Year 5 of the debt instrument and complies with the other requirements necessary for the NPC to be treated as a hedge under §§ 1.1221–2 and 1.446–4. *TP* terminates the NPC on the last day of Year 2 and either receives or makes a termination payment.

Situation 2

The facts are the same as *Situation 1*, but, in addition, *TP* retires the debt instrument in Year 4.

LAW

Section 1.446–4(a) provides that a hedging transaction as defined in § 1.1221–2(b) must be accounted for under the rules set forth in § 1.446–4.

Section 1.446–4(b) provides that the method of accounting used by a taxpayer for a hedging transaction must clearly reflect income. Section 1.446–4(b) further provides that to clearly reflect income, the method used for a hedging transaction must reasonably match the timing of income, deduction, gain, or loss from the hedging transaction with the timing of income, deduction, gain, or loss from the item being hedged.

Section 1.446–4(e)(4) provides that gain or loss from a transaction that hedges a debt instrument issued or to be issued by a taxpayer, or a debt instrument held or to be held by a taxpayer, must be accounted for by reference to the terms of the debt instrument and the period or periods to which the hedge relates. A hedge of an instrument that provides for interest to be paid at a fixed rate or a qualified floating rate, for example, generally is accounted for using constant yield principles. Thus, assuming that a fixed rate or qualified floating rate instrument remains outstanding, hedging gain or loss is taken into account in the same periods in which it would be taken into account if it adjusted the yield of the instrument over the term to which the hedge relates. Section 1.446–4(e)(4) provides, as an example, that gain or loss realized on a transaction that hedged an anticipated fixed rate borrowing for its entire term is accounted for, solely for purposes of § 1.446–4, as if it decreased or increased the issue price of the debt instrument. However, in all events, the taxpayer's method, as actually applied to the taxpayer's hedging transactions, must clearly reflect income by meeting the matching requirement of § 1.446–4(b). *See* § 1.446–4(e) (introductory sentences).

ANALYSIS

Situation 1

Unlike the hedging transaction described in § 1.446–4(e)(4) that hedges a fixed rate borrowing over its entire term, *TP's* NPC does not hedge the entire term of the debt instrument. Rather, *TP's* NPC hedges, and relates only to, Year 1 through Year 5 of the 10-year term of the debt instrument. Prior to its termination on the last day of Year 2, the NPC would have continued to hedge Year 3 through Year 5 of the debt instrument, and *TP* generally would have been required to take into account the remaining income, deduction, gain, or loss over the period from Year 3 through Year 5. The termination payment made or received by *TP* represents the present value of the extinguished rights and obligations under the NPC for Year 3 through Year 5. Therefore, the gain or loss from the hedging transaction relates to Year 3 through Year 5. To clearly reflect income in accordance with the matching requirement of § 1.446–4(b), *TP* must take into account the gain or loss from terminating the NPC over the period from Year 3 through Year 5.

Situation 2

Following the analysis from *Situation 1*, *TP* would have already taken into account in Year 3 a portion of the gain or loss from termination of the NPC in Year 2. However, upon retiring the debt instrument in Year 4, *TP's* remaining gain or loss from the termination of the NPC should be recognized in order to match the timing of income, deduction, gain, or loss from the hedging transaction with the timing of income, deduction, gain, or loss from the item being hedged.

HOLDING

(1) In *Situation 1*, *TP* must account for the gain or loss arising from terminating the NPC over the period from Year 3 through Year 5, the remaining period to which the terminated hedge relates.

(2) In *Situation 2*, *TP* takes into account in Year 3 a portion of the gain or loss arising from the termination of the NPC and takes into account in Year 4 the remaining balance of the gain or loss from the terminated hedge.

DRAFTING INFORMATION

The principal authors of this revenue ruling are K. Scott Brown and Clay Littlefield of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this revenue ruling, contact Messrs. Brown or Littlefield at (202) 622–3920 (not a toll-free call).

Part III. Administrative, Procedural, and Miscellaneous

Certain Reinsurance Arrangements

Notice 2002–70

The Internal Revenue Service and Treasury Department have become aware of a type of transaction, described below, that is being used by taxpayers to shift income from taxpayers to related companies purported to be insurance companies that are subject to little or no U.S. federal income tax. This notice alerts taxpayers and their representatives that these transactions often do not generate the federal tax benefits that taxpayers claim are allowable for federal income tax purposes. This notice also alerts taxpayers, their representatives, and promoters of these transactions, to certain reporting and record keeping obligations and penalties that they may be subject to with respect to these transactions.

The transaction generally involves a taxpayer ("Taxpayer") (typically a service provider, automobile dealer, lender, or retailer) that offers its customers the opportunity to purchase an insurance contract through Taxpayer in connection with the products or services being sold. The insurance provides coverage for repair or replacement costs if the product breaks down or is lost, stolen, or damaged, or coverage for the customer's payment obligations in case the customer dies, or becomes disabled or unemployed.

Taxpayer offers the insurance to its customers by acting as an insurance agent for an unrelated insurance company ("Company X"). Taxpayer receives a sales commission from Company X equal to a percentage of the premiums paid by Taxpayer's customers. Taxpayer forms a wholly-owned corporation ("Company Y"), typically in a foreign country, to reinsure the policies sold by Taxpayer. Promoters sometimes refer to these companies as producer owned reinsurance companies or "PORCs". If Company Y is a foreign corporation, it typically elects to be treated as a domestic insurance company under § 953(d) of the Internal Revenue Code. Company Y takes the position that it is entitled to the benefits of § 501(c)(15) (providing that non-life insurance companies are tax exempt if premiums written for the taxable year do not exceed $350,000), § 806 (providing a deduction for certain life insurance companies with life insurance company taxable income not in excess of $15,000,000), or § 831(b) (allowing qualifying non-life insurance companies whose net written premiums are between $350,000 and $1,200,000 to elect to be taxed solely on investment income).

Taxpayer receives premiums from its customers and remits those premiums (typically net of its sales commission) to Company X. Company X pays any claims and state premium taxes due and retains an amount from the premiums received from Taxpayer. Under Company Y's reinsurance agreement with Company X, Company Y reinsures all insurance policies that Taxpayer sells to its customers. Company X transfers the remainder of the premiums to Company Y as reinsurance premiums.

ANALYSIS

Many of the transactions described in this notice have been designed to use a reinsurance arrangement to divert income properly attributable to Taxpayer to Company Y, Taxpayer's wholly-owned reinsurance company that is subject to little or no federal income tax. The Service intends to challenge the purported tax benefits from these transactions on a number of grounds.

First, depending upon the facts and circumstances, the Service may assert that Company Y is not an insurance company for federal income tax purposes. For federal income tax purposes, an insurance company is a company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. § 1.801–3(a) of the Income Tax Regulations; § 816(a) (which provides that a company will be treated as an insurance company for federal income tax purposes only if "more than half of the business" of that company is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies). While a taxpayer's name, charter powers, and state regulation help to indicate the activities in which it may properly engage, whether the taxpayer qualifies as an insurance company for tax purposes depends on its actual activities during the year. *Inter-American Life Ins. Co. v. Commissioner*, 56 T.C. 497, 506–08 (1971), *aff'd per curiam*, 469 F.2d 697 (9th Cir. 1972) (taxpayer whose predominant source of income was from investments did not qualify as an insurance company); *see also Bowers v. Lawyers Mortgage Co.*, 285 U.S. 182, 188 (1932). To qualify as an insurance company, a taxpayer "must use its capital and efforts primarily in earning income from the issuance of contracts of insurance." *Indus. Life Ins. Co. v. United States*, 344 F. Supp. 870, 877 (D. S.C. 1972), *aff'd per curiam*, 481 F.2d 609 (4th Cir. 1973). To determine whether Company Y qualifies as an insurance company, all of the relevant facts will be considered, including but not limited to, the size and activities of any staff, whether Company Y engages in other trades or businesses, and its sources of income. *See generally Lawyers Mortgage Co.* at 188–90; *Indus. Life Ins. Co.*, at 875–77; *Cardinal Life Ins. Co. v. United States*, 300 F. Supp. 387, 391–92 (N.D. Tex. 1969), *rev'd on other grounds*, 425 F. 2d 1328 (5th Cir. 1970); *Serv. Life Ins. Co. v. United States*, 189 F. Supp. 282, 285–86 (D. Neb. 1960), *aff'd on other grounds*, 293 F.2d 72 (8th Cir. 1961); *Inter-Am. Life Ins. Co.*, at 506–08 ; *Nat'l. Capital Ins. Co. of the Dist. of Columbia v. Commissioner*, 28 B.T.A. 1079, 1085–86 (1933).

If Company Y is not an insurance company, it is not entitled to the benefits of §§ 501(c)(15), 806, or 831(b). Further, if Company Y is a foreign corporation and is not an insurance company, any election Company Y made under § 953(d) is not valid and Company Y will be treated as a controlled foreign corporation as defined in § 957. In such a case, Taxpayer will be treated as a U.S. shareholder of Company Y and generally will include in its gross income on a current basis any subpart F income of Company Y. *See* § 951(a) and (b). In addition, Company Y will not qualify for the exceptions from subpart F income under §§ 953(a)(2) and 954(i) for certain insurance income because those exceptions are only available to a foreign corporation that, among other requirements, is engaged in the insurance business and would be subject to tax under subchapter L if such corporation were a domestic corporation. *See* § 953(e)(3)(C).

Second, the Service may apply §§ 482 or 845 to allocate income from Company Y to Taxpayer if necessary clearly to reflect the income of Taxpayer and Company Y. Section 482 provides the Secretary with authority to allocate gross income, deductions, credits or allowances among persons owned or controlled directly or indirectly by the same interests, if such allocation is necessary to prevent evasion of taxes or clearly to reflect income. The § 482 regulations provide that in determining the taxable income of a controlled person, the standard to be applied is that of a person dealing at arm's length with an uncontrolled person. § 1.482–1(b)(1). Section 482 may apply to a transaction between two or more controlled persons notwithstanding that an uncontrolled person participates in the transaction as an intermediary. *See GAC Produce Co. v. Commissioner*, T.C.M. 1999–134. If, as a result of the reinsurance transaction, Taxpayer's income is not consistent with the arm's length standard, then § 482 authorizes the Secretary to allocate income from Company Y to Taxpayer. Section 845(a) allows the Service to reallocate income, deductions, assets, reserves, credits, and other items between two or more related parties who are parties to a reinsurance agreement. Thus, such items may be reallocated from Company Y to Taxpayer under the authority of § 845(a).

Third, in appropriate cases, the Service may disregard the insurance and reinsurance arrangements, and thereby require Taxpayer to recognize an additional portion of premiums received from its customers as its income, if the arrangements are shams in fact or shams in substance. *See Kirchman v. Commissioner*, 862 F.2d 1486, 1492 (11th Cir. 1989). Courts have distinguished between "shams in fact" where the reported transactions never occurred and "shams in substance" which actually occurred but lack the substance their form represents. *ACM Partnership v. Commissioner*, 157 F.3d 231, 247 n. 30 (3d Cir. 1998), *cert. denied*, 526 U.S. 1017 (2002) (citations omitted). In determining whether a transaction constitutes a sham in substance, both a majority of the Courts of Appeals and the Tax Court consider two related factors, economic substance apart from tax consequences, and business purpose. *See ACM Partnership; Karr v. Commissioner*, 924 F.2d 1018, 1023 (11th Cir. 1991), *cert. denied*, 502 U.S. 1082 (1992); *James v. Commissioner*, 899 F.2d 905, 908–09 (10th Cir. 1990); *Shriver v. Commissioner*, 899 F.2d 724, 727 (8th Cir. 1990); *Rose v. Commissioner*, 868 F.2d 851, 853 (6th Cir. 1989); *Kirchman*. Although a taxpayer has the right to arrange its affairs to reduce its tax liability, the substance of a transaction must govern its tax consequences regardless of the form in which the transaction is cast. *See Gregory v. Helvering*, 293 U.S. 465, 469 (1935). If the transactions involving Taxpayer, Company X, and Company Y are disregarded, the income of Company Y is income of Taxpayer. *See Wright v. Commissioner*, T.C.M. 1993–328.

Transactions that are the same as, or substantially similar to, the transaction described in this notice that involve taxpayers claiming entitlement to the benefits of §§ 501(c)(15), 806, or 831(b) are identified as "listed transactions" for purposes of § 1.6011–4T(b)(2) of the temporary Income Tax Regulations and § 301.6111–2T(b)(2) of the temporary Procedure and Administration Regulations. See also § 301.6112–1T, A–4. Independent of their classification as "listed transactions" for purposes of §§ 1.6011–4T(b)(2) and 301.6111–2T(b)(2), transactions that are the same as, or substantially similar to, the transaction described in this notice may already be subject to the disclosure requirements of § 6011, the tax shelter registration requirements of § 6111, or the list maintenance requirements of § 6112 (§§ 1.6011–4T, 301.6111–1T, 301.6111–2T and 301.6112–1T, A–3 and A–4).

Persons who are required to satisfy the registration requirement of § 6111 with respect to the transactions described in this notice and who fail to do so may be subject to the penalty under § 6707(a). Persons who are required to satisfy the list-keeping requirement of § 6112 with respect to the transactions described in this notice and who fail to do so may be subject to the penalty under § 6708(a). In addition, the Service may impose penalties on participants in these transactions or substantially similar transactions involving taxpayers claiming entitlement to the benefits of §§ 501(c)(15), 806, or 831(b) or, as applicable, on persons who participate in the promotion or reporting of such transactions, including the accuracy-related penalty under § 6662, the return preparer penalty under § 6694, the promoter penalty under § 6700, and the aiding and abetting penalty under § 6701.

The principal authors of this notice are John Glover of the Office of Associate Chief Counsel (Financial Institutions and Products) and Theodore Setzer and Sheila Ramaswamy of the Office of Associate Chief Counsel (International). For further information regarding this notice, contact Mr. Glover at (202) 622–3970 or Mr. Setzer or Ms. Ramaswamy (202) 622–3870 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking and Notice of Public Hearing

Electing Mark to Market for Marketable Stock

REG–112306–00

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains procedures for certain United States persons holding marketable stock in a passive foreign investment company (PFIC) to elect mark to market treatment for that stock under section 1296 and related provisions of sections 1291 and 1295. These proposed regulations affect United States persons owning marketable stock in a PFIC. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments and outlines of oral comments to be presented at the public hearing scheduled for November 6, 2002, at 10 a.m., must be received by October 16, 2002.

ADDRESSES: Send submissions to: CC:IT&A:RU (REG–112306–00), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:IT&A:RU (REG–112306–00), Courier's Desk, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically directly to the IRS Internet site at: *www.irs.gov/regs*. The public hearing will be held in room 4718, Internal Revenue Service Building, 1111 Consitiution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Mark Pollard at (202) 622–3850, concerning submissions and the hearing, Ms. Lanita Vandyke (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Since the enactment of the Tax Reform Act of 1986, United States persons that own PFIC stock have been subject to two alternative tax regimes: the interest charge rules under section 1291 of the Internal Revenue Code (Code) and the qualified electing fund (QEF) rules under section 1293. Congress recognized that the interest charge rules are a substantial source of complexity for PFIC shareholders and that some shareholders would prefer the current inclusion method afforded by the QEF regime, but are unable to obtain the necessary information from the PFIC. See H.R. Rep. No. 105–148, at 533 (1997); S. Rep. No. 105–33 at 94 (1997). Accordingly, Congress enacted new section 1296 in the Taxpayer Relief Act of 1997 to provide shareholders with an alternative method to include income currently with respect to their interest in a PFIC by allowing them to elect to mark to market their PFIC stock provided the stock is marketable. In 1998, Congress enacted certain technical corrections to section 1296 and related provisions, including rules to address the overlap between the PFIC and other mark to market provisions in the Code. IRS Restructuring and Reform Act of 1998, section 6011(c).

Proposed § 1.1291–8 (INTL–656–87, 1992–1 C.B. 1124) had been published on April 1, 1992 (57 FR 11024). This proposed regulation would have provided an election for certain regulated investment companies (RICs) to use a mark to market method for their PFIC stock. Although § 1.1291–8 was originally proposed to be effective prospectively, the IRS subsequently notified taxpayers that the proposed regulations, when finalized, would permit this limited mark to market election to be made only for taxable years ending after March 31, 1992, and before April 1, 1993. Notice 92–53, 1992–2 C.B. 384. As a result of the enactment of section 1296, proposed § 1.1291–8 was withdrawn (64 FR 5015); see also Notice 99–14, 1999–1 C.B. 736.

On January 25, 2000, final regulations were published under section 1296(e) (2000 final regulations). T.D. 8867, 2000–1 C.B. 620 [65 FR 3817]. The 2000 final regulations provide guidance regarding the definition of marketable stock for purposes of section 1296.

In General

United States persons who own marketable stock (as defined in section 1296(e)) in a PFIC may elect to mark to market that stock annually pursuant to section 1296 (section 1296 election). United States persons making a section 1296 election with respect to PFIC stock (section 1296 stock) are not subject to the generally applicable interest charge regime of section 1291. The section 1296 election is available to United States persons and controlled foreign corporations (CFCs) that own, or are treated as owning, marketable stock in a PFIC.

Explanation of Provisions

A. *Changes to Proposed § 1.1291–1(c): Coordination of PFIC Rules and other Mark to Market Provisions*

Except for the coordination rules discussed herein, section 1291(d)(1) provides that the interest charge regime does not apply in the case of PFIC stock that is marked to market under (i) section 1296, or (ii) section 475 or any other provision of chapter 1 of the Code. This regulation revises § 1.1291–1(c), 57 FR 11024, proposed April 1, 1992, to incorporate this coordination rule and to clarify that the interest charge regime does not apply to a United States person that marks to market its PFIC stock under any provision of chapter 1 of the Code, without regard to whether such regime is mandatory or elective. Proposed § 1.1295–1(i)(3) and proposed § 1.1296–1(h)(3)(i) further clarify that, with respect to taxation under a mark to market provision other than under section 1296, this coordination rule applies without regard to whether the taxpayer also has made a section 1296 election or a QEF election with respect to such stock, by providing that either election is automatically terminated immediately following the close of the taxpayer's taxable year preceding the first taxable year for which the stock of the PFIC

is subject to the mark to market regime under another provision of chapter 1 of the Code.

The proposed regulations also provide a special rule for situations where a taxpayer owns PFIC stock that becomes subject to a mark to market regime other than section 1296 after the first taxable year of the taxpayer's holding period. In such instances, the taxpayer must apply the coordination rules of § 1.1291–1(c)(3)(ii) for the first taxable year that such other mark to market regime applies. Thereafter, the general rule above, overriding the application of the section 1291, QEF and PFIC mark to market regimes, applies for all subsequent taxable years provided that the PFIC stock continues to be marked to market under another provision of chapter 1 of the Code.

B. *Changes to § 1.1295–1*

1. *Revocation of QEF election*

The proposed regulations also provide guidance on the coordination of the mark to market provisions under section 1296 with the existing rules for QEFs. In general, the Service considered the circumstances in which a taxpayer would be permitted to switch from one regime to another in light of the relative administrative burdens imposed under each set of rules, and the stated intent of Congress that one of the purposes for enacting section 1296 was to provide another alternative to the interest charge rules of section 1291 that would be available in instances where taxpayers cannot obtain sufficient information to make a QEF election. See H.R. Rep. No. 105–148, at 533 (1997); S. Rep. No. 105–33 at 94 (1997). Accordingly, the proposed regulations are structured to facilitate an election for mark to market treatment by permitting a taxpayer with an existing QEF election to make a section 1296 election and terminate the existing QEF election without requiring consent of the Commissioner. In instances where a taxpayer has an existing section 1296 election, it is permitted to make a QEF election only if the section 1296 election is terminated as provided by section 1296 and the regulations thereunder (*e.g.*, if the PFIC stock ceases to be marketable) or is revoked with consent of the Commissioner.

2. *Re-election of QEF regime*

The proposed regulations further provide that if the section 1296 election is subsequently terminated or revoked, other than because the taxpayer marks to market under another provision of the Code, (*e.g.*, because the stock is no longer marketable), the shareholder will be subject to tax under section 1291, unless a new QEF election is made. Section 1.1295–1(i)(4) currently provides that without the Commissioner's consent, a shareholder whose QEF election was invalidated, terminated, or revoked may not make a new QEF election with respect to the PFIC before the sixth taxable year ending after the taxable year in which the invalidation, termination, or revocation became effective. The regulations propose to amend § 1.1295–1(i) to provide an exception for situations where a United States person's QEF election was terminated because it elected to mark to market such stock under section 1296, and the 1296 election was subsequently terminated because the stock ceased to be marketable. A similar exception is provided for situations where a United States person's QEF election is terminated because its PFIC stock is marked to market under another provision of chapter 1 of the Code, and such provision subsequently ceases to apply. In either circumstance, consent of the Commissioner will not be required for the United States person to reelect QEF status prior to the sixth taxable year ending after the taxable year that its QEF election was terminated. In situations where a QEF election is terminated because a United States person makes a section 1296 election, and then this election terminates for some reason other than the stock ceasing to be marketable (*e.g.*, pursuant to the consent of the Commissioner under proposed § 1.1296–1(h)(3)(A)), a taxpayer may request consent under § 1.1295–1(i) to make a new QEF election prior to such sixth taxable year.

Special issues arise in situations where a taxpayer makes a QEF election with respect to stock that was previously marked to market under section 1296 (or where a taxpayer re-elects QEF treatment after a termination of mark-to-market treatment). In such situations, the taxpayer shifts from annual inclusions under the mark to market rules that are based on the amount of unrealized gain (or loss) in the stock of the PFIC, to annual inclusions of a *pro rata* share of the ordinary earnings and long-term capital gain of a PFIC under the QEF rules. For example, unrealized items that were reflected in annual mark to market inclusions could be taken into account subsequently under the QEF rules when realized. These issues presently are addressed through the respective basis adjustments provided for under the QEF and mark to market rules. See sections 1293(d) and 1296(b). Comments are requested on possible alternative approaches for addressing this situation with a view toward ensuring administrability and avoiding additional complexity.

C. *Addition of § 1.1296–1*

1. *Effect of election*

The proposed regulations provide that, on the last day of a taxable year to which a section 1296 election applies, the United States person recognizes gain to the extent that the fair market value of section 1296 stock exceeds its adjusted basis. Any such gain shall be treated as ordinary income. To the extent that the adjusted basis of section 1296 stock exceeds its fair market value, the United States person may take a deduction equal to the lesser of the amount of such excess or the unreversed inclusions with respect to such stock. Any such deduction will be treated as an ordinary loss.

Under former proposed § 1.1291–8, certain RICs were permitted to mark to market PFIC stock. For RICs that elect to mark to market their PFIC stock under section 1296, the unreversed inclusions include amounts that were included in gross income under former proposed § 1.1291–8 with respect to that stock for prior taxable years. See Notice 92–53, 1992–2 C.B. 384.

The proposed regulations also address the application of section 1296 in taxable years in which the foreign corporation has ceased to be a PFIC under section 1297(a), and is not treated as a PFIC under section 1298(b)(1) (the once a PFIC, always a PFIC rule). The proposed regulations clarify that there will be no mark to market inclusions or deductions for taxable years in which the foreign corporation is not a PFIC. The suspension of mark to market treatment while the foreign corporation is not a PFIC is consistent with § 1.1295–1(c)(2)(ii), which provides that a shareholder that has made a QEF election

with respect to stock of a foreign corporation is not required to include its *pro rata* share of ordinary income and capital gains under section 1293 for years in which the foreign corporation is not a PFIC.

In order to accomplish this suspension of mark to market treatment, the proposed regulations start a new holding period, for all purposes of the PFIC rules, in stock that is marked to market under section 1296 beginning on the first day of the first taxable year beginning after the last taxable year for which section 1296 applied. Accordingly, prior periods during which the foreign corporation was a PFIC, but for which the shareholder had a section 1296 election in effect, are not included in such shareholder's holding period for purposes of applying section 1298(b)(1).

Cessation of a foreign corporation's status as a PFIC will not, however, terminate a section 1296 election (although a shareholder may request consent of the Commissioner to revoke the election in such instance, as discussed below). Thus, if the foreign corporation once again becomes a PFIC in any taxable year after a year in which it is not treated as a PFIC, the shareholder's original section 1296 election continues to apply and the shareholder must mark to market the PFIC stock for such year.

2. *Adjustment to basis*

The proposed regulations provide that a United States person will increase the adjusted basis of its section 1296 stock by the amount of mark to market gain recognized. Conversely, if the United States person is entitled to a deduction under this section, the adjusted basis of its section 1296 stock is decreased by the amount of such deduction.

If a United States person owns section 1296 stock through a foreign partnership, foreign trust, or foreign estate, the basis rules apply to both the United States person and the entity or entities through which the United States person is considered to own the stock. The increase or decrease in the adjusted basis of the stock in the hands of the foreign partnership, foreign trust, or foreign estate will be solely attributable to the electing United States person (in a manner similar to an adjustment under section 743(b)), and will apply only for purposes of determining the subsequent U.S. income tax treatment of the United States person with respect to such stock. The IRS considered imposing reporting and record keeping requirements on the foreign entities to track the adjustments to the adjusted basis of any section 1296 stock they held directly or indirectly. The IRS decided not to adopt this approach in the proposed regulations because one of the motivations for the enactment of section 1296 was to provide an alternative tax regime to section 1291 for taxpayers that could not obtain sufficient information from a PFIC to make a QEF election. Comments are requested about other approaches for satisfying the compliance obligations of U.S. persons making a section 1296 election and the intervening entity or entities through which such stock is owned.

The taxpayer and the entity through which the taxpayer owns section 1296 stock may have different taxable years. Consistent with the general approach of sections 706(a), 652(c), and 662(c), a United States person who owns stock in a PFIC through any foreign partnership, foreign trust, or foreign estate determines the mark to market gain or mark to market loss with reference to the last day of the taxable year of the foreign partnership, foreign trust or foreign estate and then includes that gain or loss in the taxable year of such United States person that includes the last day of the taxable year of the entity.

Finally, if PFIC stock is acquired from a decedent by bequest, devise, or inheritance (or by the decedent's estate) and a mark to market election was in effect on the decedent's date of death, the adjusted basis of such stock in the hands of the recipient will be equal to the lesser of the basis determined under section 1014 or the adjusted basis of the stock in the hands of the decedent immediately prior to his or her death.

3. *Rule for individuals that become subject to United States income taxation*

The proposed regulations provide that if any individual becomes a United States person in a taxable year beginning after December 31, 1997, the adjusted basis (before any adjustments resulting from the mark to market election are made) of any stock in a PFIC owned by such individual on the first day of such taxable year shall be treated as being the greater of its fair market value on such first day or its adjusted basis on such first day. This special rule for determining the taxpayer's adjusted basis will apply only for purposes of section 1296 and the regulations thereunder. Accordingly, any gain or loss recognized on the disposition of section 1296 stock that is attributable to the period before the individual became a United States person will be subject to the general rules of the Code, including any limitation on the deductibility of a loss, for example, under section 1211.

4. *Indirect ownership of PFIC stock*

Except as discussed below in the case of eligible RICs, the proposed regulations apply the specific attribution rules of section 1296(g) in determining whether PFIC stock is considered owned by a taxpayer for purposes of section 1296 and, therefore, with respect to which the taxpayer is permitted to make a section 1296 election. Thus, a United States person will be permitted to make a section 1296 election with respect to stock owned through a foreign partnership, foreign trust, or foreign estate. In general, stock owned by or for such entities will be considered as being owned proportionately by its partners or beneficiaries. For purposes of this rule, stock owned, directly or indirectly, by or for a foreign trust described in sections 671 through 679, shall be considered as being owned proportionately by its grantors or other persons treated as owners under sections 671 through 679 of any portion of the trust that includes the stock.

The section 1296(g) attribution rules do not attribute ownership through foreign corporations. Accordingly, a United States person will not be permitted to make a section 1296 election with respect to stock owned indirectly through a foreign corporation. However, as discussed below, in instances where the foreign corporation is a CFC, the foreign corporation is permitted to make a section 1296 election directly.

Special attribution rules for eligible RICs are provided in § 1.1296(e)–1(f). There is a different attribution rule for RICs because section 1296(e)(2), which provides a special rule for RICs, states that stock owned, directly or indirectly, by the RIC, without reference to the ownership attribution rules in section 1296(g), shall be treated as marketable stock. This approach is consistent with former proposed § 1.1291–8, which permitted certain RICs to mark to market PFIC stock that it owned

directly or indirectly.

An issue not addressed in these proposed regulations is the treatment of certain situations involving multiple tiers of PFICs. For example, assume a United States person owns marketable stock in a PFIC, that itself owns stock in a second PFIC, the ownership of which is attributable to the United States person under section 1298(a)(2). If the United States person makes a section 1296 election with respect to stock of the upper-tier PFIC, the annual mark to market inclusions of income under section 1296 will be based on the fair market value of the upper-tier PFIC stock, whose value should reflect the value of the lower-tier PFIC, as such stock is an asset of the upper-tier PFIC. However, under current law, the United States person continues to be subject to taxation with respect to its indirect ownership of the lower-tier PFIC under section 1291 on any excess distributions from the lower-tier PFIC or gain from an indirect disposition of the lower-tier PFIC stock (although the consequences from the tiered ownership may be ameliorated by adjustments to the basis of the upper-tier PFIC stock). See proposed §§ 1.1291–2(f), and 1.1291–3(e). Similar issues arise if the United States person makes a QEF election with respect to the lower-tier PFIC. Comments are requested regarding coordination rules or other adjustments that may be appropriate to address this situation and similar structures involving a United States person that owns stock directly and indirectly in tiers of PFICs.

5. *Treatment of CFCs as United States persons*

A CFC that owns PFIC stock is treated as a United States person for purposes of section 1296 and, as noted above, is permitted to make a section 1296 election directly. If a section 1296 election is made with respect to PFIC stock owned by a CFC directly, or treated as owned by a CFC applying the section 1296(g) attribution rules, then any mark to market gains are included in the gross income of the CFC as foreign personal holding company income under section 954(c)(1)(A) and any mark to market losses are treated as deductions allocable to such foreign personal holding company income for purposes of computing net foreign base company income under § 1.954–1(c).

Under the proposed regulations, if a section 1296 election is made for a CFC with respect to its PFIC stock, the PFIC rules do not also apply separately to any United States shareholder, as defined in section 951(b), with respect to its *pro rata* share of the PFIC stock held by the CFC. Instead, the United States shareholder generally will recognize the mark to market gain as an inclusion of income under section 951(a). Thus, United States shareholders of CFCs are appropriately excluded from the application of section 1291 if a section 1296 election is made by the CFC. This rule, however, does not apply to United States persons who own stock of the CFC but are not United States shareholders within the meaning of section 951(b). Those United States persons continue to be subject to the PFIC provisions with respect to the stock of such foreign corporation, and may avail themselves of a QEF election. This rule is consistent with the CFC/PFIC overlap rule in section 1297(e), which eliminates the application of the PFIC provisions solely for United States shareholders of the entity that is both a PFIC and a CFC. Finally, comments are requested about whether similar rules should apply to United States persons that are United States shareholders of a CFC solely by application of section 953(c)(1)(A).

6. *Elections*

The proposed regulations provide that a United States person may make a section 1296 election for a taxable year beginning after December 31, 1997, by the due date (including extensions) of the United States person's federal income tax return. The proposed regulations further provide that a section 1296 election of a CFC is made by its controlling United States shareholders by the due date (including extensions) of their federal income tax returns in accordance with the general rules for elections by a CFC under § 1.964–1(c)(5).

The proposed regulations provide that a section 1296 election applies to the year for which made and to each succeeding year unless the election is terminated or revoked. A section 1296 election automatically terminates when (i) the PFIC stock ceases to be marketable, or (ii) when the PFIC stock is marked to market under another provision of chapter 1 of the Code. A section 1296 election also may be revoked with the consent of the Commissioner. Such consent will only be granted, however, upon a showing of a substantial change in circumstances. Similar rules apply in the case of the revocation of a QEF election.

7. *Coordination rules for first year of election*

Finally, the proposed regulations provide coordination rules that apply to the first taxable year to which section 1296 applies. A United States person (other than a RIC) whose holding period includes a period when the foreign corporation was a PFIC and for which a QEF election had not been made generally will be subject to section 1291 in the year of the election and subject to section 1296 in subsequent years. Special rules also apply to RICs for the first year in which a section 1296 election applies.

D. *Changes to § 1.1296(e)–1(b)*

As discussed above, a section 1296 election is only available for marketable stock of a PFIC. Section 1296(e) defines marketable stock to include any stock which is regularly traded on certain securities exchanges or other markets. The 2000 final regulations provide guidance regarding the definition of marketable stock for purposes of section 1296. In particular, the 2000 final regulations define regularly traded for these purposes to require that a class of stock be traded on at least 15 days during each calendar quarter for any calendar year. Taxpayers have noted that this rule would exclude stock issued as a result of an initial public offering (IPO) from qualifying as marketable stock for the year of issuance in many instances (*e.g.*, stock issued through a public offering occurring other than during the first quarter of the year). Therefore, these regulations propose modifying the current rule in such instances.

The proposed regulations provide that the stock issued in a public offering will qualify as regularly traded if the stock is traded on one or more qualified exchanges or other markets, other than in *de minimis* quantities, on 1/6 of the days remaining in the quarter in which the offering occurs, and on at least 15 days during each remaining quarter of the calendar year. If the public offering occurs in the fourth quarter of the calendar year, the stock will qualify as regularly traded if it is traded on such ex-

changes or markets, other than in *de minimis* quantities, on the greater of 1/6 of the days remaining in the quarter in which the offering occurs, or 5 days. The proposed regulations also modify the anti-abuse rule in § 1.1296(e)–1(b)(2) to apply to these changes to the definition of regularly traded.

E. *Amendment of § 1.6031(a)–1*

In general, a foreign partnership that has U.S. source income is required to file a U.S. Federal income tax return pursuant to § 1.6031(a)–1(b)(1). An issue arises whether a filing obligation is created on behalf of a foreign partnership where a U.S. partner of the foreign partnership makes a section 1296 election with respect to the U.S. partner's share of the PFIC stock held by the partnership. The income of the partner arising as a result of the section 1296 election generally will be U.S. source. See sections 1296(c)(2) and 865(a), (i)(5). The proposed regulations resolve this issue by modifying § 1.6031(a)–1(b)(1) such that a foreign partnership will not be required to file a partnership return if the only reason for filing a return, but for this special rule, would be U.S. source income resulting from a direct or indirect partner's section 1296 election.

Special Analysis

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because the 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 Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

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

A public hearing is scheduled for November 6, 2002, beginning at 10:00 a.m. in room 4718, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. 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 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" portion of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to this hearing. Persons who wish to present oral comments must submit written comments and an outline of the topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by October 16, 2002. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for reviewing outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal authors of this regulation are Mark Pollard and Laurie Hatten-Boyd, Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their 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 TAXES

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

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

Section 1.1296–1 also issued under 26 USC 1296(g) and 26 USC 1298(f). * * *

Par. 2. Section 1.1291–1, as proposed on April 1, 1992, at 57 FR 11024, is amended by:

1. Revising the headings to paragraphs (c) and (c)(1).
2. Redesignating the text of paragraphs (c)(1) and (c)(2) as (c)(1)(i) and (c)(1)(ii), respectively.
3. Adding new paragraphs (c)(2) and (c)(3).
4. Revising paragraph (j)(1).
5. Removing paragraph (j)(3).

The revisions and addition read as follows:

§ 1.1291–1 Taxation of U.S. persons that are shareholders of section 1291 funds.

* * * * *

(c) *Coordination with other PFIC rules*—(1) *Coordination with QEF rules*.* * *

(2) *Coordination with section 1296: distributions and dispositions*. If PFIC stock is marked to market under section 1296 for any taxable year, then, except as provided in § 1.1296–1(i), section 1291 and the regulations thereunder shall not apply to any distribution with respect to section 1296 stock (as defined in § 1.1296–1(a)(2)), or to any disposition of such stock, for such taxable year.

(3) *Coordination with mark to market rules under chapter 1 of the Internal Revenue Code other than section 1296*—(i) *In general*. If PFIC stock is marked to market for any taxable year under section 475 or any other provision of chapter 1 of the Internal Revenue Code, other than section 1296, regardless of whether the application of such provision is mandatory or results from an election by the taxpayer or another person, then, except as provided in paragraph (c)(3)(ii) of this section, section 1291 and the regulations thereunder shall not apply to any distribution with respect to such PFIC stock or to any disposition of such PFIC stock for such taxable year. See §§ 1.1295–1(i)(3) and 1.1296–1(h)(3)(i) for rules regarding the automatic termination of an existing election under section 1295 or section 1296 when a tax-

payer marks to market PFIC stock under section 475 or any other provision of chapter 1 of the Internal Revenue Code.

(ii) *Coordination rule*—(A) Notwithstanding any provision in this section to the contrary, the rule of paragraph (c)(3)(ii)(B) of this section shall apply to the first taxable year in which a United States person marks to market its PFIC stock under a provision of chapter 1 of the Internal Revenue Code, other than section 1296, if such foreign corporation was a PFIC for any taxable year, prior to such first taxable year, during the United States person's holding period (as defined in section 1291(a)(3)(A) and § 1.1296–1(f)) in such stock, and for which such corporation was not treated as a QEF with respect to such United States person.

(B) For the first taxable year of a United States person that marks to market its PFIC stock under any provision of chapter 1 of the Internal Revenue Code, other than section 1296, such United States person shall, in lieu of the rules under which the United States person marks to market, apply the rules of § 1.1296–1(i)(2) and (3) as if the United States person had made an election under section 1296 for such first taxable year.

* * * * *

(j) *Effective date*—(1) *In general*. Except as otherwise provided in this paragraph (j), §§ 1.1291–1 through 1.1291–7 apply on April 11, 1992. Section 1.1291–1(c)(2) and (3) apply as of the date final regulations are published in the **Federal Register**. Shareholders of 1291 funds, in determining their liability under sections 1291 through 1297 beginning after December 31, 1986, and before the effective date of these regulations, must apply reasonable interpretations of the statute and legislative history and employ reasonable methods to apply the interest charge.

* * * * *

Par. 3. Section 1.1295–1 is amended by:

1. Redesignating paragraphs (i)(3) and (i)(4) as paragraphs (i)(4) and (i)(5), respectively.

2. Adding a new paragraph (i)(3).

3. Revising newly designated paragraph (i)(5).

4. Revising paragraph (k).

The revisions and addition read as follows:

§ 1.1295–1 Qualified electing funds

* * * * *

(i)* * *

(3) *Automatic termination*. If a United States person, or the United States shareholder on behalf of a controlled foreign corporation, makes an election pursuant to section 1296 and the regulations thereunder with respect to PFIC stock for which a QEF election is in effect, or marks to market such stock under another provision of chapter 1 of the Internal Revenue Code, the QEF election is automatically terminated with respect to such stock that is marked to market under section 1296 or another provision of Chapter 1 of the Internal Revenue Code. Such termination shall be effective on the last day of the shareholder's taxable year preceding the first taxable year for which the section 1296 election is in effect or such stock is marked to market under another provision of chapter 1 of the Internal Revenue Code.

Example. A, a U.S. corporation, owns directly 100 shares of marketable stock in foreign corporation X, a PFIC. A also owns a 50 percent interest in Y, a foreign partnership that owns 200 shares of X. Accordingly, under section 1298(a)(3) and § 1.1296–1(e)(1), A is treated as indirectly owning 100 shares of X. A also owns 100 percent of the stock of Z, a foreign corporation that is not a PFIC. Z owns 100 shares of X, and therefore under section 1298(a)(2)(A), A is treated as owning the 100 shares of X owned by Z. For taxable year 2003, A has a QEF election in effect with respect to X that applies to all 300 shares of X stock owned directly or indirectly by A. See generally § 1.1295–1(c)(1). For taxable year 2004, A makes a timely election pursuant to section 1296 and the regulations thereunder. For purposes of section 1296, A is treated as owning stock held indirectly through a partnership, but not through a foreign corporation. Section 1296(g); § 1.1296–1(e)(1). Accordingly, A's section 1296 election covers the 100 shares it owns directly and the 100 shares it owns indirectly through Y, but not the 100 shares owned by Z. With respect to the first 200 shares, A's QEF election is automatically terminated effective December 31, 2003. With respect to the 100 shares A owns through foreign corporation Z, A's QEF election remains in effect unless invalidated, terminated, or revoked pursuant to this paragraph (i).

* * * * *

(5) *Effect after invalidation, termination, or revocation*— (i) *In general.* Without the Commissioner's consent, a shareholder whose section 1295 election was invalidated, terminated, or revoked under this paragraph (i) may not make the section 1295 election with respect to the PFIC before the sixth taxable year in which the invalidation, termination, or revocation became effective.

(ii) *Special rule*. Notwithstanding paragraph (i)(5)(i) of this section, a shareholder whose section 1295 election was terminated pursuant to paragraph (i)(3) of this section, and either whose section 1296 election has subsequently been terminated because its PFIC stock ceased to be marketable or who no longer marks to market such stock under another provision of chapter 1 of the Internal Revenue Code, may make a section 1295 election with respect to its PFIC stock before the sixth taxable year in which its prior section 1295 election was terminated.

* * * * *

(k) *Effective dates*. Except as otherwise provided, paragraphs (b)(2)(iii), (b)(3), (b)(4), and (c) through (j) of this section are applicable to taxable years of shareholders beginning after December 31, 1997. However, taxpayers may apply the rules under paragraphs (b)(4), (f) and (g) of this section to a taxable year beginning before January 1, 1998, provided the statute of limitations on the assessment of tax has not expired as of April 27, 1998, and, in the case of paragraph (b)(4) of this section, the taxpayers who filed the joint return have consistently applied the rules of that section to all taxable years following the year the election was made. Paragraph (b)(3)(v) of this section is applicable as of February 7, 2000, however, a taxpayer may apply the rules to a taxable year prior to the applicable date provided the statute of limitations on the assessment of tax for that taxable year has not expired. Paragraphs (i)(3) and (i)(5)(ii) of this section are applicable as of the date final regulations are published in the **Federal Register**.

Par. 4. Section 1.1296–1 is added to read as follows:

§ 1.1296–1 Mark to market election for marketable stock.

(a) *Definitions*—(1) *Eligible RIC*. An *eligible RIC* is a regulated investment company that offers for sale, or has outstanding, any stock of which it is the issuer and which is redeemable at net asset value, or that publishes net asset valuations at least annually.

(2) *Section 1296 stock*. The term *section 1296 stock* means marketable stock in a passive foreign investment company (PFIC), including any PFIC stock owned directly or indirectly by an eligible RIC, for which there is a valid section 1296 election. Section 1296 stock does not include

stock of a foreign corporation that previously had been a PFIC, and for which a section 1296 election remains in effect.

(3) *Unreversed inclusions*—(i) *General rule*. The term *unreversed inclusions* means with respect to any section 1296 stock, the excess, if any, of—

(A) The amount of mark to market gain included in gross income of the United States person under paragraph (c)(1) of this section with respect to such stock for prior taxable years; over

(B) The amount allowed as a deduction to the United States person under paragraph (c)(3) of this section with respect to such stock for prior taxable years.

(ii) *Section 1291 adjustment.* The amount referred to in paragraph (a)(3)(i)(A) of this section shall include any amount subject to section 1291 under the coordination rule of paragraph (i)(2)(ii) of this section.

(iii) *Example*. An example of the computation of unreversed inclusions is as follows:

Example. A, a United States person, acquired stock in D, a foreign corporation, on January 1, 2003, for $150. At such time and at all times thereafter, D was a PFIC and A's stock in D was marketable. For taxable years 2003 and 2004, D was a nonqualified fund subject to taxation under section 1291. A made a timely section 1296 election with respect to the D stock, effective for tax year 2005. The fair market value of the D stock was $200 as of December 31, 2004, and $240 as of December 31, 2005. Additionally, D made no distribution with respect to its stock for the taxable years at issue. In 2005, pursuant to paragraph (i)(2)(ii) of this section, A must include the $90 gain in the D stock in accordance with the rules of section 1291 for purposes of determining the deferred tax amount and any applicable interest. Nonetheless, for purposes of determining the amount of the unreversed inclusions pursuant to paragraph (a)(3)(ii) of this section, A will include the $90 of gain that was taxed under section 1291 and not the interest thereon.

(iv) *Special rule for regulated investment companies*. In the case of a regulated investment company which had elected to mark to market the PFIC stock held by such company as of the last day of the taxable year preceding such company's first taxable year for which such company makes a section 1296 election, the amount referred to in paragraph (a)(3)(i)(A) of this section shall include amounts previously included in gross income by the company pursuant to such mark to market election with respect to such stock for prior taxable years. See Notice 92–53, 1992–2 C.B. 384.

(b) *Application of section 1296 election*—(1) *In general*. Any United States person and any controlled foreign corporation (CFC) that owns directly, or is treated as owning under this section, marketable stock, as defined in § 1.1296(e)–1, in a PFIC may make an election to mark to market such stock in accordance with the provisions of section 1296 and this section.

(2) *Election applicable to specific United States person*. A section 1296 election applies only to the United States person (or CFC that is treated as a U.S. person under paragraph (g)(2) of this section) that makes the election. Accordingly, a United States person's section 1296 election will not apply to a transferee of section 1296 stock.

(3) *Election applicable to specific corporation only*. A section 1296 election is made with respect to a single foreign corporation, and thus a separate section 1296 election must be made for each foreign corporation that otherwise meets the requirements of this section. A United States person's section 1296 election with respect to stock in a foreign corporation applies to all marketable stock of the corporation that the person owns directly, or is treated as owning under paragraph (e) of this section, at the time of the election or that is subsequently acquired.

(c) *Effect of election*—(1) *Recognition of gain*. If the fair market value of section 1296 stock on the last day of the United States person's taxable year exceeds its adjusted basis, the United States person shall include in gross income for its taxable year the excess of the fair market value of such stock over its adjusted basis (mark to market gain).

(2) *Character of gain.* (i) Mark to market gain, and any gain on the sale or other disposition of section 1296 stock, shall be treated as ordinary income.

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

Example. A, a United States person, purchases stock in C, a foreign corporation that is not a PFIC, in 1990 for $1,000. On January 1, 2003, when the fair market value of the C stock is $1,100, foreign corporation C becomes a PFIC. A makes a timely section 1296 election for year 2003. On December 31, 2003, the fair market value of the C stock is $1,200. For taxable year 2003, A includes $200 of mark to market gain (the excess of the fair market value of C stock ($1,200) over A's adjusted basis ($1,000)) in gross income as ordinary income.

(3) *Recognition of loss*. If the adjusted basis of section 1296 stock exceeds its fair market value on the last day of the United States person's taxable year, such person shall be allowed a deduction for such taxable year equal to the lesser of the amount of such excess or the unreversed inclusions with respect to such stock (mark to market loss).

(4) *Character of loss*—(i) *Losses not in excess of unreversed inclusions*. Any mark to market loss allowed as a deduction under paragraph (c)(3) of this section, and any loss on the sale or other disposition of section 1296 stock, to the extent that such loss does not exceed the unreversed inclusions attributable to such stock, shall be treated as an ordinary loss, deductible in computing adjusted gross income.

(ii) *Losses in excess of unreversed inclusions*. (A) Any loss recognized on the sale or other disposition of section 1296 stock in excess of any prior unreversed inclusions will be subject to the rules generally applicable to losses provided elsewhere in the Internal Revenue Code and the regulations thereunder.

(B) The following example illustrates the treatment of losses in excess of unreversed inclusions:

Example. A, a United States person and a calendar year taxpayer, purchased marketable stock in FC, a foreign corporation that was a PFIC, for $1,000 on January 31, 2003. A made a section 1296 election with respect to the stock of FC for 2003. At the close of 2003, the fair market value of A's stock in FC was $1,200. Under paragraph (c)(1) and (2) of this section, A included $200 of mark to market gain as ordinary income for 2003, and pursuant to paragraph (d)(1) of this section, increased his basis in the stock by that amount. On June 15, 2004, A sold his stock in FC for $900. At that time, A's unreversed inclusions with respect to the stock in FC were $200. Accordingly, A may deduct the amount equal to his unreversed inclusions, $200, as an ordinary loss. The $100 loss in excess of A's unreversed inclusions will be treated as a long term capital loss because A has held the FC stock for more than one year.

(5) *Application of election to separate lots of stock*. (i) In the case in which a United States person purchased or acquired shares of stock in a PFIC at different prices, the rules of this section shall be applied in a manner consistent with the rules of § 1.1012–1.

(ii) *Example*. The following example illustrates this paragraph (c)(5):

Example. On January 1, 2003, United States corporation A purchased 100 shares (first lot) of stock in foreign corporation X, a PFIC, for $500 ($5 per share). On June 1, 2003, A purchased 100 shares (second lot) of stock in X for $1,000 ($10 per share). A made a timely section 1296 election with respect to its stock in X for taxable year 2003. On December 31, 2003, the fair market value of X stock was $8 per share. For taxable year 2003, A recognizes $300 of gross income under paragraph (c)(1) of this section with respect to the first lot, and adjusts its basis in that lot

to $800 pursuant to paragraph (d)(1) of this section. With respect to the second lot, A is not permitted to recognize a loss under paragraph (c)(3) of this section for taxable year 2003. Although A's adjusted basis in that stock exceeds its fair market value by $200, A has no unreversed inclusions with respect to that particular lot of stock. On July 1, 2004, A sells 100 shares of X stock for $900. Assuming that A adequately identifies (in accordance with the rules of § 1.1012–1(c)) the shares of X corporation stock sold as being from the second lot, A recognizes $100 of long term capital loss pursuant to paragraph (c)(4)(ii) of this section.

(6) *Source rules*. The source of any amount included in gross income under paragraph (c)(1) of this section, or the allocation and apportionment of any amount allowed as a deduction under paragraph (c)(3) of this section, shall be determined in the same manner as if such amounts were gain or loss (as the case may be) from the sale of stock in the PFIC.

(d) *Adjustment to basis*—(1) *Stock held directly*. The adjusted basis of the section 1296 stock shall be increased by the amount included in the gross income of the United States person under paragraph (c)(1) of this section with respect to such stock, and decreased by the amount allowed as a deduction to the United States person under paragraph (c)(3) of this section with respect to such stock.

(2) *Stock owned through certain foreign entities*. (i) In the case of section 1296 stock that a United States person is treated as owning through certain foreign entities pursuant to paragraph (e) of this section, the basis adjustments under paragraph (d)(1) of this section shall apply to such stock in the hands of the foreign entity actually holding such stock, but only for purposes of determining the subsequent treatment under chapter 1 of the Internal Revenue Code of the United States person with respect to such stock. Such increase or decrease in the adjusted basis of the section 1296 stock shall constitute an adjustment to the basis of partnership property only with respect to the partner making the section 1296 election. Corresponding adjustments shall be made to the adjusted basis of the United States person's interest in the foreign entity and in any intermediary entity described in paragraph (e) of this section through which the United States person holds the PFIC stock.

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

Example. FP is a foreign partnership. A, a U.S. corporation, owns a 20% interest in FP. B, a U.S. corporation, owns a 30% interest in FP. C, a foreign corporation, with no direct or indirect shareholders that are U.S. persons, owns a 50% interest in FP. A, B, C, and FP are all calendar year taxpayers. In 2002, FP purchases stock in a PFIC for $1,000. A makes a timely section 1296 election for taxable year 2003. On December 31, 2003, the fair market value of the PFIC stock is $1,100. A includes $20 of ordinary income in 2003 under paragraphs (c)(1) and (2) of this section. A increases its basis in its FP partnership interest by $20. FP increases its basis in the stock to $1,020 solely for purposes of determining the subsequent treatment of A, under chapter 1 of the Internal Revenue Code, with respect to such stock. In 2004, FP sells the stock for $1,200. For purposes of determining the amount of gain of A, FP will be treated as having $180 in gain of which $20 is allocated to A. A's $20 of gain will be treated as ordinary income under paragraph (c)(2) of this section. For purposes of determining the amount of gain attributable to B, FP will be treated as having $200 gain, $60 of which will be allocated to B.

(3) *Stock owned indirectly by an eligible RIC*. Paragraph (d)(2) of this section shall also apply to an eligible RIC which is an indirect shareholder under § 1.1296(e)–1(f) of stock in a PFIC and has a valid section 1296 election in effect.

(4) *Stock acquired from a decedent*. In the case of stock of a PFIC which is acquired by bequest, devise, or inheritance (or by the decedent's estate) and with respect to which a section 1296 election was in effect as of the date of the decedent's death, notwithstanding section 1014, the basis of such stock in the hands of the person so acquiring it shall be the adjusted basis of such stock in the hands of the decedent immediately before his death (or, if lesser, the basis which would have been determined under section 1014 without regard to this paragraph).

(5) *Transition rule for individuals becoming subject to United States income taxation*—(i) *In general*. If any individual becomes a United States person in a taxable year beginning after December 31, 1997, solely for purposes of this section, the adjusted basis, before adjustments under this paragraph (d), of any section 1296 stock owned by such individual on the first day of such taxable year shall be treated as being the greater of its fair market value or its adjusted basis on such first day.

(ii) An example of the transition rule for individuals becoming subject to United States income taxation is as follows:

Example. X, a nonresident alien individual, purchases marketable stock in a PFIC for $50 in 1995. On January 1, 2003, X becomes a United States person and makes a timely section 1296 election with respect to the stock in accordance with paragraph (h) of this section. The fair market value of the stock on January 1, 2003, is $100. The fair market value of the stock on December 31, 2003, is $110. Under paragraph (d)(5)(i) of this section, X computes the amount of mark to market gain or loss in 2003 by reference to an adjusted basis of $100, and therefore X includes $10 in gross income as mark to market gain under paragraph (c)(1) of this section. Additionally, under paragraph (d)(1) of this section, X's adjusted basis in the stock for purposes of this section is increased to $110 (or to $60 for all other tax purposes). X sells the stock in 2004 for $120. For purposes of applying section 1001, X must use its original basis of $50, with any adjustments under paragraph (d)(1) of this section, $10 in this case, and therefore X recognizes $60 of gain. Under paragraph (c)(2) of this section (which is applied using an adjusted basis of $110), $10 of such gain is treated as ordinary income. The remaining $50 of gain from the sale of the stock is long-term capital gain because X held such stock for more than one year.

(e) *Stock owned through certain foreign entities*—(1) *In general*. Except as provided in paragraph (e)(2) of this section, the following rules shall apply in determining stock ownership for purposes of this section. PFIC stock owned, directly or indirectly, by or for a foreign partnership, foreign trust (other than a foreign trust described in sections 671 through 679), or foreign estate shall be considered as being owned proportionately by its partners or beneficiaries. PFIC stock owned, directly or indirectly, by or for a foreign trust described in sections 671 through 679 shall be considered as being owned proportionately by its grantors or other persons treated as owners under sections 671 through 679 of any portion of the trust that includes the stock. The determination of a person's proportionate interest in a foreign partnership, foreign trust or foreign estate will be made on the basis of all the facts and circumstances. Stock considered owned by reason of this paragraph shall, for purposes of applying the rules of this section, be treated as actually owned by such person.

(2) *Stock owned indirectly by eligible RICs*. The rules for attributing ownership of stock contained in § 1.1296(e)–1(f) will apply to determine the indirect ownership of PFIC stock by an eligible RIC.

(f) *Holding period*. Solely for purposes of sections 1291 through 1298, if section 1296 applied to stock with respect to the taxpayer for any prior taxable year, the taxpayer's holding period in such stock shall be treated as beginning on the first day of the first taxable year beginning after the last taxable year for which section 1296 so applied.

(g) *Special rules*—(1) *Certain dispositions of stock*. To the extent a United States

person is treated as actually owning stock in a PFIC under paragraph (e) of this section, any disposition which results in the United States person being treated as no longer owning such stock, and any disposition by the person owning such stock, shall be treated as a disposition by the United States person of the stock in the PFIC.

(2) *Treatment of CFC as a United States person.* In the case of a CFC that owns, or is treated as owning under paragraph (e) of this section, section 1296 stock:

(i) Other than with respect to the sourcing rules in paragraph (c)(6) of this section, this section shall apply to the CFC in the same manner as if such corporation were a United States person. The CFC will be treated as a foreign person for purposes of applying the source rules of paragraph (c)(6).

(ii) For purposes of subpart F of part III of subchapter N of the Internal Revenue Code—

(A) Amounts included in the CFC's gross income under paragraph (c)(1) or (i)(2)(ii) of this section shall be treated as foreign personal holding company income under section 954(c)(1)(A); and

(B) Amounts allowed as a deduction under paragraph (c)(3) of this section shall be treated as a deduction allocable to foreign personal holding company income for purposes of computing net foreign base company income under § 1.954–1(c).

(iii) A United States shareholder, as defined in section 951(b), of the CFC shall not be subject to section 1291 with respect to any stock of the PFIC for the period during which the section 1296 election is in effect for that stock, and the holding period rule of paragraph (f) of this section shall apply to such United States shareholder.

(iv) The rules of this paragraph (g)(2) shall not apply to a United States person that is a shareholder of the PFIC for purposes of section 1291, but is not a United States shareholder under section 951(b) with respect to the CFC making a section 1296 election.

(3) *Timing of inclusions for stock owned through certain foreign entities.* In the case of section 1296 stock that a United States person is treated as owning through certain foreign entities pursuant to paragraph (e) of this section, the mark to market gain or mark to market loss is determined in accordance with paragraphs (c) and (i)(2)(ii) of this section as of the last day of the taxable year of the foreign partnership, foreign trust or foreign estate and then included in the taxable year of such United States person that includes the last day of the taxable year of the entity.

(h) *Elections*—(1) *Timing and manner for making a section 1296 election*—(i) *United States persons.* A United States person that owns marketable stock in a PFIC, or is treated as owning marketable stock under paragraph (e) of this section, on the last day of the taxable year of such person, and that wants to make a section 1296 election, must make a section 1296 election for such taxable year on or before the due date (including extensions) of the United States person's income tax return for that year. The section 1296 election must be made on the Form 8621, *"Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund"*, included with the original tax return of the United States person for that year, or on an amended return, provided that the amended return is filed on or before the election due date.

(ii) *Controlled foreign corporations*. A section 1296 election by a CFC shall be made by its controlling United States shareholders, as defined in § 1.964–1(c)(5), and shall be included with the Form 5471, *"Information Return of U.S. Persons With Respect To Certain Foreign Corporations"*, for that CFC by the due date (including extensions) of the original income tax returns of the controlling United States shareholders for that year. A section 1296 election by a CFC shall be binding on all United States shareholders of the CFC.

(iii) *Retroactive elections for PFIC stock held in prior years*. A late section 1296 election may be permitted only in accordance with § 301.9100 of this chapter.

(2) *Effect of section 1296 election*—(i) *In General.* A section 1296 election will apply to the taxable year for which such election is made and remain in effect for each succeeding taxable year unless such election is revoked or terminated pursuant to paragraph (h)(3) of this section.

(ii) *Cessation of a foreign corporation as a PFIC.* A United States person will not include mark to market gain or loss pursuant to paragraph (c) of this section with respect to any stock of a foreign corporation for any taxable year that such foreign corporation is not a PFIC under section 1297 or treated as a PFIC under section 1298(b)(1) (taking into account the holding period rule of paragraph (f) of this section). Cessation of a foreign corporation's status as a PFIC will not, however, terminate a section 1296 election. Thus, if a foreign corporation is a PFIC in a taxable year after a year in which it is not treated as a PFIC, the United States person's original election (unless revoked or terminated in accordance with paragraph (h)(3) of this section) continues to apply and the shareholder must include any mark to market gain or loss in such year.

(3) *Revocation or termination of election*—(i) *In general.* A United States person's section 1296 election is terminated if the section 1296 stock ceases to be marketable; if the United States person elects, or is required, to mark to market the section 1296 stock under another provision of chapter 1 of the Internal Revenue Code; or if the Commissioner, in the Commissioner's discretion, consents to the United States person's request to revoke its section 1296 election upon a finding of a substantial change in circumstances. A substantial change in circumstances for this purpose may include a foreign corporation ceasing to be a PFIC.

(ii) *Timing of termination or revocation.* Where a section 1296 election is terminated automatically (*e.g.*, the stock ceases to be marketable), section 1296 will cease to apply beginning with the taxable year in which such termination occurs. Where a section 1296 election is revoked with the consent of the Commissioner, section 1296 will cease to apply beginning with the first taxable year of the United States person after the revocation is granted unless otherwise provided by the Commissioner.

(4) *Examples.* The operation of the rules of this paragraph (h) are illustrated by the following examples:

Example 1. X, a United States person, owns stock in a PFIC. X makes a QEF election in 1996 with respect to such stock. For taxable year 1999, X makes a timely section 1296 election with respect to its stock, and thus its QEF election is automatically terminated pursuant to § 1.1295–1(i)(3). In 2000, X's stock ceases to be marketable, and therefore its section 1296 election is automatically terminated under paragraph (h)(3) of this section. Beginning with taxable year 2000, X is subject to the rules of section 1291 with respect to its stock in the PFIC unless it makes a new QEF election. See § 1.1295–1(i)(5).

Example 2. The facts are the same as in *Example 1*, except that X's stock in the PFIC becomes marketable again in 2001. X may make a new section 1296 election with respect to such stock for its tax year

2001, or thereafter. X will be subject to the coordination rules under paragraph (i) of this section unless it made a new QEF election in 2000.

(i) *Coordination rules for first year of election*—(1) *In general*. Notwithstanding any provision in this section to the contrary, the rules of this paragraph (i) shall apply to the first taxable year in which a section 1296 election is effective with respect to marketable stock of a PFIC if such foreign corporation was a PFIC for any taxable year, prior to such first taxable year, during the United States person's holding period (as defined in paragraph (f) of this section) in such stock, and for which such corporation was not treated as a QEF with respect to such United States person.

(2) *Shareholders other than regulated investment companies*. For the first taxable year of a United States person (other than a regulated investment company) for which a section 1296 election is in effect with respect to the stock of a PFIC, such United States person shall, in lieu of the rules of paragraphs (c) and (d) of this section—

(i) Apply the rules of section 1291 to any distributions with respect to, or disposition of, section 1296 stock;

(ii) Apply section 1291 to the amount of the excess, if any, of the fair market value of such section 1296 stock on the last day of the United States person's taxable year over its adjusted basis, as if such amount were gain recognized from the disposition of stock on the last day of the taxpayer's taxable year; and

(iii) Increase its adjusted basis in the section 1296 stock by the amount of excess, if any, subject to section 1291 under paragraph (i)(2)(ii) of this section.

(3) *Shareholders that are regulated investment companies*. For the first taxable year of a regulated investment company for which a section 1296 election is in effect with respect to the stock of a PFIC, such regulated investment company shall increase its tax under section 852 by the amount of interest that would have been imposed under section 1291(c)(3) for such taxable year if such regulated investment company were subject to the rules of paragraph (i)(2) of this section, and not this paragraph (i)(3). No deduction or increase in basis shall be allowed for the increase in tax imposed under this paragraph (i)(3).

(4) The operation of the rules of this paragraph (i) is illustrated by the following examples.

Example 1. A, a United States person and a calendar year taxpayer, owns marketable stock in a PFIC that it acquired on January 1, 1995. At all times, A's PFIC stock was a nonqualified fund subject to taxation under section 1291. A made a timely section 1296 election effective for taxable year 2003. At the close of taxable year 2003, the fair market value of A's PFIC stock exceeded its adjusted basis by $10. Pursuant to paragraph (i)(2)(ii) of this section, A must treat the $10 gain under section 1291 as if the stock were disposed of on December 31, 2003. Further, A will increase its adjusted basis in the PFIC stock by the $10 in accordance with paragraph (i)(2)(iii) of this section.

Example 2. Assume the same facts as in *Example 1*, except that A is a RIC. In taxable year 2003, A would include $10 of ordinary income under paragraph (c)(1) of this section, and such amount will not be subject to section 1291. A also must increase its tax imposed under section 852 by the amount of interest that would have been determined under section 1291(c)(3), and no deduction will be permitted for such amount. Finally, under paragraph (d)(1) of this section, A will increase its adjusted basis in the PFIC stock by $10.

(j) *Effective Date*. The provisions is this section are applicable as of the date final regulations are published in the **Federal Register**.

* * * * *

Par. 5. Section 1.1296(e)–1 is amended by:

1. Revising paragraph (b)(2).
2. Adding paragraph (b)(3).
3. Revising both references to "sections 958(a)(1) and (2)" in paragraph (f)(1) to read "section 1298(a)".

The revision and addition reads as follows:

§ 1.1296(e)–1 Definition of marketable stock.

* * * * *

(b) * * *

(2) *Special rule for year of initial public offering*. For the calendar year in which a corporation initiates a public offering of a class of stock for trading on one or more qualified exchanges or other markets, as defined in paragraph (c) of this section, such class of stock meets the requirements of paragraph (b)(1) of this section for such year if the stock is regularly traded on such exchanges or markets, other than in *de minimis* quantities, on 1/6 of the days remaining in the quarter in which the offering occurs, and on at least 15 days during each remaining quarter of the taxpayer's calendar year. In cases where a corporation initiates a public offering of a class of stock in the fourth quarter of the calendar year, such class of stock meets the requirements of paragraph (b)(1) of this section in the calendar year of the offering if the stock is regularly traded on such exchanges or markets, other than in *de minimis* quantities, on the greater of 1/6 of the days remaining in the quarter in which the offering occurs, or 5 days.

(3) *Anti-abuse rule*. Trades that have as one of their principal purposes the meeting of the trading requirements of paragraph (b)(1) or (2) of this section shall be disregarded. Further, a class of stock shall not be treated as meeting the trading requirement of paragraph (b)(1) or (2) of this section if there is a pattern of trades conducted to meet the requirement of paragraph (b)(1) or (2) of this section. Similarly, paragraph (b)(2) of this section shall not apply to a public offering of stock that has as one of its principal purposes to avail itself of the reduced trading requirements under the special rule for the calendar year of an initial public offering. For purposes of applying the immediately preceding sentence, consideration will be given to whether the trading requirements of paragraph (b)(1) of this section are satisfied in the subsequent calendar year.

* * * * *

Par. 6. Section 1.6031(a)–1 is amended by:

1. Redesignating the text of paragraph (b)(1) as (b)(1)(i).
2. Adding a heading to newly designated paragraph (b)(1)(i).
3. Adding paragraph (b)(1)(ii).

The additions read as follows:

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

* * * * *

(b) * * * (1) * * * (i) *Filing requirement.* * * *

(ii) *Special rule*. For purposes of this paragraph (b)(1) and paragraph (b)(3)(iii) of this section, a foreign partnership will not be considered to have derived income from sources within the United States solely because a U.S. partner marks to market his *pro rata* share of PFIC stock held by the foreign partnership pursuant to an election under section 1296.

* * * * *

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue

(Filed by the Office of the Federal Register on July 30, 2002, 8:45 a.m., and published in the issue of the Federal Register for July 31, 2002, 67 F.R. 49634)

Notice of Proposed Rulemaking and Notice of Public Hearing

Redemptions Taxable as Dividends

REG–150313–01

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations that provide guidance regarding the treatment of the basis of redeemed stock when a distribution in redemption of such stock is treated as a dividend, as well as guidance regarding certain acquisitions of stock by related corporations that are treated as distributions in redemption of stock. The proposed regulations affect shareholders whose stock in a corporation is redeemed or is acquired by a corporation related to the issuer of the stock, and are necessary to provide such shareholders with guidance regarding the treatment of the basis of such stock. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by January 16, 2003. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for February 20, 2003, at 10 a.m. must be received by January 30, 2003.

ADDRESSES: Send submissions to: CC:ITA:RU (REG–150313–01), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:ITA:RU (REG–150313–01), Courier's desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224. Alternatively, taxpayers may submit electronic comments directly to the IRS Internet site at *www.irs.gov/regs*. The public hearing will be held in Room 4718, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations generally, Lisa K. Leong, (202) 622–7530; concerning issues under sections 367, 861 and 864 of the Internal Revenue Code, Aaron A. Farmer, (202) 622–3860; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Treena V. Garrett, (202) 622–7180 (not toll-free numbers).

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, W:CAR:MP:FP:S, Washington, DC 20224. Comments on the collection of information should be received by December 17, 2002. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the IRS, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collection of information in these proposed regulations is in § 1.302–5(e) and § 1.1502–19(b)(5)(v). This collection of information is required by the IRS to verify compliance with section 302. This information will be used to determine whether the amount of tax has been calculated correctly. The collection of information is required to properly determine the amount permitted to be taken into account as a loss. The respondents are shareholders (including individuals, corporations and passthrough entities) whose stock in a corporation is redeemed or is treated as redeemed.

Estimated total annual reporting burden: 1,500 hours.

Estimated average annual burden per respondent: 30 minutes.

Estimated number of respondents: 3,000.

Estimated annual frequency of responses: On occasion.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless 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

This document contains proposed revisions and amendments to the Income Tax Regulations (26 CFR part 1) under sections 302, 304, 704, 861, 1371, 1374, and 1502 of the Internal Revenue Code (Code). The proposed regulations would amend the temporary and final regulations under sections 302, 304, 704, 861, 1371, 1374, and 1502 to provide guidance concerning the treatment of the basis of stock redeemed or treated as redeemed where the redemption proceeds are treated as a dividend distribution. These proposed regulations would also amend the final regulations under section 304 to conform them to certain of the amendments made to section 304 by legislation, including section 226 of the Tax Equity and Fiscal Responsibility Act of

1982, Public Law 97–248 (96 Stat. 325, 490) (September 3, 1982), section 712(l) of the Deficit Reduction Act of 1984, Public Law 98–369 (98 Stat. 494, 953–55) (July 18, 1984), section 1875(b) of the Tax Reform Act of 1986, Public Law 99–514 (100 Stat. 2085, 2894) (October 22, 1986), and section 1013 of the Taxpayer Relief Act of 1997, Public Law 105–34 (111 Stat. 788, 918) (August 5, 1997).

A. *The Character of Property Received in Redemption of Stock*

Section 302 of the Code governs the tax treatment of distributions in redemption of stock. The rules of section 302 attempt to distinguish between distributions that "may have capital-gain characteristics because they are not made *pro rata* among the various shareholders" and distributions "characterized by what happens solely at the corporate level by reason of the assets distributed." S. Rep. No. 1622, 83d Cong., 2d Sess. 49 (1954). Section 302(a) provides that a corporation's redemption of its stock is treated as a distribution in part or full payment in exchange for the stock if the redemption satisfies any one of the following criteria: (1) the redemption is not essentially equivalent to a dividend (section 302(b)(1)); (2) the redemption is substantially disproportionate (section 302(b)(2)); (3) the redemption completely terminates the redeemed shareholder's interest (section 302(b)(3)); or (4) the redemption is in connection with a qualifying partial liquidation (section 302(b)(4)). If a redemption satisfies none of these criteria, pursuant to section 302(d), the redemption is treated as a distribution of property to which section 301 applies.

Under sections 301(c)(1) and 316(a), a distribution is treated as a dividend to the extent of the redeeming corporation's earnings and profits. Any portion of the distribution that is not treated as a dividend is first applied against the adjusted basis of the redeemed stock to the extent of such basis under section 301(c)(2), and then treated as gain from the sale or exchange of property under section 301(c)(3).

B. *The Character of Property Received in Certain Stock Acquisitions*

The redemption rules of section 302 are implicated not only when an issuing corporation acquires its own stock, but also in the case of certain stock acquisitions by corporations related to the issuer of the acquired stock. Pursuant to section 304(a)(1), an acquisition of stock by a corporation from one or more persons that are in control of both the acquiring and issuing corporations is treated as if the property received in respect of the acquired stock were a distribution in redemption of the stock of the acquiring corporation. Prior to the amendments made by the Taxpayer Relief Act of 1997, section 304 provided that, to the extent that the deemed distribution was treated as a distribution to which section 301 applies, the stock acquired was treated as having been transferred by the person from whom acquired and as having been received by the corporation acquiring it, as a contribution to the capital of such corporation. The Taxpayer Relief Act of 1997 amended section 304(a)(1) to provide that, to the extent that this deemed distribution is treated as a distribution to which section 301 applies, the shareholder and the acquiring corporation are treated as if the shareholder had transferred the stock of the issuing corporation to the acquiring corporation in exchange for stock of the acquiring corporation in a transaction to which section 351(a) applies, and then the acquiring corporation had redeemed the stock it was treated as issuing in that transaction. Pursuant to section 304(a)(2), an acquisition of stock by a corporation controlled by the issuer of the acquired stock is treated as if the property received in respect of the acquired stock was a distribution in redemption of the stock of the issuing corporation.

For purposes of section 304, control means the ownership of stock possessing at least 50 percent of either the total combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock. The determination of the amount and source of the distribution that is treated as a dividend is made as if the property received in respect of the redeemed stock were distributed by the acquiring corporation to the extent of its earnings and profits and then by the issuing corporation to the extent of its earnings and profits. Because section 304 recharacterizes certain stock acquisition transactions as redemptions of stock, transactions to which section 304 applies implicate the redemption rules of section 302.

C. *The Unutilized Basis of Stock Redeemed in Certain Transactions*

While sections 301 and 302 clearly set forth the character of property received in a redemption (whether actual or deemed) of stock, they do not prescribe the tax treatment of the unutilized basis of the redeemed stock or the stock treated as redeemed. In 1955, the IRS and Treasury promulgated regulations under section 302 that provide guidance in this regard in the case of an actual redemption of stock. Section 1.302–2(c) of the Income Tax Regulations states that "[i]n any case in which an amount received in redemption of stock is treated as a distribution of a dividend, proper adjustment of the basis of the remaining stock will be made with respect to the stock redeemed." The regulation contains examples illustrating what constitutes a proper adjustment. In *Example 1* and *Example 3*, the redeemed shareholder actually owns stock of the redeeming corporation immediately after a redemption that is treated as a distribution of a dividend. In those cases, the basis of the shares of the redeeming corporation that the shareholder owns after the redemption is increased by the basis of the redeemed shares. *See also United States v. Davis*, 397 U.S. 301 (1970) (interpreting § 1.302–2(c) to shift the basis of redeemed stock to other shares held by the redeemed shareholder, even where those other shares are of a different class of stock than those redeemed); Rev. Rul. 66–37, 1966–1 C.B. 209 (same). In *Example 2*, although the redeemed shareholder actually owns no stock of the redeeming corporation immediately after a redemption that is treated as a distribution of a dividend, he does constructively own stock of the redeeming corporation immediately after the redemption by reason of his wife's continuing ownership of stock of the redeeming corporation. The example concludes that the redeemed shareholder's basis in the redeemed shares shifts to his wife's basis in her shares of stock of the redeeming corporation.

In addition, on December 2, 1955, the IRS and Treasury promulgated §§ 1.304–2(a) and 1.304–3(a). With respect to an acquisition of stock by a related corporation (other than a subsidiary), § 1.304–2(a) provides that the transferor's basis for his stock in the acquiring corporation is increased by the basis of the stock of the issuing corporation surrendered by him. Similarly, with

respect to an acquisition of stock by a subsidiary, § 1.304–3(a) provides that the transferor's basis in his remaining stock in the parent corporation is increased by the basis of the stock deemed redeemed by the parent corporation. The treatment of the transferor's unutilized basis in stock of the issuing corporation as a result of transactions subject to section 304(a) is the subject of Revenue Ruling 70–496, 1970–2 C.B. 74, and Revenue Ruling 71–563, 1971–2 C.B. 175.

In Revenue Ruling 70–496, a first-tier subsidiary (Y) of a parent corporation (X) sold all of its stock in a second-tier subsidiary of X (S) to another first-tier subsidiary of X (Z). The ruling concludes that the transaction is governed by sections 304(a)(1) and 302(d). Accordingly, the ruling holds that the sales proceeds constitute dividends to the extent of Z's earnings and profits and, to the extent in excess of such amount, constitute gain under section 301(c)(3). With respect to Y's basis in the sold S stock, the ruling holds that because Y had no direct stock ownership in Z before or after the sale, Y's basis in the S stock surrendered disappears and cannot be used to increase the basis of any asset of Y.

In Revenue Ruling 71–563, A, an individual, owned all the stock of X. C, A's son, owned all of the outstanding stock of Y. A sold 25 percent of its stock in X to Y for cash. The ruling states that, under section 304(a)(1), the sale is treated as a contribution by A of the stock of X to the capital of Y and a distribution to A by Y in redemption of its stock. Because the deemed redemption is governed by section 302(d), the cash received is taxable as a dividend to A under section 301(c)(1). Furthermore, the ruling reasons that, because A owns no stock in Y directly after the transaction, the basis of the X stock should be added to the basis of the remaining stock of X that A continues to own after the transaction.

The current regulatory regime preserves, and prevents the elimination of, basis in transactions subject to section 302 where a proper adjustment may be made to the basis of the remaining stock of the redeeming corporation and in transactions subject to section 304 where, immediately after the transaction, the seller owns stock of the acquiring corporation. In certain transactions, however, taxpayers have taken the position that certain adjustments are proper, even if they shift basis from a person that is not subject to U.S. tax to a person that is subject to U.S. tax or to stock other than stock of the redeeming corporation. Notice 2001–45, 2001–2 C.B. 129, describes a type of transaction with respect to which taxpayers have taken the position that, under § 1.302–2(c), all or a portion of the basis of stock redeemed from a person that is not subject to U.S. tax or is otherwise indifferent to the Federal income tax consequences of the redemption of the stock is added to the basis of other stock in the redeeming corporation owned by a taxpayer that is subject to U.S. tax to create a loss on the disposition of the other stock. Although the IRS intends to challenge the adjustments claimed in such transactions, the IRS and Treasury believe it is desirable to revise the rules that govern accounting for unutilized basis attributable to redeemed stock to better reflect the purposes of the relevant Code provisions.

Explanation of Provisions

A. *Rules Under Section 302*

This notice of proposed rulemaking proposes a replacement for the "proper adjustment" regime of current § 1.302–2(c) for taking into account the unutilized basis attributable to redeemed stock in any case in which a redemption of stock is treated as a distribution of property to which section 301 applies. The rules are proposed to apply both where the redeemed shareholder actually owns no stock of the redeeming corporation immediately after the redemption (a complete redemption) and where the redeemed shareholder actually owns stock of the redeeming corporation immediately after the redemption (a partial redemption). While consideration was given to retaining the "proper adjustment" rule of current § 1.302–2(c) where only a portion of the shareholder's interest in the redeeming corporation is redeemed, the IRS and Treasury believe the two situations are similar enough to warrant the same rules, and that the rules proposed herein best carry out the purposes of section 302 even where the redeemed shareholder continues directly to own stock in the redeeming corporation because, even in that case, dividend treatment under section 302 may have resulted from shares owned by attribution rather than directly. The following paragraphs describe the proposed rules.

1. *General description of the proposed rules*

Certain transactions that, in form, involve the redemption of shares are economically identical or similar to distributions to shareholders that do not involve any redemption of shares. For example, if a single shareholder owns all of the stock of the redeeming corporation, the redemption of some shares from that shareholder for cash is economically indistinguishable from the mere distribution of corporate cash to the shareholder. In recognition of this, section 302 taxes these transactions as corporate distributions notwithstanding their form as redemptions. The underlying premise of section 302 is that distribution treatment is called for in these cases because, in effect, the redeemed shareholder still owns (or is treated as owning) its stock in the corporation, even if it may have turned in some physical shares.

Although section 302 does not provide any explicit guidance regarding the shareholder's basis of the shares redeemed, in deriving a regulatory regime to address the treatment of the unutilized basis of redeemed stock, it is appropriate to consider what happens when a shareholder receives a distribution and keeps its shares, because that analogy underlies distribution treatment under section 302. Because the Code does not permit basis to offset any portion of the redemption distribution that is treated as a dividend, and because such an offset is not available when a corporation distributes a dividend and the shareholder retains its shares, the redemption date is not the appropriate time to recover the unutilized basis of the redeemed stock. However, if the shareholder receives a distribution and retains its shares, it also retains its basis, which it can recover later in situations other than dividends, such as the sale of the shares. Accordingly, the unutilized basis of the redeemed stock should not disappear and should be taken into account for Federal income tax purposes at some time. In addition, any tax benefit associated with the unutilized basis of redeemed stock should remain with the taxpayer that made, or succeeded to, the investment that gave rise to the unutilized basis. Accordingly, these regulations propose that, in any case where a redemption of stock is treated as a distribution of a dividend, an amount equal to the adjusted basis of the redeemed stock is treated as a loss

recognized on the disposition of the redeemed stock on the date of the redemption. That loss is taken into account as described below.

Once the facts and circumstances that caused the redemption distribution to be treated as a distribution subject to section 301 no longer exist (*i.e.*, the redeemed shareholder has sufficiently reduced its actual and constructive ownership interest in the redeeming corporation), these regulations permit the loss attributable to the unutilized basis of redeemed stock that has not previously been taken into account to be taken into account. The first date on which the redeemed shareholder would satisfy the criteria of section 302(b)(1), (2) or (3) if the facts and circumstances that exist on such date had existed immediately after the redemption is referred to as the "final inclusion date." In addition, a date is the final inclusion date if there is no later date on which the redeemed shareholder could take the loss into account. For example, if the redeemed shareholder is an individual, the final inclusion date includes the date of death of such individual. If the redeemed shareholder is a corporation, the final inclusion date includes the date such corporation transfers its assets in a liquidation described in section 331. If the redeemed shareholder is a foreign corporation, the final inclusion date includes the date such corporation transfers its assets to a domestic corporation in either a liquidation described in section 332 or a reorganization described in section 368(a)(1) to which section 381 applies. If the redeemed shareholder is a foreign corporation that is not a controlled foreign corporation, within the meaning of section 957(a), on the date of the redemption, the term final inclusion date includes the date such corporation transfers its assets to a controlled foreign corporation in a liquidation described in section 332 or a reorganization described in section 368(a)(1) to which section 381 applies.

These proposed regulations also provide that the redeemed shareholder is permitted to take into account the loss attributable to the unutilized basis of redeemed stock when the redeemed shareholder recognizes a gain on stock of the redeeming corporation to the extent of the gain recognized. Any date on which the redeemed shareholder must take into account gain recognized pursuant to section 301(c)(3) or gain recognized on a disposition of stock of the redeeming corporation is referred to as an "accelerated loss inclusion date." Although there can be only one final inclusion date, there can be several accelerated loss inclusion dates.

Because the loss attributable to the basis of the redeemed stock is treated as recognized on a disposition of the redeemed stock on the redemption date, the attributes (*e.g.*, character and source) of that loss are fixed on the redemption date, even if such loss is not taken into account until after the redemption date. For example, if a corporation redeems its stock from a shareholder within one year after the shareholder's acquisition of such stock and the proceeds of the redemption are treated as a dividend distribution, the character of any amount of the loss that is taken into account is treated as short-term capital loss (assuming the redeemed shareholder held the redeemed stock as a capital asset), even if such loss is taken into account more than one year after the redeemed shareholder's acquisition of the redeemed stock. Nonetheless, for purposes of the carryforward and carryback provisions of sections 172 and 1212, such loss is treated as a loss for the taxable year in which it is taken into account rather than for the taxable year of the stock redemption that gave rise to such loss.

Because a redemption of stock may give rise to, or increase, an excess loss account in redeemed stock where the redeemed shareholder and the redeeming corporation are members of the same consolidated group, these regulations propose rules similar to those described above where the redeemed shareholder has an excess loss account in the redeemed stock.

These proposed regulations do not apply on the redemption of stock described in section 306(c). Pursuant to section 306(a)(2), a redemption of stock described in section 306(c) is treated as a distribution of property to which section 301 applies. *Example 2* of § 1.306–1 suggests that the unutilized basis of redeemed section 306 stock is added back to the basis of the stock with respect to which the section 306 stock was distributed. The IRS and Treasury request comments on whether such treatment of the unutilized basis of redeemed section 306 stock is appropriate or whether an alternative regime should apply when such a redemption is treated as a distribution to which section 301 applies.

2. *Special issues related to certain pass-through entities*

Where stock is redeemed from a partnership and all or a portion of the distribution in redemption of such stock is treated as a dividend, any loss attributable to the basis of redeemed stock is treated as a current loss to the partnership on the date of the redemption. To the extent of the lesser of the amount of such distribution that is treated as a dividend and such loss that is not allocated pursuant to section 704(c) and the regulations thereunder, the dividend and the loss must be allocated in equal amounts. Such amounts must be allocated in accordance with the partners' interests in the partnership. An allocation will be deemed to be in accordance with a partner's interest in the partnership if the allocation is in the same proportion as the allocation of (i) the excess of the dividend income over the loss attributable to the basis of the redeemed stock, if any, (ii) the excess of the loss attributable to the basis of the redeemed stock over the dividend income, if any, or, (iii) if neither, in the same proportion as the partnership's net taxable income or loss for the year is allocated. This rule ensures that the benefit of the loss may be realized by the person to whom the dividend income was allocated. The excess dividend or loss attributable to the basis of redeemed stock must be allocated in a manner that takes into account the requirements of section 704.

The loss attributable to the basis of redeemed stock allocated to a partner under the rules of this section is not taken into account at the partner level until the final inclusion date or an accelerated loss inclusion date, as applicable. For purposes of determining whether a particular date is the final inclusion date with respect to such a loss, if the partner is a partner of the partnership on such date, the partnership is treated as the redeemed shareholder. Otherwise, the former partner is treated as the redeemed shareholder and the determination of whether a particular date is the final inclusion date is made by comparing such former partner's actual and constructive ownership of the redeeming corporation immediately prior to the redemption to such former partner's actual and constructive ownership of the redeeming corporation at the end of such particular date. For purposes of determining whether a particular date is an accelerated loss inclusion date

with respect to a loss attributable to the basis of redeemed stock that is allocated to a partner from a partnership, the partner is treated as the redeemed shareholder. Similar rules are proposed to apply where stock is redeemed from an S corporation.

The proposed regulations provide that where stock is redeemed from a C corporation, and the C corporation subsequently elects to be taxed as an S corporation, any loss attributable to the basis of redeemed stock that has not been taken into account at the time of the election is treated as a carryforward arising in a taxable year for which the corporation was a C corporation. Such loss is allowed as a deduction against net recognized built-in gain under section 1374 in the year of the final inclusion date or an accelerated loss inclusion date.

To the extent that a trust from which stock is redeemed is wholly or partially a grantor trust, the proposed rules treat the redeemed stock as having been owned directly by the grantor. When stock is redeemed from an estate or from a trust that is not a wholly grantor trust, and all or a portion of a distribution in redemption of such stock is treated as a dividend, any loss attributable to the basis of redeemed stock that is not attributable to the basis of redeemed stock treated as owned by the grantor is not taken into account by such estate or trust until the final inclusion date or an accelerated loss inclusion date. In that case, whether a particular date is the final inclusion date or an accelerated loss inclusion date is determined by treating such estate or trust, not its beneficiaries, as the redeemed shareholder. In the event that the trust or estate terminates before it has been permitted to take into account all of the loss attributable to the basis of redeemed stock, any remaining loss is treated as a loss under section 172 or section 1212 for purposes of section 642(h) (regarding the availability to beneficiaries of unused loss carryovers and excess deductions of an estate or trust upon termination). Each beneficiary's interest in the loss distributed under section 642(h), however, shall be limited to the proportion of that loss that is equal to the proportion of the total amount of the distribution treated as a dividend that is represented by that beneficiary's beneficial interest in that dividend. Once all or a portion of such a loss is distributed to a beneficiary, whether a particular date is the final inclusion date or an accelerated loss inclusion date with respect to such a loss is determined by treating such beneficiary as the redeemed shareholder.

3. *Special rules related to apportionment of interest and other expenses*

Under section 864(e), taxpayers apportion interest expense between U.S. and foreign source income on the basis of the relative values of their U.S. and foreign assets. For this purpose, taxpayers may choose to value their assets using either fair market value or tax book value (adjusted basis). If the taxpayer apportions interest expense using tax book value, the adjusted basis of stock in any nonaffiliated 10 percent owned corporation (as defined in section 864(e)(4)(B)) is increased by the amount of earnings and profits (and reduced by any deficits in earnings and profits) attributable to such stock that accumulated during the period the taxpayer held such stock. The proposed regulations provide that for purposes of apportioning expenses on the basis of the tax book value of assets, the adjusted basis in any remaining shares of the redeeming corporation that are owned by the redeemed shareholder or certain affiliated corporations will be increased by the amount of the unutilized basis of redeemed stock. This adjustment is intended to provide consistent interest allocation consequences in the case of dividends and redemptions treated as dividends by nonaffiliated 10 percent owned corporations.

B. *Revisions to Regulations Under Section 304*

The current regulations under section 304 do not reflect all of the legislative amendments that have been made to section 304. This notice of proposed rulemaking proposes certain revisions to the current regulations under section 304 to incorporate these legislative amendments to the extent that those legislative amendments are relevant to the issues that are subject to the proposed regulations under section 302. In particular, these revisions reflect the amendments to section 304 made by section 1013 of the Taxpayer Relief Act of 1997, Public Law 105–34 (111 Stat. 788, 918) (August 5, 1997), that provide that, to the extent that a stock acquisition to which section 304(a)(1) applies is treated as a distribution to which section 301 applies, the transferor and the acquiring corporation are treated as if (1) the transferor transferred the stock of the target corporation to the acquiring corporation in exchange for stock of the acquiring corporation in a transaction to which section 351(a) applies, and (2) the acquiring corporation then redeemed the stock it is treated as having issued. The same rules that govern an actual redemption govern a deemed redemption.

In transactions under section 304 that involve one or more foreign corporations, further consequences may apply under the international provisions of the Code. For example, where target corporation stock is transferred to a foreign corporation in the deemed section 351 transaction, section 367 and the regulations promulgated thereunder apply to the transfer. See Rev. Rul. 91–5, 1991–1 C.B. 114, (holding that section 367 applied to the deemed contribution to capital of the target corporation stock under prior law because section 367(c)(2) resulted in the stock transfer constituting a section 351 transaction). The IRS intends to issue guidance on the application of the international provisions to section 304 transactions and requests comments on such transactions, including what changes, if any, to existing published guidance may be appropriate in light of the 1997 amendments to section 304.

Proposed Effective Date

These regulations are proposed to apply to transactions occurring after the date these regulations are published as final regulations in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. It is hereby certified that the collection of information in this Notice of Proposed Rulemaking will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that the IRS and Treasury estimate that at most 3,000 taxpayers will be subject to these requirements and most of those taxpayers will be individuals or large businesses. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C.

chapter 6) is not required. Pursuant to section 7805(f), 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 (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for February 20, 2003, beginning at 10 a.m. in Room 4718 of the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. 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 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the FOR FURTHER INFORMATION CONTACT portion of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments must submit written or electronic comments and an outline of the topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by January 30, 2003. 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 Lisa K. Leong of the Office of the Associate Chief Counsel (Corporate), IRS. 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 continues to read in part as follows:

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

§ 1.302–2 [Amended]

Par. 2. In § 1.302–2, paragraph (c) is removed.

Par. 3. Section 1.302–5 is added to read as follows:

§ 1.302–5 Redemptions taxable as dividends.

(a) *In general.* In any case in which an amount received in redemption of stock is treated as a distribution of a dividend, an amount equal to the basis of the redeemed stock, after adjusting such basis to reflect the application of section 301(c)(2), 961(b), 1059, § 1.1502–32, or any other applicable provision of the Internal Revenue Code or the regulations thereunder, is treated as a loss recognized on a disposition of the redeemed stock on the date of the redemption. The redeemed shareholder (as defined in paragraph (b)(1) of this section) shall be permitted to take such loss into account pursuant to the provisions of this section. Although such loss may be taken into account on a date later than the date of the redemption, the attributes (*e.g.*, character and source) of such loss are determined on the date of the redemption of the stock that gave rise to such loss. See § 1.1502–19(b)(5) for rules that apply where an amount received in redemption of stock is treated as a dividend and such amount either increases or creates an excess loss account in the redeemed stock.

(b) *Definitions*—(1) *Redeemed shareholder*. Except as provided in paragraphs (d)(6), (7), and (8) of this section, the redeemed shareholder is the person whose stock is redeemed in a transaction in which a portion or all of the redemption proceeds are treated as a dividend. If the assets of the redeemed shareholder are acquired in a transaction described in section 381(a), the acquiring corporation (within the meaning of section 381) thereafter is treated as the redeemed shareholder. For rules concerning the person that is treated as the redeemed shareholder where the redeemed stock is held by a partnership or an S corporation at the time of the redemption, see paragraphs (d)(6) and (7) of this section. For rules concerning the person that is treated as the redeemed shareholder where the redeemed stock is held by an estate or a trust not treated as wholly owned by the grantor or another person at the time of the redemption and a loss attributable to the basis of such redeemed stock is distributed to a beneficiary of such estate or trust, see paragraph (d)(8) of this section.

(2) *Redeeming corporation*. Except as provided in paragraph (d)(5) of this section, the redeeming corporation is the corporation that issued the stock that is redeemed. For rules concerning the entity that is treated as the redeeming corporation where the redeeming corporation ceases to exist in a transaction described in section 381(a) or where the redeeming corporation distributes to its shareholders stock of one or more controlled corporations in a distribution described in section 355(a), see paragraph (d)(5) of this section.

(3) *Final inclusion date*. Except as otherwise provided in paragraphs (d)(5), (6), (7), and (8) of this section, the final inclusion date is the first date on which the redeemed shareholder would satisfy the criteria of section 302(b)(1), (2), or (3) if the facts and circumstances that exist at the end of such day had existed immediately after the redemption. In addition, a date is the final inclusion date if there is no later date on which the redeemed shareholder could take the loss into account. For purposes of the preceding sentence, the existence or creation of a limitation under section 382 is not treated as preventing the loss from being taken into account. For example, if the redeemed shareholder is an individual, the final inclusion date includes the date of death of such individual. If the redeemed shareholder is a corporation, the final inclusion date includes the date such corporation transfers its assets in a liquidation described in section 331. If the redeemed shareholder is a foreign corporation, the final inclusion date includes the date such corporation transfers its assets to a do-

mestic corporation in either a liquidation described in section 332 or a reorganization described in section 368(a)(1) to which section 381 applies. If the redeemed shareholder is a foreign corporation that is not a controlled foreign corporation, within the meaning of section 957(a), on the date of the redemption, the term final inclusion date includes the date such corporation transfers its assets to a controlled foreign corporation in a liquidation described in section 332 or a reorganization described in section 368(a)(1) to which section 381 applies.

(4) *Accelerated loss inclusion date*. An accelerated loss inclusion date is a date other than the final inclusion date on which the redeemed shareholder must take into account gain from an actual or deemed sale or exchange of stock of the redeeming corporation. For example, the redeemed shareholder must take into account gain from an actual or deemed sale or exchange of stock of the redeeming corporation when such shareholder receives a distribution with respect to stock of the redeeming corporation to which section 301(c)(3) applies, recognizes gain on stock of the redeeming corporation as a result of the application of section 475, recognizes gain on a sale or exchange of stock of the redeeming corporation (even if such gain is characterized as a dividend under section 1248), recognizes gain in connection with a constructive sale of stock of the redeeming corporation within the meaning of section 1259, or is a partner of a partnership or a shareholder of an S corporation that is allocated, and must take into account, gain recognized on the partnership's or S corporation's sale or exchange of stock of the redeeming corporation.

(c) *Inclusion of loss attributable to basis of redeemed stock*—(1) *Amount taken into account on final inclusion date*. On the final inclusion date, the redeemed shareholder is permitted to take into account the loss attributable to the basis of redeemed stock, reduced by the amount of such loss that was previously taken into account pursuant to paragraph (c)(2) of this section.

(2) *Amount taken into account on accelerated loss inclusion date*. On an accelerated loss inclusion date, the redeemed shareholder is permitted to take into account the loss attributable to the basis of redeemed stock in the amount of the lesser of—

(i) The amount of such loss reduced by the amount of such loss previously taken into account pursuant to this paragraph (c)(2); and

(ii) The amount of gain recognized with respect to stock of the redeeming corporation that must be taken into account by the redeemed shareholder on such accelerated loss inclusion date.

(d) *Special rules*—(1) *Treatment of loss attributable to basis of redeemed stock.* Except as otherwise provided in this section, for purposes of applying the provisions of the Internal Revenue Code and the regulations thereunder, any loss attributable to the basis of redeemed stock that has not been permitted to be taken into account shall be treated as a net operating loss carryforward or a capital loss carryforward, as applicable. For example, for purposes of determining under sections 382 and 383 whether the redeemed shareholder is a loss corporation that has an ownership change and whether the loss attributable to the basis of redeemed stock is a pre-change loss, any loss attributable to the basis of redeemed stock that the redeemed shareholder is not permitted to take into account before a testing date shall be treated as a net operating loss carryforward or a capital loss carryforward, as applicable, that arose in the taxable year in which the redemption that gave rise to such loss occurred and that can be carried forward to the taxable year that includes the testing date. If such loss is treated as a pre-change loss because of an ownership change on the testing date, it is subject to the section 382 limitation (and the other rules of section 382 or 383) for any post-change year in which it is taken into account under paragraph (c) of this section and any other post-change year to which it is carried pursuant to section 172 or 1212, as applicable, and paragraph (d)(2) of this section. The order in which the loss is absorbed (and in which it absorbs the section 382 limitation (see § 1.383–1(d)(2)), however, is determined in a manner consistent with the principles of section 172 or 1212, as applicable, and paragraph (d)(2) of this section.

(2) *Net operating loss deduction and capital loss carrybacks and carryovers.* For purposes of sections 172 and 1212, any portion of a loss attributable to the basis of redeemed stock shall be treated as occurring in the taxable year in which the redeemed shareholder is permitted to take such loss into account, not the taxable year of the redemption that gave rise to such loss. If an estate or trust terminates before it is permitted to take into account all of the loss attributable to the basis of redeemed stock, such loss that it has not been permitted to take into account is treated as a loss under section 172 or 1212 for purposes of section 642(h), provided, however, that the identification of carryover years of the beneficiaries will be determined in accordance with the preceding sentence. Notwithstanding the preceding sentence, each beneficiary's interest in the loss distributed under section 642(h) shall be limited to the proportion of that loss that is equal to the proportion of the total amount of the distribution treated as a dividend that is represented by that beneficiary's beneficial interest in that dividend. If a deduction for any portion of such loss is disallowed by section 382 or 383 for the taxable year in which the redeemed shareholder is permitted to take such loss into account, such portion shall be carried forward to subsequent taxable years under rules similar to the rules for the carrying forward of net operating losses or capital losses, as applicable, but shall be subject to the section 382 limitation (and the other rules of sections 382 and 383) for any post-change year to which it is carried.

(3) *Expenses apportioned on the basis of assets*. For special rules regarding adjustments in the case of taxpayers apportioning expenses on the basis of the tax book value of assets, see § 1.861–12(c)(2)(vi).

(4) *Effect of loss attributable to basis of redeemed stock on earnings and profits*. If the redeemed shareholder is a corporation, any loss attributable to the basis of redeemed stock is not reflected in such corporation's earnings and profits before it is taken into account pursuant to the rules of paragraph (c) of this section. See, for example, §§ 1.312–6(a), 1.312–7, and 1.1502–33(c)(2).

(5) *Successors to the redeeming corporation*—(i) *Acquisitive transactions*. If the assets of the redeeming corporation are acquired by another corporation in a transaction described in section 381(a), the determination of whether a particular date is the final inclusion date or an accelerated loss inclusion date is made by treating the facts and circumstances that exist at the end of such day (including the ac-

quisition of the assets of the redeeming corporation) as existing immediately after the redemption and treating the acquiring corporation (within the meaning of section 381) as the redeeming corporation.

(ii) *Divisive transactions*. In general, if the redeeming corporation distributes to its shareholders the stock of one or more controlled corporations in a distribution to which section 355 (or so much of section 356 as relates to section 355) applies, the loss attributable to the basis of redeemed stock is allocated among the stock of the distributing and any controlled corporations that the redeemed shareholder owns, actually and constructively pursuant to the rules of section 318, immediately after the distribution in proportion to the fair market value of the stock of the distributing corporation that the redeemed shareholder is treated as so owning and the distributed stock of the controlled corporation that the redeemed shareholder is treated as so owning. To the extent that such loss is allocated to the stock of the distributing corporation, the distributing corporation will be treated as the redeeming corporation for purposes of determining whether a particular date is the final inclusion date or an accelerated loss inclusion date with respect to such loss. To the extent that such loss is allocated to the stock of a controlled corporation, such controlled corporation will be treated as the redeeming corporation for purposes of determining whether a particular date is the final inclusion date or an accelerated loss inclusion date with respect to such loss. Where the controlled corporation was wholly owned by the distributing corporation and all of the stock of the controlled corporation was distributed to the shareholders of the distributing corporation in a distribution to which section 355 (or so much of section 356 as relates to section 355) applies, the determination of whether a particular date is the final inclusion date with respect to a loss that is allocated to a controlled corporation is made by treating the redeemed shareholder as owning a percentage of stock of the controlled corporation immediately prior to the redemption equal to the percentage of stock of the distributing corporation the redeemed shareholder actually and constructively owned immediately prior to the redemption. In all other cases, appropriate calculations shall apply to determine whether a particular date is the final inclusion date.

(6) *Redeemed shareholder is a partnership*—(i) *Treatment and allocation of loss attributable to basis of redeemed stock*. Where stock is redeemed from a partnership and all or a portion of the distribution in redemption of such stock is treated as a dividend, any loss attributable to the basis of redeemed stock is treated as a current loss to the partnership on the date of the redemption. To the extent of the lesser of the amount of such distribution that is treated as a dividend and such loss that is not allocated pursuant to section 704(c) and the regulations thereunder, the dividend and the loss must be allocated in equal amounts. Such amounts must be allocated in accordance with the partners' interests in the partnership. An allocation will be deemed to be in accordance with a partner's interest in the partnership if the allocation is in the same proportion as the allocation of the excess of the dividend income over the loss attributable to the basis of the redeemed stock, if any, the excess of the loss attributable to the basis of the redeemed stock over the dividend income, if any, or, if neither, in the same proportion as the partnership's net taxable income or loss for the year is allocated. The excess dividend or loss attributable to the basis of redeemed stock must be allocated to the partners in a manner that takes into account the requirements of section 704. The loss attributable to the basis of redeemed stock allocated to a partner under the rules of this section is not taken into account until the final inclusion date or an accelerated loss inclusion date, as provided in this section.

(ii) *Identification of redeemed shareholder*. For purposes of determining whether a particular date is the final inclusion date with respect to a loss that is allocated to a partner, if the partner is a partner of the partnership at the end of such day, the partnership is treated as the redeemed shareholder. If the partner is not a partner of the partnership at the end of such day, the former partner is treated as the redeemed shareholder and the determination of whether such date is the final inclusion date is made by comparing such former partner's actual and constructive ownership of the redeeming corporation immediately prior to the redemption to such former partner's actual and constructive ownership of the redeeming corporation at the end of such particular day. For purposes of determining whether a particular date is an accelerated loss inclusion date with respect to a loss attributable to the basis of redeemed stock that is allocated to a partner from a partnership, the partner is treated as the redeemed shareholder.

(7) *Redeemed shareholder is an S corporation*—(i) *Treatment and allocation of loss attributable to basis of redeemed stock*. Where stock is redeemed from an S corporation and all or a portion of the distribution in redemption of such stock is treated as a dividend, any loss attributable to the basis of redeemed stock is treated as a current loss to the S corporation on the date of the redemption and is allocated to the S corporation's shareholders under section 1366(a). The portion of such loss that is allocated to an S corporation shareholder from the S corporation is not permitted to be taken into account by such shareholder until the final inclusion date or an accelerated loss inclusion date, as provided in this section.

(ii) *Identification of redeemed shareholder*. For purposes of determining whether a particular date is the final inclusion date with respect to a loss attributable to the basis of redeemed stock that is allocated to a shareholder of an S corporation from an S corporation, if the S corporation shareholder is a shareholder of the S corporation at the end of such day, the S corporation is treated as the redeemed shareholder. If the S corporation shareholder is not a shareholder of the S corporation at the end of such day, the former S corporation shareholder is treated as the redeemed shareholder and the determination of whether such date is the final inclusion date is made by comparing such former S corporation shareholder's actual and constructive ownership of the redeeming corporation immediately prior to the redemption to such former S corporation shareholder's actual and constructive ownership of the redeeming corporation at the end of such particular day; provided, however, that for purposes of computing such former S corporation shareholder's ownership of the redeeming corporation immediately prior to the redemption, section 318(a)(2)(C) shall be applied without regard to the 50 percent limitation contained therein. For purposes of determining whether a particular date is an accelerated loss inclusion date with respect to a loss attributable to the basis of redeemed stock that is allocated to an S cor-

poration shareholder from an S corporation, the S corporation shareholder is treated as the redeemed shareholder.

(8) *Redeemed shareholder is an estate or trust.* To the extent that a trust from which stock is redeemed is treated as owned (in part or in whole) by the grantor or another person under subpart E of part I of subchapter J of the Internal Revenue Code, the rules of this section are applied as though the redeemed stock were owned directly by such grantor or other person. Where stock is redeemed from an estate or from a trust not treated as wholly owned by the grantor or another person under subpart E of part I of subchapter J of the Internal Revenue Code, and all or a portion of the distribution in redemption of such stock is treated as a dividend, any loss attributable to the basis of redeemed stock, except any loss attributable to the basis of redeemed stock treated as owned by the grantor or another person, is not taken into account by such estate or trust until the final inclusion date or an accelerated loss inclusion date, and whether a particular date is the final inclusion date or an accelerated loss inclusion date is determined by treating such estate or trust, not its beneficiaries, as the redeemed shareholder. However, if all or a portion of such loss is distributed to a beneficiary of such estate or trust pursuant to section 642(h) and paragraph (d)(2) of this section, the determination of whether a particular date is the final inclusion date or an accelerated inclusion date shall be made by treating each such beneficiary as the redeemed shareholder with respect to the loss distributed to such beneficiary.

(9) *Redeemed shareholder is a C corporation that converts to an S corporation.* For rules regarding the treatment of a loss attributable to the basis of redeemed stock when the redeemed shareholder is a C corporation on the date of the redemption and elects to be taxed as an S corporation prior to the final inclusion date or an accelerated loss inclusion date, see §§ 1.1371–1(a)(1) and 1.1374–5(b)(2).

(e) *Statement to be filed with returns.* With or as part of the income tax return for the year in which a redeemed shareholder takes into account any loss pursuant to this section, the redeemed shareholder shall provide a statement entitled "Claim of Loss Attributable to Basis of Redeemed Stock." The statement shall specify the amount of the loss that is taken into account on such return pursuant to this section and shall identify the shares to which such amounts relate.

(f) *Examples.* For purposes of the examples in this section, each of corporation X, corporation Y, corporation Z, corporation D, and corporation C is a domestic corporation that files U.S. tax returns on a calendar-year basis. The principles of this section are illustrated by the following examples:

Example 1. (i) *Facts.* A and B, husband and wife, each own 100 shares (50 percent) of the stock of corporation X and hold the corporation X stock as a capital asset. A purchased his corporation X shares on February 1, Year 1, for $200. On December 31, Year 1, corporation X redeems all of A's 100 shares of its stock for $300. At the end of Year 1, corporation X has current and accumulated earnings and profits of $200. In connection with the redemption transaction, A does not file an agreement described in section 302(c)(2) waiving the application of the family attribution rules. The redemption proceeds, therefore, are treated under section 301(c)(1) as a dividend to the extent of corporation X's earnings and profits of $200, and under section 301(c)(2) as a recovery of basis in the amount of $100. On July 1, Year 2, B sells all of her shares of corporation X stock to G, her mother.

(ii) *Analysis.* Under this section, an amount equal to A's basis in the corporation X stock ($100 after application of section 301(c)(2)) is treated as a loss recognized on a disposition of the redeemed stock on December 31, Year 1, the date of the redemption. When B sells her shares to G, A no longer owns, actually or constructively, any shares of corporation X stock. Thus, if the facts that existed at the end of July 1, Year 2, had existed immediately after the redemption, A would have been treated as having received a distribution in part or full payment in exchange for the redeemed stock pursuant to section 302(a). Under this section, therefore, July 1, Year 2, is the final inclusion date and, on that date, A is permitted to take into account the loss of $100 attributable to his basis in the redeemed stock. Because that loss is treated as having been recognized on a disposition of the redeemed stock on the date of the redemption, December 31 of Year 1, such loss is treated as a short-term capital loss.

Example 2. (i) *Facts.* The facts are the same as in *Example 1*, except that, instead of selling all of her 100 shares of corporation X stock to G on July 1, Year 2, B sells only 75 shares of corporation X stock to G on that date.

(ii) *Analysis.* As in *Example 1*, an amount equal to A's basis in the redeemed stock ($100 after application of section 301(c)(2)) is treated as a loss recognized on a disposition of the redeemed stock on December 31, Year 1, the date of the redemption. Immediately after B's sale of 75 shares of corporation X stock to G, A constructively owns 25 percent of the shares of corporation X stock. Thus, if the facts that existed at the end of July 1, Year 2, had existed immediately after the redemption, A would have been treated as receiving a distribution in part or full payment in exchange for the redeemed stock pursuant to section 302(a). Under this section, therefore, July 1, Year 2, is the final inclusion date and, on that date, A is permitted to take into account the loss of $100 attributable to his basis in the redeemed stock. Because that loss is treated as having been recognized on a disposition of the redeemed stock on the redemption date, December 31 of Year 1, such loss is treated as a short-term capital loss.

Example 3. (i) *Facts.* Corporation Y has 200 shares of common stock outstanding. L, an individual, owns 150 shares of common stock in corporation Y and has owned these shares for several years. The remaining 50 shares are owned by K, L's father. In Year 1, corporation Y redeems 50 shares of L's corporation Y stock, which have a basis of $75, for $200. At the end of Year 1, corporation Y's current and accumulated earnings and profits exceed $200. The redemption of L's stock is treated as a distribution to which section 301 applies. L recognizes dividend income in the amount of $200. In Year 4, L sells 25 of his remaining shares of corporation Y stock, which have a basis of $50, to K for $100 and recognizes $50 of long-term capital gain.

(ii) *Analysis.* Under this section, an amount equal to L's basis in the corporation Y stock that is redeemed, $75, is treated as a loss recognized on a disposition of the redeemed stock on the date of the redemption. The date on which L sells 25 shares of corporation Y stock to K is not the final inclusion date under paragraph (b)(3) of this section because L does not satisfy the criteria of section 302(b)(1), (2), or (3) at the end of such day. Under paragraph (b)(4) of this section, however, that date is an accelerated loss inclusion date because, on that date, L recognizes gain of $50 on a disposition of stock of corporation Y, the redeeming corporation. Thus, on that date, L is permitted to take into account $50 of the loss attributable to his basis in the redeemed stock. The remaining $25 of such loss is taken into account on the earlier of the final inclusion date or the next accelerated loss inclusion date (to the extent of gain recognized).

Example 4. (i) *Facts.* The facts are the same as in *Example 3*, except that L does not sell any shares of corporation Y to K in Year 4. Instead, in Year 4, corporation Y distributes $75 to L with respect to his remaining 100 shares of corporation Y stock. L's basis in these shares is only $30, and at the end of Year 4, corporation Y's current and accumulated earnings and profits are $20, instead of $200. Under section 301(c)(1), $20 of the distribution is treated as a dividend, under section 301(c)(2), $30 of the distribution is treated as a recovery of basis, and, under section 301(c)(3), $25 of the distribution is treated as gain from the sale or exchange of stock.

(ii) *Analysis.* As in *Example 3*, an amount equal to L's basis in the corporation Y stock redeemed in Year 1, $75, is treated as a loss recognized on a disposition of the redeemed stock on the date of the redemption. Because L recognizes gain under section 301(c)(3) upon the receipt of the Year 4 distribution, the date of that distribution is an accelerated loss inclusion date. Accordingly, on that date, L is permitted to take into account $25 of the loss attributable to the basis of the redeemed stock. The remaining $50 of such loss is taken into account on the earlier of the final inclusion date or the next accelerated loss inclusion date (to the extent of gain recognized).

Example 5. (i) *Facts.* Corporation Z has 100 shares of stock outstanding, 50 shares of which are owned by each of A and his son, B. A's basis in each of his shares of corporation Z stock is $1. During Year 1, corporation Z redeems from A 25 shares of corpora-

tion Z stock for $200. At the end of Year 1, corporation Z has current and accumulated earnings and profits in excess of $200. The redemption is treated as a distribution to which section 301 applies. Accordingly, A recognizes dividend income of $200. In Year 2, corporation Y acquires all of corporation Z's assets in exchange solely for voting stock in a reorganization described in section 368(a)(1)(C). In the reorganization, A and B surrender their shares of corporation Z stock. A receives 2,500 shares of common stock of corporation Y and B receives 5,000 shares of common stock of corporation Y. Immediately after the reorganization, corporation Y has outstanding one million shares of common stock.

(ii) *Analysis.* Under this section, an amount equal to A's basis in the redeemed stock after the Year 1 redemption, $25, is treated as a loss recognized on a disposition of the redeemed stock on the date of the redemption. Under paragraph (d)(5) of this section, for purposes of determining whether a particular date on or after the date of the reorganization is the final inclusion date or an accelerated loss inclusion date, corporation Y, the acquiring corporation, is treated as the redeeming corporation. If the facts and circumstances that exist at the end of the day of the reorganization had existed on the date of the redemption, the redemption would have been treated as a distribution in part or full payment in exchange for the redeemed stock pursuant to section 302(a). Therefore, the date of the reorganization is the final inclusion date and A is permitted to take into account the loss of $25 attributable to his basis in the redeemed stock.

Example 6. (i) *Facts.* Corporation D has 300 shares of stock outstanding. J and her two daughters, M and N, each own 100 shares of corporation D stock. J's basis in her corporation D shares is $400. In Year 1, corporation D redeems all of J's shares for $1,000. At the end of Year 1, corporation D has current earnings and profits exceeding $1,000. The redemption is treated as a distribution to which section 301 applies. Accordingly, J recognizes dividend income in the amount of $1,000. Subsequently, M and N decide to separate corporation D's business. Accordingly, they cause corporation D to contribute one-half of its assets to corporation C, a newly formed corporation, in exchange for all of corporation C's stock and to distribute all of the corporation C stock to N in exchange for all of her corporation D stock. Immediately after the distribution, the value of corporation D is equal to the value of corporation C. In Year 6, M sells her shares in corporation D to an unrelated person.

(ii) *Analysis.* Under this section, an amount equal to J's basis in the corporation D stock redeemed, $400, is treated as a loss recognized on a disposition of the redeemed stock on the date of the redemption. Upon corporation D's distribution of the stock of corporation C in Year 2, J's loss attributable to the basis of the redeemed corporation D stock is allocated among the stock of corporation D and corporation C that J owns, actually and constructively, immediately after the distribution in proportion to the fair market value of the stock of each such corporation. Although J does not actually own any stock of corporation D or corporation C, because J constructively owns all of the stock of both corporation D and corporation C and each of the stock of corporation D and the stock of corporation C have the same value immediately after the distribution, $200 of the loss is allocated to each of the stock of corporation D and the stock of corporation C that J is treated as so owning. Accordingly, each of corporation D and corporation C is treated as the redeeming corporation for purposes of determining whether a particular date after the date of the distribution is an accelerated loss inclusion date or the final inclusion date with respect to $200 of the loss. In this case, the date in Year 6 on which M sells her corporation D stock to an unrelated person is the final inclusion date with respect to J's loss allocated to J's constructively owned corporation D stock, because had corporation D's distribution of corporation C stock occurred immediately after the redemption of J's stock and M's Year 6 sale of corporation D stock occurred immediately thereafter in Year 1, the redemption of J's corporation D stock would have been treated as a distribution in part or full payment in exchange for the redeemed stock pursuant to section 302(a). Accordingly, on that date in Year 6, J is permitted to take into account the $200 loss allocated to the corporation D stock. The $200 loss allocated to the corporation C stock is taken into account on the earlier of the final inclusion date or the next accelerated loss inclusion date (to the extent of gain recognized) with respect to the corporation C stock.

Example 7. (i) *Facts.* In Year 1, A and B, two unrelated individuals, each contribute $100 to form a 50–50 general partnership, PS. A and B share in the income of PS equally. PS buys 100 shares of corporation Z stock for $200. A owns the remaining 400 outstanding shares of corporation Z stock directly. In Year 2, corporation Z redeems all of PS's shares for $300. At that time, the basis of A's interest in PS is $100 and the basis of B's interest in PS is $100. At the end of Year 2, corporation Z has current and accumulated earnings and profits of $150. Because A's ownership of the Z stock is attributed to PS under section 318(a)(3)(A), the redemption is treated as a distribution to which section 301 applies. The redemption proceeds, therefore, are treated as a dividend to the extent of corporation Z's earnings and profits, $150, and as a recovery of basis in the amount of $150. Assume that PS's only items of income, gain, loss, deduction, and credit for Year 2 arise from the redemption of the corporation Z stock. On January 1 of Year 4, A sells his entire interest in PS to C, an unrelated individual.

(ii) *Analysis.* Under this section, an amount equal to PS's basis in the corporation Z stock, ($50 after application of section 301(c)(2)), is treated as a current loss recognized by the partnership on a disposition of the redeemed stock on the date of the redemption. Under this section, $50 of the dividend and $50 of the loss must be allocated in equal amounts in accordance with A's and B's interests in PS. Accordingly, if the remaining $100 of the dividend is allocated $50 to A and $50 to B under section 704 and the regulations thereunder, $25 of each of the dividend and the loss is allocated to each of A and B. A's and B's basis in their PS interests are increased by their shares of the dividend and decreased by their shares of the loss attributable to the basis of the redeemed stock. A and B will not be able to take that loss into account until the final inclusion date or an accelerated loss inclusion date. When A sells his PS interest to C, an unrelated individual, PS and A are no longer related. Therefore, PS no longer owns, actually or constructively, any shares of corporation Z stock. Because B remains a partner in PS after January 1, Year 4, PS is treated as the redeemed shareholder for purposes of determining if January 1, Year 4, is the final inclusion date for B. If the facts that exist at the end of the day of A's sale of his PS interest to C had existed immediately after the redemption, PS would have been treated as receiving a distribution in part or full payment in exchange for the redeemed stock pursuant to section 302(a). Therefore, B is permitted to take into account the $25 loss attributable to the basis of the redeemed stock that was allocated to him. Because A is no longer a partner in PS after January 1, Year 4, A is treated as the redeemed shareholder for purposes of determining if January 1, Year 4, is the final inclusion date for A. Immediately prior to the redemption, A actually and constructively owns 90 percent of the corporation Z stock. After the sale of the PS interest, A actually owns 100 percent of the corporation Z stock. If these facts had existed immediately after the redemption, A would not have been treated as receiving a distribution in part or full payment in exchange for the redeemed stock pursuant to section 302(a). Therefore, January 1, Year 4, is not the final inclusion date for A.

Example 8. (i) *Facts.* H, I, and J are shareholders in corporation S, a corporation that has made a valid election to be taxed as an S corporation. H, I, and J respectively hold 60 percent, 20 percent, and 20 percent of the stock in corporation S. H, I, and J have no relation to each other apart from their ownership interests in corporation S. Corporation S owns 20 percent of the outstanding shares of corporation X with a $100 adjusted basis. H owns the remaining outstanding shares of corporation X. In Year 1, all of corporation S's shares of corporation X stock are redeemed for their fair market value, $200. Corporation X has current and accumulated earnings and profits of $300 at the end of Year 1. Because H's ownership of X stock is attributed to corporation S under section 318(a)(2)(C), the redemption is treated as a distribution to which section 301 applies and is treated as a dividend. H, I, and J will be allocated $120, $40, and $40 of dividend income, respectively. In Year 2, J sells his stock of corporation S to K, an unrelated person. In Year 3, H sells his stock of corporation X to L, an unrelated person.

(ii) *Analysis.* Under this section, an amount equal to corporation S's basis in the redeemed stock ($100) is treated as a loss recognized on a disposition of the redeemed stock on the date of the disposition. H, I, and J will be allocated $60, $20, and $20 of the loss, respectively, in the year of the redemption. Both the allocation of dividend income and the allocation of the loss give rise to adjustments to each shareholder's basis in corporation S. H, I, and J, however, will not be able to take into account this loss until the final inclusion date or an accelerated loss inclusion date. In Year 2, when J sells his stock of corporation S to K, J is no longer a shareholder in corporation S and will be treated as the redeemed shareholder for purposes of determining whether a particular date is the final inclusion date or an accelerated loss inclusion date. In addition, the determination of whether the date of the Year 2 sale is the final inclusion date for J is made by comparing J's actual and constructive ownership of corporation S stock immediately prior to the redemption to J's actual and constructive ownership of corporation S stock at the end of the date of the Year 2 sale. However, for purposes of computing J's ownership of the redeeming corporation immediately prior to the redemption, section 318(a)(2)(C) is applied without regard to the 50 percent limitation contained therein. Immediately prior to the redemption,

therefore, J is treated as owning actually and constructively 4 percent of the stock of corporation X and, at the end of the day of J's sale of corporation S stock, J owns, actually and constructively, no corporation X stock. Therefore, if the facts that existed on the date of the Year 2 sale had existed immediately after the redemption, J would have been treated as having received a distribution in part or full payment in exchange for the redeemed stock pursuant to section 302(a). Therefore, the date of J's sale of corporation S stock to K is the final inclusion date. J is permitted to take into account J's share of the loss attributable to the basis of the redeemed stock as of that date. While H and I remain shareholders of corporation S, whether a particular date is the final inclusion date will be determined by treating corporation S as the redeemed shareholder. Thus, in Year 3 when H disposes of his shares of corporation X, corporation S actually and constructively owns no stock of corporation X. As of that date, therefore, H and I will be permitted to take into account their respective shares of the loss attributable to the basis of the redeemed stock.

(g) *Effective date*. This section applies to transactions occurring after the date these regulations are published as final regulations in the **Federal Register**.

Par. 4. Section 1.304–1 is revised to read as follows:

§ 1.304–1 In general.

(a) *In general*. Section 304 is applicable where a shareholder sells stock of one corporation to a related corporation as defined in section 304. Sales to which section 304 is applicable shall be treated as redemptions subject to sections 302 and 303.

(b) *Effective date*. This section applies to transactions occurring after the date these regulations are published as final regulations in the **Federal Register**.

Par. 5. Section 1.304–2 is amended as follows:

1. Paragraphs (a) and (c) are revised.

2. Paragraph (d) is added.

The revisions and addition read as follows:

§ 1.304–2 Acquisition by related corporation (other than subsidiary).

(a) *In general*. (1) If a corporation (the acquiring corporation), in return for property, acquires stock of another corporation (the issuing corporation) from one or more persons, and the person or persons from whom the stock was acquired were in control of both such corporations, then such property shall be treated as received in redemption of stock of the acquiring corporation. As to each person transferring stock, the amount received shall be treated as a distribution to which section 301 applies if section 302(a) or 303 does not apply. For rules regarding the amount constituting a dividend in such cases, see § 1.304–6.

(2) In applying section 302(b), reference shall be had to the shareholder's ownership of stock in the issuing corporation and not to its ownership of stock in the acquiring corporation (except for purposes of applying section 318(a)), section 318(a) (relating to the constructive ownership of stock) shall be applied without regard to the 50 percent limitation contained in section 318(a)(2)(C) and (3)(C), and a series of redemptions referred to in section 302(b)(2)(D) shall include acquisitions by either of the corporations of stock of the other and stock redemptions by both corporations.

(3) If, pursuant to section 302(d), section 301 applies to the property treated as received in redemption of stock of the acquiring corporation pursuant to paragraph (a)(1) of this section, the transferor and the acquiring corporation shall be treated, for all Federal income tax purposes, in the same manner as if the transferor had transferred the stock of the issuing corporation to the acquiring corporation in exchange for stock of the acquiring corporation in a transaction to which section 351(a) applies, and then the acquiring corporation had redeemed the stock it was treated as issuing in the transaction in exchange for the property. Accordingly, under section 362, the acquiring corporation's basis in the stock of the issuing corporation is equal to the basis the transferor had in that stock and, under section 358, the transferor's basis in the stock of the acquiring corporation deemed issued to the transferor in the deemed transaction to which section 351(a) applies is equal to the transferor's basis in the stock of the issuing corporation it surrendered. Section 1.302–5 applies to the transferor's unutilized basis, if any, in the stock of the acquiring corporation treated as redeemed in connection with an acquisition described in paragraph (a)(1) of this section by treating the acquiring corporation as the redeeming corporation and the transferor as the redeemed shareholder.

(4) If section 301 does not apply to the property treated as received in redemption of stock of the acquiring corporation pursuant to paragraph (a)(1) of this section, the property received by the transferor shall be treated as received in a distribution in full payment in exchange for stock of the acquiring corporation under section 302(a). The basis and holding period of the stock of the acquiring corporation that is treated as having been redeemed shall be the same as the basis and holding period of the stock of the issuing corporation actually surrendered. The acquiring corporation shall take a cost basis in the stock of the issuing corporation that it acquires. See section 1012.

* * * * *

(c) *Examples.* For purposes of the examples in this section, each of corporation X and corporation Y is a domestic corporation that files U.S. tax returns on a calendar-year basis. The principles of this section are illustrated by the following examples:

Example 1. (i) *Facts.* Corporation X and corporation Y each have outstanding 100 shares of common stock. A, an individual, owns one-half of the stock of each corporation, B owns one-half of the stock of corporation X, and C owns one-half of the stock of corporation Y. A, B, and C are unrelated. A sells 30 shares of the stock of corporation X, which have an adjusted basis of $10,000, to corporation Y for $50,000.

(ii) *Analysis*. Because before the sale A owns 50 percent of the stock of corporation X and after the sale A owns only 35 percent of such stock (20 shares directly and 15 constructively because one-half of the 30 shares owned by corporation Y are attributed to A), the redemption is substantially disproportionate as to A pursuant to the provisions of section 302(b)(2). A, therefore, realizes a gain of $40,000 ($50,000 minus $10,000). If the stock surrendered is a capital asset, such gain is long-term or short-term capital gain depending on the period of time that such stock was held. The basis to A for the stock of corporation Y is not changed as a result of the sale. Under section 1012, the basis that corporation Y takes in the acquired stock of corporation X is its cost of $50,000.

Example 2. (i) *Facts*. Corporation X and corporation Y each have outstanding 200 shares of common stock, all of which are owned by H, an individual. H has a basis in his corporation X stock of $60 and in his corporation Y stock of $30. Corporation X has $80 of current and accumulated earnings and profits and corporation Y has $80 of current and accumulated earnings and profits. H sells his 200 shares of corporation X stock to corporation Y for $150.

(ii) *Analysis*. Because H is in control of both corporation X and corporation Y and receives property from corporation Y in exchange for the corporation X stock, H's sale of 200 shares of corporation X stock to corporation Y is subject to section 304(a)(1). Accordingly, H is treated as receiving $150 as a distribution in redemption of corporation Y stock. Because H actually owns 100 percent of corporation X before the sale and is treated as owning 100 percent of corporation X after the sale, pursuant to section 302(d), section 302(a) does not apply to the deemed redemption distribution and the proceeds of the deemed redemption are treated as a distribution to which section 301 applies. Therefore, H is treated as transferring the corporation X stock to corporation Y in exchange for

corporation Y stock in a transaction to which section 351(a) applies. Corporation Y's basis in the corporation X stock acquired is $60, the same basis that H had in the corporation X stock surrendered. H takes a basis of $60 in the corporation Y stock he is treated as receiving in the deemed section 351 exchange. That corporation Y stock is then treated as redeemed by corporation Y for $150. Under section 302, that redemption is treated as a distribution to which section 301 applies because H owns directly 100 percent of corporation Y both before and after the redemption of the corporation Y stock that was deemed issued. Thus, the deemed redemption proceeds are treated as a distribution to which section 301 applies. Pursuant to § 1.304–6(a), H is treated as receiving a dividend of $150 ($80 from the current and accumulated earnings and profits of corporation Y and then $70 from the current and accumulated earnings and profits of corporation X). An amount equal to the basis in the corporation Y stock that H is deemed to receive and that is deemed redeemed, $60 is treated as a loss recognized on a disposition of the stock deemed redeemed on the date of the deemed redemption and is taken into account under rules set forth in § 1.302–5. H's basis in the 200 shares of corporation Y stock that H owned before the sale and continues to own immediately after the sale remains $30.

Example 3. (i) *Facts.* The facts are the same as in *Example 2*, except that corporation X has $5 of current and accumulated earnings and profits and corporation Y has $25 of current and accumulated earnings and profits.

(ii) *Analysis*. As in *Example 2*, H takes a basis of $60 in the corporation Y stock he is treated as receiving and $150 is treated as a distribution to which section 301 applies. Pursuant to § 1.304–6(a), H is treated as receiving a dividend of $30 ($25 from the current and accumulated earnings and profits of corporation Y and $5 from the current and accumulated earnings and profits of corporation X). In addition, $60 of the distribution is treated as a return of basis and $60 of the distribution is treated as gain from the sale or exchange of corporation Y stock. H's basis in the 200 shares of corporation Y stock that he owned before and continues to own immediately after the sale remains $30. Corporation Y's basis in the corporation X stock acquired is $60, the same basis that H had in the corporation X stock surrendered.

Example 4. (i) *Facts*. A, an individual, owns 100 shares of corporation X stock, which is all of the outstanding stock of corporation X. A has a basis of $1 in each share of his corporation X stock. B, the son of A, owns all the outstanding stock of corporation Y. A sells 25 shares of the stock of corporation X to corporation Y for $50. For that year, the current and accumulated earnings and profits of corporation Y exceed $50.

(ii) *Analysis.* Because A is in control of both corporation X and corporation Y (corporation X directly and corporation Y through attribution from B) and receives property in exchange for the corporation X stock, A's sale of corporation X stock to corporation Y is subject to section 304(a)(1). Consequently, A is treated as transferring the corporation X stock to corporation Y in exchange for corporation Y stock in a transaction to which section 351(a) applies. That corporation Y stock is then treated as redeemed by corporation Y for $50. Before the deemed redemption of the corporation Y stock, A owned 100 percent of corporation Y directly and constructively. After the deemed redemption, A owns 100 percent of corporation Y constructively by attribution from B. Accordingly, the redemption distribution is treated as a distribution to which section 301 applies. Because the earnings and profits of corporation Y exceed the amount of cash paid by corporation Y to A for the corporation X stock, pursuant to § 1.304–6(a), the entire amount is a dividend. An amount equal to the basis in the corporation Y stock that A was deemed to receive and that was then deemed redeemed, $25, is treated as a loss recognized on a disposition of the stock deemed redeemed on the date of the deemed redemption and is taken into account under rules set forth in §1.302–5. A's basis in the 75 shares that he continues to hold remains $1 per share for an aggregate basis of $75.

(d) *Effective date*. This section, except for paragraph (b) of this section, applies to transactions occurring after the date these regulations are published as final regulations in the **Federal Register**. Paragraph (b) of this section applies on and after December 2, 1955.

Par. 6. Section 1.304–3 is amended as follows:

1. Paragraph (a) is revised.

2. Paragraph (c) is added.

The revision and addition read as follows:

§ 1.304–3 Acquisition by a subsidiary.

(a) *In general*. If a subsidiary, in return for property, acquires stock of its parent corporation from a shareholder of the parent corporation, the acquisition of such stock shall be treated as if the parent corporation had redeemed its own stock in exchange for the property. For purposes of this section, a corporation is a parent corporation if it meets the 50 percent ownership requirements of section 304(c). The determination of whether the amount received shall be treated as an amount received in payment in exchange for the stock shall be made by applying section 303, or by applying section 302(b) with reference to the stock of the issuing parent corporation. For rules regarding the amount that constitutes a dividend in a redemption treated as a distribution subject to section 301, see § 1.304–6. For the treatment of the redeemed shareholder's basis in the redeemed stock in such cases, see § 1.302–5. Section 1.302–5 applies to the shareholder's unutilized basis, if any, in the stock of the parent corporation treated as redeemed in connection with an acquisition described in this paragraph (a) by treating the parent corporation as the redeeming corporation and the shareholder as the redeemed shareholder.

* * * * *

(c) *Effective date*. This section applies on and after December 2, 1955, except for paragraph (a) of this section, which applies to transactions occurring after the date these regulations are published as final regulations in the **Federal Register**.

Par. 7. Section 1.304–5 is amended as follows:

1. Paragraph (a) is amended by adding a sentence at the end of the paragraph.

2. Paragraph (c) is revised.

The revision and addition read as follows:

§ 1.304–5 Control.

(a) * * * Specifically, section 318(a) shall be applied by using the language "5 percent" instead of "50 percent" in section 318(a)(2)(C) and by using the language "5 percent" instead of "50 percent" in section 318(a)(3)(C), except that if section 318(a)(3)(C) would not have applied but for this substitution, by considering a corporation as owning the stock (other than stock in such corporation) owned by or for any shareholder of such corporation in that proportion which the value of the stock which such shareholder owned in such corporation bears to the value of all stock in such corporation.

* * * * *

(c) *Effective date*. This section applies on and after January 20, 1994, except the last sentence of paragraph (a) of this section applies to transactions occurring after the date these regulations are published as final regulations in the **Federal Register**.

Par. 8. Section 1.304–6 is added to read as follows:

§ 1.304–6 Amount constituting a dividend.

(a) *In general.* The determination of the amount of the property that is a dividend is made as if the property were distributed by the acquiring corporation to the extent of its earnings and profits and then by the issuing corporation to the extent of its earnings and profits. Where, however, the acquiring corporation is a foreign corporation, for purposes of the preceding sentence, the earnings and profits of the

acquiring corporation are taken into account only to the extent that they—

(1) Are attributable to stock of the acquiring corporation owned (within the meaning of section 958(a)) by a corporation or individual that is—

(i) A United States shareholder (within the meaning of section 951(b)) of the acquiring corporation; and

(ii) The transferor or a person who bears a relationship to the transferor described in section 267(b) or 707(b); and

(2) Were accumulated during the period or periods such stock was owned by such person while the acquiring corporation was a controlled foreign corporation.

(b) *Effective date*. This section applies to transactions occurring after the date these regulations are published as final regulations in the **Federal Register**.

Par. 9. Section 1.704–1 is amended by adding paragraph (b)(4)(viii) to read as follows:

§ 1.704–1 Partner's distributive share.

* * * * *

(b) * * *

(4) * * *

(viii) *Loss attributable to basis of redeemed stock under § 1.302–5.* For rules regarding allocations on a redemption of stock all or a portion of which is treated as a dividend, see § 1.302–5(d)(6)(i).

* * * * *

Par. 10. Section 1.861–12 is added to read as follows:

§ 1.861–12 Characterization rules and adjustments for certain assets.

(a) through (c)(2)(v) [Reserved]. For further guidance, see § 1.861–12T(a) through (c)(2)(v).

(c)(2)(vi) *Adjustments in respect of redeemed stock for taxpayers using the tax book value method.* Solely for purposes of apportioning expenses on the basis of the tax book value of assets, the adjusted basis of any stock in a 10 percent owned corporation owned directly by a taxpayer that is a redeemed shareholder (as defined in § 1.302–5(b)(1)) with respect to such corporation shall be increased by the amount of any loss that has not been taken into account under § 1.302–5(c) as of the close of the redeemed shareholder's taxable year (unrecovered loss). If the redeemed shareholder does not own directly any shares in the 10 percent owned corporation as of the end of the taxable year, but is treated for purposes of section 302(b) as owning shares actually owned by another member of the redeemed shareholder's affiliated group, as defined in section 1504(a), or by a corporation that is either an affiliate described in § 1.904(i)–1(b)(1) or an affiliated corporation described in § 1.861–11T(d)(6) with respect to the redeemed shareholder, then the adjusted basis of the shares in the 10 percent owned corporation, if any, that are owned by such other corporation or corporations shall be increased by the amount of the redeemed shareholder's unrecovered loss (and allocated among such corporations, if applicable, in proportion to their relative adjusted bases (as adjusted pursuant to this paragraph and § 1.861–12T(c)(2)) in the stock of the redeeming corporation). These adjustments are to be made annually and are noncumulative.

(vii) *Examples.* [Reserved]. Certain of the rules of this paragraph (c)(2) may be illustrated by the following examples:

Examples 1 and 2. [Reserved]. For further guidance, see § 1.861–12T(c)(2)(vii), Examples 1 and 2.

Example 3. The facts are the same as in § 1.861–12T(c)(2)(vii) *Example 2*, except that the taxable year is 2003, and during the taxable year Y redeems some of the shares of its stock held by X for $100,000. X's adjusted basis in the redeemed shares is $50,000. Because X still owns all of the outstanding stock of Y, the redemption is treated as a distribution with respect to the stock of Y under section 301. Under § 1.302–5, X's $50,000 adjusted basis in the redeemed shares is treated as a loss recognized on the date of the redemption, none of which is taken into account in 2003. X invests the $100,000 of redemption proceeds in assets that generate foreign source general limitation income. Under paragraph (c)(2)(vi) of this section, X's adjusted basis in its remaining Y stock is considered to be $2,000,000 ($1,950,000 adjusted basis in the Y stock plus $50,000 unrecovered loss in the redeemed shares). X's adjusted basis of assets that generate foreign source general limitation income is considered to be $2,500,000 ($2,000,000 adjusted basis in the Y stock plus $500,000 other assets), and the resulting apportionment of interest expense is the same as in § 1.861–12T(c)(2)(vii) *Example 2*.

(c)(3) through (j) [Reserved]. For further guidance, see § 1.861–12T(c)(3) through (j).

Par. 11. Section 1.861–12T is amended as follows:

1. Paragraph (c)(2)(vi) is redesignated as paragraph (c)(2)(vii).

2. New paragraph (c)(2)(vi) is added.

The addition reads as follows:

§ 1.861–12T Characterization rules and adjustments for certain assets (temporary regulations.)

* * * * *

(c) * * *

(2) * * *

(vi) [Reserved]. For further guidance, see § 1.861–12(c)(2)(vi).

* * * * *

Par. 12. Section 1.1371–1 is added to read as follows:

§ 1.1371–1 Coordination with subchapter C.

(a) *No carryover between C and S years*—(1) *Loss attributable to basis of redeemed stock.* A loss described in § 1.302–5(a) is treated as a carryforward arising in a taxable year for which a corporation is a C corporation. Therefore, it may not be carried to a taxable year for which such corporation is an S corporation.

(2)*[Reserved].*

(b) *Effective date*. This section applies to transactions occurring after the date these regulations are published as final regulations in the **Federal Register**.

Par. 13. In § 1.1374–5, paragraph (a) is amended by adding a sentence at the end of the paragraph.

§ 1.1374–5 Loss carryforwards.

(a) *In general.* * * * However, for redemptions of stock occurring after the date these regulations are published as final regulations in the **Federal Register**, a loss attributable to the basis of redeemed stock that is taken into account pursuant to the rules of § 1.302–5 is allowed for purposes of section 1374(b)(2) as a deduction against net recognized built-in gain of the S corporation for the taxable year, provided that the loss arose in a year in which the corporation was a C corporation.

* * * * *

Par. 14. In § 1.1374–10, paragraph (a) is revised to read as follows:

§ 1.1374–10 Effective date and additional rules.

(a) *In general*. Except as provided in § 1.1374–5(a), §§ 1.1374–1 through

1.1374–9 apply for taxable years ending on or after December 27, 1994, but only in cases where the S corporation's return for the taxable year is filed pursuant to an S election or a section 1374(d)(8) transaction occurring on or after December 27, 1994.

* * * * *

Par. 15. In § 1.1502–13, paragraph (f)(7) Example 3(b) is revised to read as follows:

§ 1.1502–13 Intercompany transactions.

* * * * *

(f) * * *

(7) * * *

Example 3. * * *

(b) *Treatment as a section 301 distribution*. The merger of S into B is a transaction to which paragraph (f)(3) of this section applies. P is treated as receiving additional B stock with a fair market value of $500 and, under section 358, a basis of $250. Immediately after the merger, $150 of the stock received is treated as redeemed, and the redemption is treated under section 302(d) as a distribution to which section 301 applies. Because the $150 distribution is treated as not received as part of the merger, section 356 does not apply and no basis adjustments are required under section 358(a)(1)(A) and (B). Because B is treated under section 381(c)(2) as receiving S's earnings and profits and the redemption is treated as occurring after the merger, $100 of the distribution is treated as a dividend under section 301 and P's basis in the B stock is reduced correspondingly under § 1 .1502–32. Under paragraph (f)(2)(ii) of this section, P's $100 of dividend income is not included in gross income. Accordingly, P has a $75 excess loss account in the redeemed stock. That excess loss account is treated as income recognized on a disposition of the redeemed stock on the date of the redemption and is taken into account under the rules of § 1.1502–19(b)(5).

* * * * *

Par. 16. Section 1.1502–19 is amended as follows:

1. Paragraph (b)(2)(i) is amended by adding a sentence at the end of the paragraph.

2. Paragraph (b)(5) is added.

3. Paragraph (g) *Example 7* is added.

4. The heading for paragraph (h) is revised.

5. The first sentence of paragraph (h)(1) is removed and two new sentences are added in its place.

The revisions and additions read as follows:

§ 1.1502–19 Excess loss accounts.

* * * * *

(b) * * *

(2) * * * (i) * * * As another example, if S redeems (or is treated as redeeming) P's S stock and, as a result, an excess loss account is either increased or created in such redeemed stock, P takes into account such excess loss account under the rules of paragraph (b)(5) of this section.

* * * * *

(5) *Redemptions of member stock; treatment of excess loss account in redeemed stock*—(i) *In general*. In any case in which an amount received in redemption of S stock is treated as a distribution to P to which section 301 applies and such amount either increases or creates an excess loss account in the redeemed S stock, after adjusting such basis or excess loss account to reflect the application of section 301(c)(2), section 1059, § 1.1502–32, or any other applicable provision of the Internal Revenue Code or the regulations thereunder, such excess loss account is treated as income (ordinary income or gain) recognized on a disposition of the redeemed stock on the date of the redemption. Such income shall be taken into account by P under the provisions of this paragraph (b)(5).

(ii) *Inclusion of gain attributable to excess loss account in redeemed stock*—(A) *Amount taken into account on final inclusion date*. On the final inclusion date (as defined in § 1.302–5(b)(3)), P must include in income as ordinary income or gain the excess loss account in the redeemed stock, reduced by any amounts of such excess loss account that are taken into account pursuant to the provisions of paragraph (b)(5)(ii)(B) of this section.

(B) *Amount taken into account on accelerated income inclusion date*. (*1*) On an accelerated income inclusion date (as defined in paragraph (b)(5)(ii)(B)(*2*) of this section), P must include in income as ordinary income or gain the excess loss account of the redeemed stock to the extent of the lesser of—

(*i*) The amount of such excess loss account reduced by the amount of such excess loss account previously taken into account pursuant to this paragraph (b)(5)(ii); and

(*ii*) The amount of loss recognized on the disposition of stock of S that the group of which P is a member is permitted to take into account on such accelerated income inclusion date without regard to the application of § 1.337(d)–2T.

(*2*) An accelerated income inclusion date is a date on which P is permitted to take into account a loss recognized on a disposition of S stock without regard to the application of § 1.337(d)–2T.

(iii) *Application of other rules*. In addition to the rules set forth in this paragraph (b)(5), the rules of § 1.302–5(d) apply for purposes of determining the appropriate time to take into account any portion of an excess loss account in redeemed stock by treating P as the redeemed shareholder and S as the redeeming corporation. However, the rules of § 1.302–5(d) shall be applied by using the language "accelerated income inclusion date" instead of "accelerated loss inclusion date" each time that term appears.

(iv) *Statement to be filed with returns*. With or as part of the income tax return for the year in which P takes into account any income attributable to an excess loss account in redeemed stock, P shall provide a statement entitled "Inclusion of Income Attributable to Excess Loss Account in Redeemed Stock." The statement shall specify the amount of the income that is taken into account on such return pursuant to this paragraph (b)(5) and shall identify the shares to which such amounts relate.

* * * * *

(g) * * *

Example 7.Redemption of member stock. (a) *Facts*. P directly owns all of the outstanding stock of S1 and S2. S1 and S2 each own 50 shares of S3's outstanding 100 shares of stock. P is the common parent of the consolidated group. S1's adjusted basis in the S3 stock is $50. In Year 1, S3 redeems all of its stock from S1 for $100. In Year 2, P sells all of its shares of S1 stock to an unrelated party.

(b) *Analysis*. In Year 1, because S1 actually and constructively owns 100 percent of stock of S3 immediately before and immediately after the redemption, the redemption is treated as a distribution to which section 301 applies. S3's distribution is an intercompany distribution under § 1.1502–13(f)(2)(ii) and excluded from S1's gross income. Under § 1.1502–32, S1's basis in S3's stock is reduced by the amount of the distribution, creating an excess loss account of $50. Pursuant to paragraph (b)(5)(i) of this section, that excess loss account is treated as income recognized on a disposition of the redeemed stock on the date of the redemption. That income, however, is not taken into account on such date. Instead, it is taken into account on the date on which S1 departs from the consolidated group as that date is the final inclusion date because, if the facts that exist at the end of that day had existed immediately after the redemption, the redemption would have been treated as a distribution in part or full payment in exchange for the redeemed stock pursuant to section 302(b)(3). Accordingly, S1 must include in its income as gain an amount equal to the excess loss account in the redeemed S3 stock.

(h) *Effective dates*—(1) *Application*. This section, except for the last sentence of paragraph (b)(2)(i), and paragraphs (b)(5) and

(g) *Example 7* of this section, applies with respect to determinations of the basis of (including an excess loss account in) the stock of a member in consolidated return years beginning on or after January 1, 1995. The last sentence of paragraph (b)(2)(i), and paragraphs (b)(5) and (g) *Example 7* of this section apply to transactions occurring after the date these regulations are published as final regulations in the **Federal Register**. * * *

* * * * *

David A. Mader,
Acting Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on October 17, 2002, 8:45 a.m., and published in the issue of the Federal Register for October 18, 2002, 67 F.R. 64331)

Notice of Proposed Rulemaking and Notice of Public Hearing

Disclosure of Relative Values of Optional Forms of Benefit

REG–124667–02

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations that would consolidate the content requirements applicable to explanations of qualified joint and survivor annuities and qualified preretirement survivor annuities payable under certain retirement plans, and would specify requirements for disclosing the relative value of optional forms of benefit that are payable from certain retirement plans in lieu of a qualified joint and survivor annuity. These regulations would affect retirement plan sponsors and administrators, and participants in and beneficiaries of retirement plans. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments, requests to speak and outlines of oral comments to be discussed at the public hearing scheduled for January 14, 2003, at 10 a.m., must be received by January 2, 2003.

ADDRESSES: Send submissions to: CC:ITA:RU (REG–124667–02), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered to: CC:ITA:RU (REG–124667–02), room 5226, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by submitting comments directly to the IRS Internet site at: *www.irs.gov/regs*. The public hearing will be held in room 4718 of the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Linda S. F. Marshall, 202–622–6090; concerning submissions and the hearing, and/or to be placed on the building access list to attend the hearing, Guy Traynor, 202–622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in this notice of proposed rulemaking have been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collections of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, W:CAR:MP:FP:S, Washington, DC 20224. Comments on the collections of information should be received by December 6, 2002. Comments are specifically requested concerning:

Whether the proposed collections of information are necessary for the proper performance of the functions of the IRS, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collections of information in this proposed regulation are in § 1.417(a)(3)–1. This information is required by the IRS to comply with the requirements of section 417(a)(3) regarding explanations that must be provided to participants in a qualified plan prior to a waiver of a qualified joint and survivor annuity (QJSA) or a qualified preretirement survivor annuity (QPSA). This information will be used by participants and spouses of participants to determine whether to waive a QJSA or QPSA, and by the IRS to confirm that the plan complies with applicable qualification requirements to avoid adverse tax consequences. The collections of information are mandatory. The respondents are nonprofit institutions.

Estimated total annual reporting burden: 375,000 hours.

The estimated annual burden per respondent varies from .01 to .99 hours, depending on individual circumstances, with an estimated average of .5 hours.

Estimated number of respondents: 750,000.

The estimated annual frequency of responses: on occasion.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless 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

This document contains proposed amendments to 26 CFR part 1 under section 417(a)(3) of the Internal Revenue Code of 1986 (Code).

A qualified retirement plan to which section 401(a)(11) applies must pay a vested participant's retirement benefit under the plan in the form of a qualified joint and survivor annuity (QJSA), except as provided in section 417. Section 401(a)(11) applies to defined benefit plans, money purchase pension plans, and certain other defined contribution plans. A QJSA is defined in section 417(b) as an annuity for the life of the participant with a survivor annuity for the life of the spouse (if the participant is married) that is not less than 50 percent of (and is not greater than 100 percent of) the amount of the annuity that is payable during the joint lives of the participant and the spouse. Under section 417(b)(2), a QJSA for a married participant generally must be the actuarial equivalent of the single life annuity benefit payable for the life of the participant. However, a plan is permitted to subsidize the QJSA for a married participant. If the plan fully subsidizes the QJSA for a married participant so that failure to waive the QJSA would not result in reduced payments over the life of the participant compared to the single life annuity benefit, then the plan need not provide an election to waive the QJSA. See section 417(a)(5).

For a married participant, the QJSA must be at least as valuable as any other optional form of benefit payable under the plan at the same time. See § 1.401(a)–20, Q&A–16. Further, the anti-forfeiture rules of section 411(a) prohibit a participant's benefit under a defined benefit plan from being satisfied through payment that is actuarially less valuable than the value of the participant's accrued benefit expressed in the form of an annual benefit commencing at normal retirement age. These determinations must be made using reasonable actuarial assumptions. However, see § 1.417(e)–1(d) for actuarial assumptions required for use in certain present value calculations.

If a plan provides a subsidy for one optional form of benefit (*i.e.*, the payments under an optional form of benefit have an actuarial present value that is greater than the actuarial present value of the accrued benefit), there is no requirement to extend a similar subsidy (or any subsidy) to every other optional form of benefit. Thus, for example, a participant might be entitled to receive a single-sum distribution upon early retirement that does not reflect any early retirement subsidy in lieu of a QJSA that reflects a substantial early retirement subsidy. As a further example, a participant might be entitled to receive a single-sum distribution at normal retirement age in lieu of a QJSA that is subsidized as described in section 417(a)(5).

Section 417(a) provides rules under which a participant (with spousal consent) may waive payment of the participant's benefit in the form of a QJSA. Section 417(a)(3) provides that a plan must provide to each participant, within a reasonable period before the annuity starting date (and consistent with such regulations as the Secretary may prescribe) a written explanation of the terms and conditions of the QJSA, the participant's right to make, and the effect of, an election to waive the QJSA form of benefit, the rights of the participant's spouse, and the right to revoke (and the effect of the revocation of) an election to waive the QJSA form of benefit.

Section 205 of the Employee Retirement Income Security Act of 1974 (ERISA), Public Law 93–406 (88 Stat. 829) as subsequently amended, provides parallel rules to the rules of sections 401(a)(11) and 417 of the Internal Revenue Code. In particular, section 205(a)(3) of ERISA provides a parallel rule to section 417(a)(3) of the Code. Treasury regulations issued under section 417(a)(3) of the Code apply as well for purposes of section 205(a)(3) of ERISA.

Regulations governing the requirements for waiver of a QJSA were published in the **Federal Register** on August 19, 1988 (T.D. 8219, 1988–2 C.B. 48 [53 FR 31837]). Section 1.401(a)–20, Q&A–36, provides rules for the explanation that must be provided under section 417(a)(3) as a prerequisite to waiver of a QJSA. Section 1.401(a)–20, Q&A–36, requires that such a written explanation must contain a general description of the eligibility conditions and other material features of the optional forms of benefit and sufficient additional information to explain the relative values of the optional forms of benefit available under the plan (*e.g.*, the extent to which optional forms are subsidized relative to the normal form of benefit or the interest rates used to calculate the optional forms). In addition, § 1.401(a)–20, Q&A–36, provides that the written explanation must comply with the requirements set forth in § 1.401(a)–11(c)(3). Section 1.401(a)–11(c)(3) was issued prior to the enactment of section 417, and provides rules relating to written explanations that were required prior to a participant's election of a preretirement survivor annuity or election to waive a joint and survivor annuity. Section 1.401(a)–11(c)(3)(i)(C) provides that such a written explanation must contain a general explanation of the relative financial effect of these elections on a participant's annuity.

In addition, under section 411 and § 1.411(a)–11(c), so long as a benefit is immediately distributable (within the meaning of § 1.411(a)–11(c)(4)), a participant must be informed of his or her right to defer that distribution. This requirement is independent of the section 417 requirements addressed in these proposed regulations.

Concerns have been expressed that, in certain cases, the information provided to participants under section 417(a)(3) regarding the available distribution forms does not adequately enable them to compare those distribution forms without professional advice. In particular, participants who are eligible for both subsidized annuity distributions and unsubsidized single-sum distributions may be receiving notices that do not adequately explain the value of the subsidy that is foregone if the single-sum distribution is elected. In such a case, merely disclosing the amount of the single-sum distribution and the amount of annuity payments may not adequately enable those participants to make an informed comparison of the relative values of those distribution forms, even if the interest rate used to derive the single sum is disclosed. Furthermore, questions have been raised as to how the relative values of optional forms of benefit are required to be expressed under current regulations. Accordingly, these proposed regulations are being issued to propose disclosure requirements that would enable participants to compare the relative values of the available distribution forms using more readily understandable information.

Explanation of Provisions

The proposed regulations would consolidate the content requirements applicable to explanations of QJSAs and QPSAs under section 417(a)(3), and would specify rules for disclosing the relative value of optional forms of benefit as part of the QJSA explanation. Similar to the requirements in the current regulations, the required expla-

nation must contain, with respect to each of the optional forms of benefit presently available to the participant, a description of the optional form of benefit, a description of the eligibility conditions for the optional form of benefit, a description of the financial effect of electing the optional form of benefit, a description of the relative value of the optional form of benefit, and a description of any other material features of the optional form of benefit. Further, as under the current regulations, the QJSA explanation would be permitted to be made either by providing the participant with information specific to the participant, or by providing the participant with generally applicable information and offering the participant the opportunity to request additional information specifically applicable to the participant with respect to any optional forms of benefit available to the participant. The proposed regulations would clarify that a defined contribution plan is not required to provide a description of the relative values of optional forms of benefit compared to the value of the QJSA.

The proposed regulations would provide additional guidance regarding the required description of the relative values of optional forms of benefit compared to the value of the QJSA and the content of the required disclosure of relative values. Under the proposed regulations, the description of the relative value of an optional form of benefit compared to the value of the QJSA must be expressed in a manner that provides a meaningful comparison of the relative economic values of the two forms of benefit without the participant having to make calculations using interest or mortality assumptions. In order to make this comparison, the benefit under one or both optional forms of benefit must be converted, taking into account the time value of money and life expectancies, so that both are expressed in the same form. The proposed regulations give several examples of techniques that may be used for this comparison: expressing the actuarial present value of the optional form of benefit as a percentage or factor of the actuarial present value of the QJSA; stating the amount of an annuity payable at the same time and under the same conditions as the QJSA that is the actuarial equivalent of the optional form of benefit; or stating the actuarial present value of both the QJSA and the optional form of benefit. For purposes of providing a description of the relative value of an optional form of benefit compared to the value of the QJSA (and also for purposes of comparing the financial effect of the distribution forms available to a participant), a plan would be permitted to provide reasonable estimates (*e.g.*, estimates based on data as of an earlier date than the annuity starting date or an estimate of the spouse's age). If estimates are used, the participant has a right to a more precise calculation upon request.

Since disclosing the relative value of every optional form of benefit regardless of the degree of subsidy may be too burdensome, and may provide participants with information that appears more precise than is warranted based on the inexact nature of the actuarial assumptions used, the proposed regulations would provide some ways to simplify this disclosure of relative values of optional forms of benefit. One way in which this disclosure would be simplified is through a banding rule under which two or more optional forms of benefit that have approximately the same value could be grouped for purposes of disclosing relative value. Under these proposed regulations, two or more optional forms of benefit would be treated as having approximately the same value if those optional forms of benefit vary in relative value in comparison to the value of the QJSA by 5 percentage points or less when the relative value comparison is made by expressing the actuarial present value of each of those optional forms of benefit as a percentage of the actuarial present value of the QJSA. For such a group of optional forms of benefit, the requirement relating to disclosing the relative value of each optional form of benefit compared to the value of the QJSA could be satisfied by disclosing the relative value of any one of the optional forms in the group compared to the value of the QJSA, and disclosing that the other optional forms of benefit in the group are of approximately the same value. If a single-sum distribution is included in such a group of optional forms of benefit, the single-sum distribution must be the distribution form that is used for purposes of this comparison. The relative value of all optional forms of benefit that have an actuarial present value that is at least 95% of the actuarial present value of the QJSA may be described by stating that those optional forms of benefit are of approximately equal value to the value of the QJSA. Thus, these rules would permit a plan that provides no subsidized forms of benefit to state the comparison of relative values simply by stating that all distribution forms are approximately equal in value to the QJSA.

Another way in which this disclosure may be simplified is through the use of representative values: if, under the banding rule, two or more optional forms of benefit are grouped, a representative relative value for all of the grouped options could be used as the approximate relative value for all of the grouped options, in lieu of using the relative value of one of the optional forms of benefit in the group. For this purpose, a representative relative value is any relative value that is not less than the relative value of the member of the group of optional forms of benefit with the lowest relative value and is not greater than the relative value of the member of that group with the highest relative value when measured on a consistent basis. For example, if three optional forms have relative values of 87.5%, 89%, and 91% of the value of the QJSA, all three optional forms can be treated as having a relative value of approximately 90% of the value of the QJSA.

The proposed regulations would also permit the disclosure of the financial effect and relative value of optional forms of benefit to be made in the form of generally applicable information rather than information specific to the participant, provided that information specific to the participant regarding the optional form of benefit must be furnished at the participant's request. Thus, under the proposed regulations, in lieu of providing a QJSA explanation that describes each optional form that is presently available to the participant, the generalized QJSA explanation need only reflect the generally available optional forms of benefits, along with a reference to where a participant can obtain the information for any other optional forms of benefits (such as optional forms from prior benefit structures for limited groups of employees) that are presently available to the participant.

With respect to the generally available optional forms of benefits, in lieu of providing a statement of financial effect and relative value comparison that is specific to the participant, the generalized QJSA explanation is permitted to include a chart or other comparable device showing a series of examples of financial effects and rela-

tive value comparisons for hypothetical participants. The examples in the chart should reflect a representative range of ages for the hypothetical participants and use reasonable assumptions for the age of the hypothetical participant's spouse and any other variable that affects the financial effect, or relative value, of the optional form of benefit. The chart must be accompanied by a general statement describing the effect of significant variations between the assumed ages or other variables on the financial effect of electing the optional form of benefit and the comparison of the relative value of the optional form of benefit to the value of the QJSA. A generalized QJSA explanation that includes this chart must also include the amount payable to the participant under the normal form of benefit, either at normal retirement age, or payable immediately. In addition, this chart must be accompanied by a statement that includes an offer to provide, upon the participant's request, a statement of financial effect along with a comparison of relative values that is specific to the participant for one or more presently available optional forms of benefit, and a description of how a participant may obtain this additional information. Thus, with respect to those optional forms of benefit for which additional information is requested, the participant must receive a QJSA explanation specific to the participant that is based on the participant's actual age and benefit.

The proposed regulations would provide rules governing the actuarial assumptions to be used in comparing the value of an optional form of benefit to the QJSA. If an optional form of benefit is subject to the requirements of section 417(e)(3) and § 1.417(e)–1(d) (*e.g.*, a single-sum distribution), any comparison of the value of the optional form of benefit to the value of the QJSA must be made using the applicable mortality table and the applicable interest rate as defined in § 1.417(e)–1(d)(2) and (3) (or, at the option of the plan, another reasonable interest rate and reasonable mortality table used under the plan to calculate the amount payable under the optional form of benefit). All other optional forms of benefit payable to the participant must be compared with the QJSA using a single set of interest rates and mortality tables that are reasonable and that are applied uniformly for this purpose with respect to all such other optional forms payable to the participant. The uniform interest and mortality assumptions should be used regardless of whether those assumptions are actually used to determine the amount of benefit payments under any particular optional form.

The proposed regulations would also require disclosure of information to help a participant understand the significance of a disclosure of the relative value of an optional form of benefit. Under the proposed regulations, the notice would be required to provide an explanation of the concept of relative value. Specifically, the notice would be required to explain that the relative value comparison is intended to allow the participant to compare the total value of distributions paid in different forms, that the relative value comparison is made by converting the value of the optional forms of benefit currently available to a common form (such as the QJSA or single-sum distribution), and that this conversion uses interest and life expectancy assumptions.

Under the proposed regulations, a required numerical comparison of the value of the optional form of benefit to the value of the QJSA under the plan generally would be required to disclose the interest rate that is used to develop a required numerical comparison. However, if all optional forms of benefit are permitted to be treated as having approximately the same value after application of the banding rule described above, then the plan would not be required to disclose the interest rate used to develop a required numerical comparison to the QJSA for optional form of benefit that is not subject to the requirements of section 417(e)(3). In addition, the proposed regulations would require the plan to provide a general statement that all numerical comparisons of relative value provided are based on average life expectancies, and that the relative value of payments ultimately made under an annuity optional form of benefit will depend on actual longevity.

Under the proposed regulations, both the QPSA explanation and the QJSA explanation must be written in a manner calculated to be understood by the average participant. A plan may wish to provide additional information beyond the minimum information that would be required under these proposed regulations, in order to help an employee to evaluate the form of benefit that would be most desirable under the employee's individual circumstances. For example, the plan may wish to add further explanation of the effects of ill health or other factors influencing expected longevity on the desirability of electing annuity forms of distribution.

The proposed regulations contain rules regarding the method for providing the QJSA explanation and the QPSA explanation. Under the proposed regulations, these explanations must be written explanations. First class mail to the last known address of the party is an acceptable delivery method for a section 417(a)(3) explanation. Likewise, hand delivery is acceptable. However, the posting of the explanation is not considered provision of the section 417(a)(3) explanation.

These proposed regulations do not address the extent to which the QJSA explanation or the QPSA explanation can be provided through electronic media. The IRS and the Treasury Department are considering the extent to which the QJSA explanation and the QPSA explanation, as well as other notices under the various Internal Revenue Code requirements relating to qualified retirement plans, can be provided electronically, taking into account the effect of the Electronic Signatures in Global and National Commerce Act (ESIGN), Public Law 106–229, 114 Stat. 464 (2000). The IRS and the Treasury Department anticipate issuing proposed regulations regarding these issues, and invite comments on these issues.

Proposed Effective Date

The regulations are proposed to be applicable to QJSA explanations with respect to distributions with annuity starting dates on or after January 1, 2004, and to QPSA explanations provided on or after January 1, 2004.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that 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 qualified retirement plans of small businesses typically commence distribution of benefits to few,

if any, plan participants in any given year and, similarly, only offer elections to waive a QPSA to few, if any, participants in any given year. Thus, the collection of information in these regulations will only have a minimal economic impact on most small entities. Therefore, an analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to written comments (preferably a signed original and eight (8) copies) that are submitted timely to the IRS. Alternatively, taxpayers may submit comments electronically to the IRS Internet site at *www.irs.gov/regs*. All comments will be available for public inspection and copying. The IRS and Treasury request comments on the clarity of the proposed rules and how they may be made easier to understand or to implement.

A public hearing has been scheduled for January 14, 2003, at 10 a.m. in room 4718 of the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. All visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts at the Constitution Avenue entrance. 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 January 2, 2003. 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 Linda S. F. Marshall of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury participated in their 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; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1986.

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

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

Par. 2. Paragraph (c)(3) of § 1.401(a)–11 is revised to read as follows:

§ 1.401(a)–11 Qualified joint and survivor annuities.

* * * * *

(c) * * *

(3) *Information to be provided by plan.* For rules regarding the information required to be provided with respect to the election to waive a QJSA or a QPSA, see § 1.417(a)(3)–1.

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Par. 3. A–36 of § 1.401(a)–20 is revised to read as follows:

§ 1.401(a)–20 Requirements of qualified joint and survivor annuity and qualified preretirement survivor annuity.

* * * * *

A–36. For rules regarding the explanation of QPSAs and QJSAs required under section 417(a)(3), see § 1.417(a)(3)–1.

* * * * *

Par. 4. Section 1.417(a)(3)–1 is added to read as follows:

§ 1.417(a)(3)–1 Required explanation of qualified joint and survivor annuity and qualified preretirement survivor annuity.

(a) *Written explanation requirement*—(1) *General rule*. A plan meets the survivor annuity requirements of section 401(a)(11) only if the plan meets the requirements of section 417(a)(3) and this section regarding the written explanation required to be provided a participant with respect to a QJSA or a QPSA. A written explanation required to be provided to a participant with respect to either a QJSA or a QPSA under section 417(a)(3) and this section is referred to in this section as a section 417(a)(3) explanation. See § 1.401(a)–20, Q&A–37, for exceptions to the written explanation requirement in the case of a fully subsidized QPSA or QJSA, and § 1.401(a)–20, Q&A–38, for the definition of a fully subsidized QPSA or QJSA.

(2) *Time for providing section 417(a)(3) explanation*—(i) *QJSA explanation*. See § 1.417(e)–1(b)(3)(ii) for rules governing the timing of the QJSA explanation.

(ii) *QPSA explanation*. See § 1.401(a)–20, Q&A–35, for rules governing the timing of the QPSA explanation.

(3) *Required method for providing section 417(a)(3) explanation*. A section 417(a)(3) explanation must be a written explanation. First class mail to the last known address of the participant is an acceptable delivery method for a section 417(a)(3) explanation. Likewise, hand delivery is acceptable. However, the posting of the explanation is not considered provision of the section 417(a)(3) explanation.

(4) *Understandability*. A section 417(a)(3) explanation must be written in a manner calculated to be understood by the average participant.

(b) *Required content of section 417(a)(3) explanation*—(1) *Content of QPSA explanation*. The QPSA explanation must contain a general description of the QPSA, the circumstances under which it will be paid if elected, the availability of the election of the QPSA, and, except as provided in paragraph (d)(3) of this section, a description of the financial effect of the election of the QPSA on the participant's benefits (*i.e.*, an estimate of the reduction to the participant's estimated normal retirement benefit that would result from an election of the QPSA).

(2) *Content of QJSA explanation*. The QJSA explanation must satisfy either paragraph (c) or paragraph (d) of this section. Under paragraph (c) of this section, the QJSA explanation must contain certain specific information relating to the benefits available under the plan to the particular participant. Alternatively, under paragraph

(d) of this section, the QJSA explanation can contain generally applicable information in lieu of specific participant information, provided that the participant has the right to request additional information regarding the participant's benefits under the plan.

(c) *Participant-specific information required to be provided*—(1) *In general*. A QJSA explanation satisfies this paragraph (c) if it provides the following information with respect to each of the optional forms of benefit presently available to the participant—

(i) A description of the optional form of benefit;

(ii) A description of the eligibility conditions for the optional form of benefit;

(iii) A description of the financial effect of electing the optional form of benefit (*i.e.*, the amount payable under the form of benefit);

(iv) In the case of a defined benefit plan, a description of the relative value of the optional form of benefit compared to the value of the QJSA, in the manner described in paragraph (c)(2) of this section; and

(v) A description of any other material features of the optional form of benefit.

(2) *Requirement for numerical comparison of relative values*—(i) *In general*. The description of the relative value of an optional form of benefit compared to the value of the QJSA under paragraph (c)(1)(iv) of this section must be expressed to the participant in a manner that provides a meaningful comparison of the relative economic values of the two forms of benefit without the participant having to make calculations using interest or mortality assumptions. Thus, in performing the calculations necessary to make this comparison, the benefits under one or both optional forms of benefit must be converted, taking into account the time value of money and life expectancies, so that the values of both optional forms of benefit are expressed in the same form. For example, such a comparison may be expressed to the participant using any of the following techniques—

(A) Expressing the actuarial present value of the optional form of benefit as a percentage or factor of the actuarial present value of the QJSA;

(B) Stating the amount of the annuity that is the actuarial equivalent of the optional form of benefit and that is payable at the same time and under the same conditions as the QJSA; or

(C) Stating the actuarial present value of both the optional form of benefit and the QJSA.

(ii) *Simplified presentations permitted*—(A) *Grouping of certain optional forms*. Two or more optional forms of benefit that have approximately the same value may be grouped for purposes of a required numerical comparison described in this paragraph (c)(2). For this purpose, two or more optional forms of benefit have approximately the same value if those optional forms of benefit vary in relative value in comparison to the value of the QJSA by 5 percentage points or less when the relative value comparison is made by expressing the actuarial present value of each of those optional forms of benefit as a percentage of the actuarial present value of the QJSA. For such a group of optional forms of benefit, the requirement relating to disclosing the relative value of each optional form of benefit compared to the value of the QJSA can be satisfied by disclosing the relative value of any one of the optional forms in the group compared to the value of the QJSA, and disclosing that the other optional forms of benefit in the group are of approximately the same value. If a single-sum distribution is included in such a group of optional forms of benefit, the single-sum distribution must be the distribution form that is used for purposes of this comparison. In addition, the relative value of all optional forms of benefit that have an actuarial present value that is at least 95% of the actuarial present value of the QJSA is permitted to be described by stating that those optional forms of benefit are approximately equal in value to the QJSA, or that all of those forms of benefit and the QJSA are approximately equal in value.

(B) *Representative relative value for grouped optional forms*. If, in accordance with paragraph (c)(2)(ii)(A) of this section, two or more optional forms of benefits are grouped, the relative values for all of the optional forms of benefit in the group can be stated using a representative relative value as the approximate relative value for the entire group. For this purpose, a representative relative value is any relative value that is not less than the relative value of the member of the group of optional forms of benefit with the lowest relative value and is not greater than the relative value of the member of that group with the highest relative value when measured on a consistent basis. For example, if three optional forms have relative values of 87.5%, 89%, and 91% of the value of the QJSA, all three optional forms can be treated as having a relative value of approximately 90% of the value of the QJSA. As required under paragraph (c)(2)(ii)(A) of this section, if a single-sum distribution is included in the group of optional forms of benefit, the 90% relative factor of the value of the QJSA must be disclosed as the approximate relative value of the single sum, and the other forms can be described as having the same approximate value as the single sum.

(iii) *Actuarial assumptions used to determine relative values*. For the purpose of providing a numerical comparison of the value of an optional form of benefit to the value of the immediately commencing QJSA, the following rules apply—

(A) If an optional form of benefit is subject to the requirements of section 417(e)(3) and § 1.417(e)–1(d), any comparison of the value of the optional form of benefit to the value of the QJSA must be made using the applicable mortality table and the applicable interest rate as defined in § 1.417(e)–1(d)(2) and (3) (or, at the option of the plan, another reasonable interest rate and reasonable mortality table used under the plan to calculate the amount payable under the optional form of benefit); and

(B) All other optional forms of benefit payable to the participant must be compared with the QJSA using a single set of interest and mortality assumptions that are reasonable and that are applied uniformly with respect to all such optional forms payable to the participant (regardless of whether those assumptions are actually used under the plan for purposes of determining benefit payments).

(iv) *Required disclosure of assumptions*—(A) *Explanation of concept of relative value*. The notice must provide an explanation of the concept of relative value, communicating that the relative value comparison is intended to allow the participant to compare the total value of distributions paid in different forms, that the relative value comparison is made by converting the value of the optional forms of benefit presently available to a common form (such as the QJSA or a single-sum distribution), and that this conversion uses in-

terest and life expectancy assumptions. The explanation of relative value must include a general statement that all comparisons provided are based on average life expectancies, and that the relative value of payments ultimately made under an annuity optional form of benefit will depend on actual longevity.

(B) *Disclosure of interest assumptions*. A required numerical comparison of the value of the optional form of benefit to the value of the QJSA under the plan is required to disclose the interest rate that is used to develop the comparison. If all optional forms of benefit are permitted to be grouped under paragraph (c)(2)(ii)(A) of this section, then the requirement of this paragraph (c)(2)(iv)(B) does not apply for any optional form of benefit not subject to the requirements of section 417(e)(3) and § 1.417(e)–1(d)(3).

(3) *Permitted estimates of financial effect and relative value*—(i) *General rule*. For purposes of providing a description of the financial effect of the distribution forms available to a participant as required under paragraph (c)(1)(iii) of this section, and for purposes of providing a description of the relative value of an optional form of benefit compared to the value of the QJSA for a participant as required under paragraph (c)(1)(iv) of this section, the plan is permitted to provide reasonable estimates (*e.g.*, estimates based on data as of an earlier date than the annuity starting date, a reasonable assumption for the age of the participant's spouse, or, in the case of a defined contribution plan, reasonable estimates of amounts that would be payable under a purchased annuity contract), including reasonable estimates of the applicable interest rate under section 417(e)(3).

(ii) *Right to more precise calculation*. If a QJSA notice uses a reasonable estimate under paragraph (c)(3)(i) of this section, the QJSA explanation must identify the estimate and explain that the plan will, upon the request of the participant, provide a more precise calculation and the plan must provide the participant with a more precise calculation if so requested. Thus, for example, if a plan provides an estimate of the amount of the QJSA that is based on a reasonable assumption concerning the age of the participant's spouse, the participant can request a calculation that takes into account the actual age of the spouse, as provided by the participant.

(iii) *Revision of prior information*. If a more precise calculation described in paragraph (c)(3)(ii) of this section materially changes the relative value of an optional form compared to the value of the QJSA, the revised relative value of that optional form must be disclosed, regardless of whether the financial effect of selecting the optional form is affected by the more precise calculation.

(4) *Special rules for disclosure of financial effect for defined contribution plans*. For a written explanation provided by a defined contribution plan, a description of financial effect required by paragraph (c)(1)(iii) of this section with respect to an annuity form of benefit must include a statement that the annuity will be provided by purchasing an annuity contract from an insurance company with the participant's account balance under the plan. If the description of the financial effect of the optional form of benefit is provided using estimates rather than by assuring that an insurer is able to provide the amount disclosed to the participant, the written explanation must also disclose this fact.

(d) *Substitution of generally applicable information for participant information in the section 417(a)(3) explanation*—(1) *Forms of benefit available*. In lieu of providing the information required under paragraphs (c)(1)(i) through (v) of this section for each optional form of benefit presently available to the participant as described in paragraph (c) of this section, the QJSA explanation may contain the information required under paragraphs (c)(1)(i) through (v) of this section for the QJSA and each other optional form of benefit generally available under the plan, along with a reference to where a participant may readily obtain the information required under paragraphs (c)(1)(i) through (v) of this section for any other optional forms of benefit that are presently available to the participant.

(2) *Financial effect and comparison of relative values*—(i) *General rule*. In lieu of providing a statement of the financial effect of electing an optional form of benefit as required under paragraph (c)(1)(iii) of this section, or a comparison of relative values as required under paragraph (c)(1)(iv) of this section, based on the actual age and benefit of the participant, the QJSA explanation is permitted to include a chart (or other comparable device) showing the financial effect and relative value of optional forms of benefit in a series of examples specifying the amount of the optional form of benefit payable to a hypothetical participant at a representative range of ages and the comparison of relative values at those same representative ages. Each example in this chart must show the financial effect of electing the optional form of benefit pursuant to the rules of paragraph (c)(1)(iii) of this section, and a comparison of the relative value of the optional form of benefit to the value of the QJSA pursuant to the rules of paragraph (c)(2) of this section, using reasonable assumptions for the age of the hypothetical participant's spouse and any other variables that affect the financial effect, or relative value, of the optional form of benefit. The requirement to show the financial effect of electing an optional form can be satisfied through the use of other methods (*e.g.*, expressing the amount of the optional form as a percentage or a factor of the amount payable under the normal form of benefit), provided that the method provides sufficient information so that a participant can determine the amount of benefits payable in the optional form. The chart or other comparable device must be accompanied by the disclosures described in paragraph (c)(2)(iv) of this section explaining the concept of relative value and disclosing certain interest assumptions. In addition, the chart or other comparable device must be accompanied by a general statement describing the effect of significant variations between the assumed ages or other variables on the financial effect of electing the optional form of benefit and the comparison of the relative value of the optional form of benefit to the value of the QJSA.

(ii) *Actual benefit must be disclosed*. The generalized notice described in this paragraph (d)(2) will satisfy the requirements of paragraph (b)(2) of this section only if the notice includes either the amount payable to the participant under the normal form of benefit or the amount payable to the participant under the normal form of benefit adjusted for immediate commencement. For this purpose, the normal form of benefit is the form under which payments due to the participant under the plan are expressed under the plan, prior to adjustments for form of benefit. For example, assuming that a plan's benefit accrual formula is expressed as a straight life annu-

ity, the generalized notice must provide the amount of either the straight life annuity commencing at normal retirement age or the straight life annuity commencing immediately.

(iii) *Ability to request additional information.* The generalized notice described in this paragraph (d)(2) must be accompanied by a statement that includes an offer to provide, upon the participant's request, a statement of financial effect and a comparison of relative values that is specific to the participant for any presently available optional form of benefit, and a description of how a participant may obtain this additional information.

(3) *Financial effect of QPSA election.* In lieu of providing a specific description of the financial effect of the QPSA election, the QPSA explanation may provide a general description of the financial effect of the election. Thus, for example, the description can be in the form of a chart showing the reduction to a hypothetical participant's normal retirement benefit at a representative range of participant ages as a result of the QPSA election (using a reasonable assumption for the age of the hypothetical participant's spouse relative to the age of the hypothetical participant). In addition, this chart must be accompanied by a statement that includes an offer to provide, upon the participant's request, an estimate of the reduction to the participant's estimated normal retirement benefit, and a description of how a participant may obtain this additional information.

(4) *Additional information required to be furnished at the participant's request*—(i) *Explanation of QJSA.* If, as permitted under paragraphs (d)(1) and (2) of this section, the content of a QJSA explanation does not include all the items described in paragraph (c) of this section, then, upon a timely request from the participant for any of the information required under paragraphs (c)(1)(i) through (v) of this section for one or more presently available optional forms (including a request for all optional forms presently available to the participant), the plan must furnish the information required under paragraphs (c)(1)(i) through (v) of this section with respect to those optional forms. Thus, with respect to those optional forms of benefit, the participant must receive a QJSA explanation specific to the participant that is based on the participant's actual age and benefit. In addition, the plan must comply with paragraph (c)(3)(iii) of this section.

(ii) *Explanation of QPSA.* If, as permitted under paragraph (d)(3) of this section, the content of a QPSA explanation does not include all the items described in paragraph (b)(1) of this section, then, upon a timely request from the participant for an estimate of the reduction to the participant's estimated normal retirement benefit that would result from a QPSA election, the plan must furnish such an estimate.

(e) *Examples*. The following examples illustrate the application of this section. Solely for purposes of these examples, the applicable interest rate that applies to any distribution that is subject to the rules of section 417(e)(3) is assumed to be 5½%, and the applicable mortality table under section 417(e)(3) and § 1.417(e)–1(d)(2) is assumed to be the table that applies as of January 1, 2003. In addition, solely for purposes of these examples, assume that a plan which determines actuarial equivalence using 6% interest and the applicable mortality table under section 417(e)(3) and § 1.417(e)–1(d)(2) that applies as of January 1, 1995, is using reasonable actuarial assumptions. The examples are as follows:

Example 1. (i) Participant M participates in Plan A, a qualified defined benefit plan. Under Plan A, the QJSA is a joint and 100% survivor annuity, which is actuarially equivalent to the single life annuity determined using 6% interest and the section 417(e)(3) applicable mortality table that applies as of January 1, 1995. On January 1, 2004, M will terminate employment at age 55. When M terminates employment, M will be eligible to elect an unreduced early retirement benefit, payable as either a life annuity or the QJSA. M will also be eligible to elect a single-sum distribution equal to the actuarial present value of the single life annuity payable at normal retirement age (age 65), determined using the applicable mortality table and the applicable interest rate under section 417(e)(3).

(ii) Participant M is provided with a QJSA explanation that describes the single life annuity, the QJSA, and single-sum distribution option under the plan, and any eligibility conditions associated with these options. The explanation indicates that, if Participant M commenced benefits at age 55 and had a spouse age 55, the monthly benefit under an immediately commencing single life annuity is $3,000, the monthly benefit under the QJSA is estimated to be 89.96% of the monthly benefit under the immediately commencing single life annuity or $2,699, and the single sum is estimated to be 74.7645 times the monthly benefit under the immediately commencing single life annuity or $224,293.

(iii) The QJSA explanation indicates that the single life annuity and the QJSA are of approximately the same value, but that the single-sum option is equivalent in value to a QJSA of $1,215. (This amount is 45% of the value of the QJSA at age 55 ($1,215 divided by 89.96% of $3,000 equals 45%).) The explanation states that the relative value comparison converts the value of the single life annuity and the single-sum options to the value of each if paid in the form of the QJSA and that this conversion uses interest and life expectancy assumptions. The explanation specifies that the calculations relating to the single-sum distribution were prepared using 5.5% interest and average life expectancy, that the other calculations were prepared using a 6% interest rate and that the relative value of actual annuity payments for an individual can vary depending on how long the individual and spouse live. The explanation notes that the calculation of the QJSA assumed that the spouse was age 55, that the amount of the QJSA will depend on the actual age of the spouse (for example, annuity payments will be significantly lower if the spouse is significantly younger than the participant), and that the amount of the single-sum payment will depend on the interest rates that apply when the participant actually takes a distribution. The explanation also includes an offer to provide a more precise calculation to the participant taking into account the spouse's actual age.

(iv) Participant M requests a more precise calculation of the financial effect of choosing a QJSA, taking into the actual age of Participant M's spouse. Based on the fact that M's spouse is age 50, Plan A determines that the monthly payments under the QJSA are 87.62% of the monthly payments under the single life annuity, or $2,628.60 per month, and provides this information to M. Plan A is not required to provide an updated calculation of the relative value of the single sum because the value of single sum continues to be 45% of the value of the QJSA.

Example 2. (i) The facts are the same as in *Example 1*, except that under Plan A, the single-sum distribution is determined as the actuarial present value of the immediately commencing single life annuity. In addition, Plan A provides a joint and 75% survivor annuity that is reduced from the single life annuity and that is the QJSA under Plan A. For purposes of determining the amount of the QJSA, the reduction is only half of the reduction that would normally apply under the actuarial assumptions specified in Plan A for determining actuarial equivalence of optional forms.

(ii) In lieu of providing information specific to Participant M in the QJSA notice as set forth in paragraph (c) of this section, Plan A satisfies the QJSA explanation requirement in accordance with paragraph (d)(2) of this section by providing M with a statement that M's monthly benefit under an immediately commencing single life annuity (which is the normal form of benefit under Plan A, adjusted for immediate commencement) is $3,000, along with the following chart showing the financial effect and the relative value of the optional forms of benefit compared to the QJSA for a hypothetical participant with a $1,000 benefit and a spouse who is three years younger than the participant. For each optional form generally available under the plan, the chart shows the financial effect and the relative value, using the grouping rules of paragraph (c)(2)(ii) of this section. Separate charts are provided for ages 55, 60, and 65.

Age 55 Commencement

Optional Form	Amount of distribution per $1,000 of immediate single life annuity	Relative Value
Life Annuity	$1,000 per month	approximately the same value as the QJSA
QJSA (joint and 75% survivor annuity)	$956 per month	n/a
Joint and 100% survivor annuity	$886 per month	approximately the same value as the QJSA
Lump sum	$165,959	approximately the same value as the QJSA

Age 60 Commencement

Optional Form	Amount of distribution per $1,000 of immediate single life annuity	Relative Value
Life Annuity	$1,000 per month	approximately 94% of the value of the QJSA
QJSA (joint and 75% survivor annuity)	$945 per month	n/a
Joint and 100% survivor annuity	$859 per month	approximately 94% of the value of the QJSA
Lump sum	$151,691	approximately the same value as the QJSA

Age 65 Commencement

Optional Form	Amount of distribution per $1,000 of immediate single life annuity	Relative Value
Life Annuity	$1,000 per month	approximately 93% of the value of the QJSA
QJSA (joint and 75% survivor annuity)	$932 per month	n/a
Joint and 100% survivor annuity	$828 per month	approximately 93% of the value of the QJSA
Lump sum	$135,759	approximately 93% of the value of the QJSA

(iii) The chart disclosing the financial effect and relative value of the optional forms specifies that the calculations were prepared assuming that the spouse is three years younger than the participant, that the calculations relating to the single-sum distribution were prepared using 5.5% interest and average life expectancy, that the other calculations were prepared using a 6% interest rate, and that the relative value of actual payments for an individual can vary depending on how long the individual and spouse live. The explanation states that the relative value comparison converts the QJSA, the single life annuity, the joint and 100% survivor annuity, and the single-sum options to an equivalent present value and that this conversion uses interest and life expectancy assumptions. The explanation notes that the calculation of the QJSA depends on the actual age of the spouse (for example, annuity payments will be significantly lower if the spouse is significantly younger than the participant), and that the amount of the single-sum payment will depend on the interest rates that apply when the participant actually takes a distribution. The explanation also includes an offer to provide a calculation specific to the participant upon request.

(iv) Participant M requests information regarding the amounts payable under the QJSA, the joint and 100% survivor annuity, and the single sum.

(v) Based on the information about the age of Participant M's spouse, Plan A determines that M's QJSA is $2,856.30 per month, the joint and 100% survivor annuity is $2,628.60 per month, and the single sum is $497,876. The actuarial present value of the QJSA (determined using the 5.5% interest and the section 417(e)(3) applicable mortality table, the actuarial assumptions required under section 417) is $525,091. Accordingly, the value of the single-sum distribution available to M at January 1, 2004, is 94.8% of the actuarial present value of the QJSA. In addition, the actuarial present value of the life annuity and the 100% joint and survivor annuity are 95.0% of the actuarial present value of the QJSA.

(vi) Plan A provides M with a QJSA explanation that incorporates these more precise calculations of the financial effect and relative value of the optional forms for which M requested information.

(f) *Effective date*. This section applies to QJSA explanations provided with respect to distributions with annuity starting dates on or after January 1, 2004, and to QPSA explanations provided on or after January 1, 2004.

§ 1.417(e)–1 [Amended]

Par. 5. In § 1.417(e)–1, paragraph (b)(2) is amended by removing the language "§ 1.401(a)–20 Q&A–36" and adding "§ 1.417(a)(3)–1" in its place.

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on October 4, 2002, 8:45 a.m., and published in the issue of the Federal Register for October 7, 2002, 67 F.R. 62417)

Dual Consolidated Loss Recapture Events; Correction

Announcement 2002–100

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains corrections to proposed regulations (REG–106879–00, 2002–34 I.R.B. 402) as published in the Internal Revenue Bulletin. These regulations under section 1503(d) relate to the events that require the recapture of dual consolidated losses.

DATES: These corrections are effective August 26, 2002.

FOR FURTHER INFORMATION CONTACT: Kenneth D. Allison or Kathryn T. Holman at (202) 622–3860 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

The notice of proposed rulemaking that is the subject of these corrections is under section 1503(d).

Need for Correction

As published in the Internal Revenue Bulletin, this notice of proposed rulemaking contains errors which may prove to be misleading and are in need of clarification.

Correction of Publication

Accordingly, the notice of proposed rulemaking (REG–106879–00) as published in the Internal Revenue Bulletin is corrected as follows:

1. On page 404 of the Internal Revenue Bulletin (I.R.B.), column 1, under "Proposed Effective Date", the language "These regulations amending the dual consolidated loss rules under § 1.1503–2 are proposed to apply to transactions otherwise constituting triggering events occurring on or after August 1, 2002." is corrected to read "These regulations amending the dual consolidated loss rules under § 1.1503–2 are proposed to apply to transactions otherwise constituting triggering events occurring on or after **[DATE THE FINAL REGULATIONS ARE PUBLISHED IN THE FEDERAL REGISTER].**"

2. On page 405 of the I.R.B., column 2, the language "Paragraphs (g)(2)(iv)(A)(*4*) and (*5*) of this section, and paragraphs (g)(2)(iv)(B)(*l*)(*ii*) and (*iii*) of this section, shall apply with respect to transactions otherwise constituting triggering events occurring on or after August 1, 2002." is corrected to read "Paragraphs (g)(2)(iv)(A)(*4*) and (*5*) of this section, and paragraphs (g)(2)(iv)(B)(*l*)(*ii*) and (*iii*) of this section, shall apply with respect to transactions otherwise constituting triggering events occurring on or after **[DATE THE FINAL REGULATIONS ARE PUBLISHED IN THE FEDERAL REGISTER].**"

The corrections made herein will be reflected in the notice of proposed rulemaking published in the Cumulative Bulletin.

Request for Applications to Participate in the 2003 IRS Individual *e-file* Partnership Program

Announcement 2002–101

The Stakeholder Partnerships, Education and Communication (SPEC) function within the Internal Revenue Service (IRS) is continuing its efforts to establish IRS *e-file* partnerships with various entities. The IRS is seeking non-monetary *e-file* partnerships for **Filing Season 2003.** No applications for funding (monetary compensation) will be considered. Applications may be submitted by a commercial business, non-profit organization, state government or local government. Applications are not solicited from other Federal government agencies. The program is an annual program and covers the period January 2003 through October 15, 2003. **All prior year partners must reapply for Filing Season 2003.**

BACKGROUND

The IRS Restructuring and Reform Act of 1998 (RRA 98) requires the IRS to receive 80 percent of all returns electronically by 2007. RRA 98 authorized the IRS Commissioner to promote the benefits of and encourage the use of *e-file* services. As a result of RRA 98, the IRS enters into non-monetary partnerships with businesses to offer low cost income tax preparation and electronic filing for qualified taxpayers.

Continued opportunities for growth in electronic tax administration are evident. For Filing Season 2002, the IRS received over 46 million electronically filed returns, an increase of 16% over the previous year. Visit the IRS web site, ***www.irs.gov***, "IRS e-file for Tax Professionals, Software Developers, and Transmitters" for the most current results from market research on individual taxpayers: demographic data and psychographic studies. This includes attitudinal surveys, customer satisfaction surveys, Public Service Announcements (PSAs)/Paid Advertising Tracking Studies and any focus group results.

The IRS currently accepts 115 forms and schedules for electronic filing. Visit the IRS web site (***www.irs.gov***) for a complete listing of accepted forms and schedules.

FILING SEASON 2003

For Filing Season 2003, the IRS will focus on the **1040** series income tax returns covering "IRS e-file Using a Tax Preparer" and "IRS e-file Using a Personal Computer." Additional emphasis is being placed on the following features: "Self-Select Personal Identification Number (PIN) for *e-file*; "Using e-file for Federal/State Returns", and "Electronic Payment Options" for balance due and estimated payment options.

Emphasis should also be placed on the first-time filer population. IRS research indicates that this segment of the population continues to lag behind other segments of the population that *e-file*. In addition, research indicates that *e-file* is still lagging in the self-prepared simple segment. Another area of emphasis is to reach those taxpayers who continue to file computer prepared paper returns (v-code). Research indicates that the number of v-code returns continues to increase (76% of all v-code returns are prepared by paid preparers). Emphasis should be placed on encouraging v-code filers to electronically file their returns through the marketing and promotion of the benefits of *e-file*.

The IRS expects all accepted partners to aggressively market, promote and offer *e-file* services through October 15, 2003. The IRS will supply the partners with the Filing Season and post April 15 *e-file* campaign message(s), if available, to target additional qualified taxpayers, *i.e.*, extensions, military returns, etc. Pending the passage of legislation, Participants are encouraged to offer the April 30 due date extension for *e-file*.

For additional information on the various *e-file* programs, features, and market research, visit our web site at ***www.irs.gov.*** For a listing of our current partners and the services they offer, refer to the IRS *e-file* Partners Page at ***www.irs.gov.***

Participants will receive hyperlinks from the IRS web site to the Participant's web site. Potential Participants may request links for the following categories: **IRS *e-file* Partners for Taxpayers, IRS *e-file* Partners for Tax Professionals, IRS *e-file* Partners for Financial Institutions/ Employers, and IRS *e-file* Partners for Credit Card Payment Options.**

PARTICIPATION REQUIREMENTS

- The Participant (Electronic Return Originator, Intermediate Service Provider, Software Developer, and Transmitter) must be in good standing with the IRS, comply with the *e-file* requirements stated in the IRS Revenue Procedure 2000–31, 2000–2 C.B. 146, Publications 1345 and 1345A, 26 U.S.C. 7216, U.S.C. 6103, and pass the annual Suitability and Participants Acceptance Testing (PATS) conducted by the IRS. All other Participants are exempt from these requirements.
- The Participant will offer their products and services to filers of the 1040 Series returns, including complicated returns, balance due returns, Federal/State returns, and 1040EZ returns. The Participant is encouraged to reach first-time filers and v-coders. The participant will offer a variety of *e-file* features including the Self-Select PIN, Electronic Payment Options, Direct Deposit of Refunds, etc.
- The Participant will aggressively market, promote and offer *e-file* services through October 15, 2003. The Participant will use the current Filing Season *e-file* marketing/promotional messages developed by the IRS. In addition, the Participant will use the post April 15 *e-file* campaign message(s) and other promotional tools, if available, to target qualified taxpayers, *i.e.*, extensions, military returns, etc.
- The Participant is encouraged to offer the April 30 due date extension for *e-file*, upon passage of authorizing legislation.
- The Participant will have a hyperlink(s) from the IRS web site to their site. Participants will not have a URL(s) containing the word "IRS".
- The Participant will place the IRS *e-file* logo on its web site.
- The Participant will provide a description (350 characters or less) for each hyperlink placed on the IRS *e-file* Partners Page. The Participant will have a link(s) to the IRS web site.
- The Participant will not offer its services and/or products based on the condition in obtaining an eligible taxpayer's consent to solicitations of additional business.
- The Participant's web site will not contain inappropriate content nor will the Participant provide links to inappropriate content.
- The Participant will clearly disclose to users its customer service support options and privacy policy.
- The Participant should submit written notification, *i.e.*, email, to the IRS of changes/additions/deletions to URLs, link descriptions, etc.
- The Participant will submit a Performance Report to the IRS Point of Contact by May 30, 2003. The report will cover Filing Season activities (*i.e.*, statistical information, web site activity, etc.). The IRS Point of Contact will provide written reporting instructions and requirements to accepted participants.

PERFORMANCE STANDARDS

- The IRS will have the accepted participant's hyperlink(s) available on the IRS web site by December 31, 2002, or before the start of electronic filing, subject to the participant's passing of the annual Suitability and PATS testing. Hyperlinks will remain on the IRS *e-file* Partners Page at least through October 15, 2003, or later.
- The IRS will rotate on a daily basis the hyperlinks that exist on the IRS *e-file* Partners Page.
- The IRS may establish a link from the IRS *e-file* Partners Page to the Free Internet Filing Consortium web page.
- The IRS will accept, if appropriate, the Participant's written request for changes/additions/deletions to a URL, link description, etc.
- The IRS has a right to review the Participant's web site(s) to ensure that participation requirements are met.
- The IRS will not endorse specific offerings or products, but will promote the IRS *e-file* Partners Page. A "Site Disclaimer" will exist on the IRS web site before the user enters the Participant's web site.

PARTICIPATION TERMS

- The IRS Individual *e-file* Partnership Program is an annual program, and all prospective Participants, including returning Participants, must reapply each year following the guidelines in the announcement advertised on ***www.irs.gov.***
- If the IRS determines that the participant is not meeting the "Participation Requirements," the IRS may terminate its partnership with the Participant and remove the participant's hyperlink(s) from the IRS *e-file* Partners Page.
- The Participant should notify the IRS immediately if it wishes to terminate its partnership with the IRS. The notification should be submitted through email to the IRS Point of Contact or sent to the Point of Contact's address.

APPLICATION PROCESS

Applications should contain the following:

- Include the Applicant's Point of Contact information (name, title, address, telephone number, fax number and e-mail address) for discussion of your application.
- Identify the Applicant's secure web site.
- Identify the Applicant's tax preparation software (if applicable).
- Include the Applicant's Electronic Filer Identification Number (EFIN) and/or Electronic Transmitter Identification Number (ETIN) (if applicable).
- Identify the Applicant's hyperlink(s) and provide a short description (350 characters or less) of the services and products to be promoted on the IRS *e-file* Partners Page. In addition, the Applicant should provide the associated URL(s). **The URL(s) address cannot contain the word "IRS."** Indicate the category for each hyperlink(s): **IRS *e-file* Partners for Taxpayers, IRS *e-file* Partners for Tax Professionals, IRS *e-file* Partners for Financial Institutions/Employers, and IRS *e-file* Partners for Electronic Payment Options.** Refer to the IRS e-file Partners Page (***www.irs.gov***) for examples of link descriptions.
- Identify the Applicant's communication vehicle(s) (*i.e.*, web site, marketing/promotional products, etc.) to market and promote your products and services and IRS *e-file*. Describe the incentives, discounts, offers, benefits to taxpayers or other specific approaches to increase *e-file* volumes.

- Certify the Applicant's compliance with the privacy and disclosure provisions of 26 U.S.C. 7216 and 26 U.S.C. 6103 (if applicable).

IRS POINT OF CONTACT/ APPLICATION SUBMISSION

Applications to participate in the IRS Individual *e-file* Partnership Program should be submitted as a Word document through email at ***WIe-filepartners@irs.gov** (Please make sure there is an asterisk before the WI (Wage and Investment) when submitting an application.) An application may also be sent to Karen Bradley at the following address:

Internal Revenue Service
5000 Ellin Road
Lanham, MD 20706
Attention: Karen Bradley
W:CAR:SPEC:FO:IMS
C5–351

If you wish to have a hyperlink(s) on the IRS *e-file* Partners Page by **December 31, 2002, or before the start of electronic filing**, your application must be submitted by **December 4, 2002**, otherwise, there is no deadline for your application.

Illustrations of marketing materials may be submitted in Adobe Acrobat Portable Document (PDF) or other appropriate files.

Any questions regarding the development of applications, the submission of Performance Reports, or any other type of contact for this program should be directed to **Karen Bradley at (202) 283–7034** or through email to ***WIe-filepartners @irs.gov** (Please make sure there is an asterisk before the WI (Wage and Investment) for any type of email contact.)

APPLICATION EVALUATION

All applications will be evaluated based on the required information provided to the IRS and the applicant's ability to fulfill their responsibilities. Prior year performance will also be considered when evaluating applications from returning partners.

ACCEPTANCE/DENIAL OF APPLICATION

If your application is accepted, you will receive written notification from the IRS. If your application is denied, you will receive written notification from the IRS with an explanation of the denial.

Exclusions From Gross Income of Foreign Corporations; Hearing

Announcement 2002–102

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Change of date of public hearing, extension of time for submitting public comments and outlines of oral comments.

SUMMARY: This document changes the date of a public hearing on proposed regulations (REG–208280–86; REG–136311–01, 2002–36 I.R.B. 485) relating to exclusions from gross income of foreign corporations under section 883 of the Internal Revenue Code, and extends the time for submitting public comments and outlines of oral comments.

DATES: The public hearing originally scheduled for Tuesday, November 12, 2002, at 10 a.m. is rescheduled for Monday, November 25, 2002, at 10 a.m. The due date for written or electronic public comments and outlines of topics to be discussed, is November 5, 2002.

ADDRESSES: The public hearing is being held in room 4718, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. Send submissions to: CC:ITA:RU (REG–208280–86; REG–136311–01), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:ITA:RU (REG–208280–86; REG–136311–01), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, comments may be transmitted electronically via the Internet by submitting comments directly to the IRS Internet site at: *http://www.irs.gov/regs.*

FOR FURTHER INFORMATION CONTACT: Guy Traynor of the Regulations Unit, Associate Chief Counsel (Income Tax & Accounting), at (202) 622–7180 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

A notice of proposed rulemaking and notice of public hearing appearing in the **Federal Register** on Friday, August 2, 2002 (67 FR 50510), announced that a public hearing on proposed regulations relating to exclusions from gross income of foreign corporations under section 883 of the Internal Revenue Code would be held on Tuesday, November 12, 2002, beginning at 10 a.m. in room 4718 of the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. The deadline for submitting public comments and outlines of topics to be discussed, is October 22, 2002.

The date of the hearing and deadline for submitting public comments has changed. The hearing is scheduled for Monday, November 25, 2002, beginning at 10 a.m. in room 4718, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. We must receive written and electronic public comments and outlines of topics to be discussed, by November 5, 2002. Because of the controlled access restrictions, attendants will not be admitted beyond the lobby area of the Internal Revenue Building until 9:30 a.m. The IRS will prepare an agenda showing the scheduling of the speakers after the outlines are received from the persons testifying and make copies available free of charge at the hearing.

Cynthia E. Grigsby,
Chief, Regulations Unit,
Associate Chief Counsel
(Income Tax & Accounting).

(Filed by the Office of the Federal Register on October 17, 2002, 8:45 a.m., and published in the issue of the Federal Register for October 18, 2002, 67 F.R. 64331)

Definition of Terms

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

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

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

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

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

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

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

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

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

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

Abbreviations

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

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

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

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

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Key to Abbreviations:

Ann	Announcement
CD	Court Decision
DO	Delegation Order
EO	Executive Order
PL	Public Law
PTE	Prohibited Transaction Exemption
RP	Revenue Procedure
RR	Revenue Ruling
SPR	Statement of Procedural Rules
TC	Tax Convention
TD	Treasury Decision
TDO	Treasury Department Order

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