Internal Revenue bulletin

Bulletin No. 2003-33
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HIGHLIGHTS OF THIS ISSUE

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

INCOME TAX

Rev. Rul. 2003–72, page 346.

Determination of a child's specific age. A child attains an age on his or her birthday for purposes of Code sections 21 (child and dependent care credit), 23 (adoption credit), 24 (child tax credit), 32 (earned income credit), 129 (excludable dependent care benefits), 131 (excludable foster care benefits), 137 (excludable adoption assistance benefits), and 151 (dependency exemptions).

Rev. Rul. 2003–76, page 355.

Exchange of a portion of annuity contract. An exchange of a portion of an annuity contract into a new annuity contract is treated as a tax-free exchange under section 1035 of the Code. Investment in the contract and basis are allocated according to cash value immediately prior to the exchange using the rules of sections 72 and 1031.

Rev. Rul. 2003–90, page 353.

Accrual of liability for California franchise tax. This ruling holds that, for federal income tax purposes, a taxpayer that uses an accrual method of accounting incurs a liability for California franchise tax in the taxable year following the taxable year in which the tax is incurred under the California Revenue and Tax Code. Rev. Rul. 79–410 amplified.

Rev. Rul. 2003–91, page 347.

Investor control doctrine. This ruling presents guidance on the investor control doctrine by presenting a factual scenario in which a variable contract holder does not have control over segregated account assets sufficient to be deemed the owner of the assets. In this manner, this ruling presents a "safe harbor" from which taxpayers may operate.

Rev. Rul. 2003–92, page 350.

Variable contract holder. This ruling holds that a variable contract holder is the owner of interests in a nonregistered partnership where interests in the nonregistered partnership are not available exclusively through the purchase of a life insurance or annuity contract. Rev. Rul. 81–225 clarified and amplified.

Rev. Rul. 2003–93, page 346.

Low-income housing credit; satisfactory bond; "bond factor" amounts for the period July through September 2003. 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 July through September 2003.

Rev. Rul. 2003–94, page 357.

Federal rates; adjusted federal rates; adjusted federal long-term rate and the long-term exempt rate. For purposes of sections 382, 1274, 1288, and other sections of the Code, tables set forth the rates for August 2003.

Rev. Rul. 2003–95, page 358.

Life insurance contracts; distributions made in connection with a change in benefits. This ruling describes the rules of section 7702(f)(7) of the Code regarding the tax treatment of a cash distribution made in connection with a reduction in the benefits of a life insurance contract.

REG–131997–02, page 366.

Proposed regulations under section 42 of the Code concerning the low-income housing tax credit make amendments to existing regulations to reflect statutory changes made by the Community Renewal Tax Relief Act of 2000. A public hearing is scheduled for September 23, 2003.

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Announcements of Disbarments and Suspensions begin on page 372.
Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

Notice 2003–51, page 361.
This notice accompanies Rev. Rul. 2003–76. The notice requests comments on possible additional guidance prescribing the tax treatment of partial exchanges of annuity contracts and also provides interim guidance.

Notice 2003–54, page 363.
This notice advises taxpayers and their representatives about a tax shelter that uses a common trust fund (CTF) to invest in offsetting gain and loss positions in foreign currencies for the purpose of creating losses for a high net worth taxpayer and notifies the taxpayers and their representatives that the claimed tax benefits purportedly generated by these transactions are not allowable for federal income tax purposes. The notice also states that this transaction is a "listed transaction" and warns of the potential penalties that may be imposed if taxpayers claim losses from such a transaction.

Rev. Proc. 2003–66, page 364.
Rents paid to a real estate investment trust (REIT) by a joint venture partnership that includes a taxable REIT subsidiary (TRS) of the REIT. This procedure provides conditions under which payments to a REIT from a joint venture between a TRS and an unrelated third party for space at a property owned by the REIT will be treated as rents from real property under section 856(d) of the Code.

EXEMPT ORGANIZATIONS

Notice 2003–53, page 362.
This notice provides modifications to the reporting requirements for distributions from Coverdell Education Savings Accounts (CESAs) for calendar years after 2002.

ADMINISTRATIVE

Notice 2003–53, page 362.
This notice provides modifications to the reporting requirements for distributions from Coverdell Education Savings Accounts (CESAs) for calendar years after 2002.

The IRS Mission

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

Introduction

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

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

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

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

The Bulletin is divided into four parts as follows:

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

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

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

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

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

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

Section 21.—Expenses for Household and Dependent Care Services Necessary for Gainful Employment

26 CFR 1.44A–1: Expenses for household and dependent care services necessary for gainful employment.

A child attains an age on his or her birthday for purposes of sections 21 (child and dependent care credit), 23 (adoption credit), 24 (child tax credit), 32 (earned income credit), 129 (excludable dependent care benefits), 131 (excludable foster care benefits), 137 (excludable adoption assistance benefits), and 151 (dependency exemptions). See Rev. Rul. 2003-72, page 346.

Section 23.—Adoption Expenses

A child attains an age on his or her birthday for purposes of sections 21 (child and dependent care credit), 23 (adoption credit), 24 (child tax credit), 32 (earned income credit), 129 (excludable dependent care benefits), 131 (excludable foster care benefits), 137 (excludable adoption assistance benefits), and 151 (dependency exemptions). See Rev. Rul. 2003-72, page 346.

Section 24.—Child Tax Credit

A child attains an age on his or her birthday for purposes of sections 21 (child and dependent care credit), 23 (adoption credit), 24 (child tax credit), 32 (earned income credit), 129 (excludable dependent care benefits), 131 (excludable foster care benefits), 137 (excludable adoption assistance benefits), and 151 (dependency exemptions). See Rev. Rul. 2003-72, page 346.

Section 32.—Earned Income

26 CFR 1.32–2: Earned income credit for taxable years beginning after December 31, 1978.
(Also §§ 21, 23, 24, 129, 131, 137, 151; 1.44A–1, 1.151–2.)

Determination of a child's specific age. A child attains an age on his or her birthday for purposes of Code sections 21 (child and dependent care credit), 23 (adoption credit), 24 (child tax credit), 32 (earned income credit), 129 (excludable dependent care benefits), 131 (excludable foster care benefits), 137 (excludable adoption assistance benefits), and 151 (dependency exemptions).

Rev. Rul. 2003–72

This revenue ruling applies a uniform method of determining when a child attains a specific age for purposes of the following sections of the Internal Revenue Code: 21 (dependent care credit), 23 (adoption credit), 24 (child tax credit), 32 (earned income credit), 129 (dependent care assistance programs), 131 (foster care payments), 137 (adoption assistance programs), and 151 (dependency exemptions).

Each of these provisions allows a credit, exclusion, or deduction to the taxpayer, provided, among other requirements, a child has not attained a specific age. For example, under § 24(c), one of the requirements for a qualifying child for the child tax credit is that the child "has not attained the age of 17 as of the close of the calendar year in which the taxable year of the taxpayer begins."

HOLDING

For purposes of each of the provisions identified in this revenue ruling, a child attains a given age on the anniversary of the date that the child was born. For example, a child born on January 1, 1987, attains the age of 17 on January 1, 2004.

DRAFTING INFORMATION

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

Section 42.—Low-Income Housing Credit

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 2003. See Rev. Rul. 2003-94, page 357.

Low-income housing credit; satisfactory bond; "bond factor" amounts for the period July through September 2003. 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 July through September 2003.

Rev. Rul. 2003–93

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 July through September 2003.

Table 1 Rev. Rul. 2003–93 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	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Jul ’03	16.23	30.04	41.83	51.93	60.50	59.37	59.27	59.27	59.35	59.58	59.83
Aug ’03	16.23	30.04	41.83	51.93	60.50	59.24	59.14	59.14	59.23	59.45	59.72
Sep ’03	16.23	30.04	41.83	51.93	60.50	59.11	59.01	59.02	59.10	59.34	59.60

Table 1 (cont’d) Rev. Rul. 2003–93 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	2000	2001	2002	2003							
Jul ’03	60.15	60.83	61.77	62.68							
Aug ’03	60.05	60.74	61.70	62.68							
Sep ’03	59.95	60.65	61.63	62.68							

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; Rev. Rul. 2001–53, 2001–2 C.B. 488; and Rev. Rul. 2002–72, 2002–44 I.R.B. 759. For dispositions occurring during the period January through March 2003, see Rev. Rul. 2003–22, 2003–8 I.R.B. 494. For dispositions occurring during the period April through June 2003, see Rev. Rul. 2003–44, 2003–18 I.R.B. 848.

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 61.—Gross Income Defined

26 CFR 1.61–1: Gross income.
(Also §§ 801, 817; 1.817–5.)

Investor control doctrine. This ruling presents guidance on the investor control doctrine by presenting a factual scenario in which a variable contract holder does not have control over segregated account assets sufficient to be deemed the owner of the assets. In this manner, this ruling presents a “safe harbor” from which taxpayers may operate.

Rev. Rul. 2003–91

ISSUE

Under the facts set forth below, will the holder of a variable contract be considered to be the owner, for federal income tax purposes, of the assets that fund the variable contract? Will income earned on those assets be included in the income of the holder in the year in which it is earned?

FACTS

Situation 1: *IC* is a life insurance company subject to tax under § 801 of the Internal Revenue Code. In states where it is authorized to do so, *IC* offers variable life and variable annuity contracts that qualify as variable contracts under § 817(d) (“Contracts”).

The assets that fund the Contracts are segregated from the assets that fund *IC*'s traditional life insurance products. *IC* maintains a separate account (“Separate Account”) for the assets funding the Contracts, and the income and liabilities associated with the Separate Account are maintained separately from *IC*'s other accounts.

The Separate Account is divided into various sub-accounts (“Sub-accounts”). Each Sub-account's assets and liabilities

are maintained separately from the assets and liabilities of other Sub-accounts. Interests in the Sub-accounts are not available for sale to the public. Rather, interests in the Sub-accounts are available solely through the purchase of a Contract. *IC* engages an independent investment advisor ("Advisor") to manage the investment activities of each Sub-account.[1] Each Sub-account will at all times meet the asset diversification test set forth in § 1.817–5(b)(1) of the Income Tax Regulations.

Twelve sub-accounts are currently available under the Contracts, but *IC* may increase or decrease this number at any time. However, there will never be more than 20 Sub-accounts available under the Contracts. Each Sub-account offers a different investment strategy. The currently available Sub-accounts include a bond fund, a large company stock fund, an international stock fund, a small company stock fund, a mortgage backed securities fund, a health care industry fund, an emerging markets fund, a money market fund, a telecommunication fund, a financial services industry fund, a South American stock fund, an energy fund and an Asian markets fund.

An individual ("Holder") purchases a life insurance Contract ("LIC"). At the time of purchase, Holder specifies the allocation of premium paid among the then available Sub-accounts. Holder may change the allocation of premiums at any time, and Holder may transfer funds from one Sub-account to another. Holder is permitted one transfer between Sub-accounts without charge per thirty-day period. Any additional transfers during this period are subject to a fee assessed against the cash value of LIC.

There is no arrangement, plan, contract, or agreement between Holder and *IC* or between Holder and Advisor regarding the availability of a particular Sub-account, the investment strategy of any Sub-account, or the assets to be held by a particular sub-account. Other than Holder's right to allocate premiums and transfer funds among the available Sub-accounts as described above, all investment decisions concerning the Sub-accounts are made by *IC* or Advisor in their sole and absolute discretion. Specifically, Holder cannot select or recommend particular investments or investment strategies. Moreover, Holder cannot communicate directly or indirectly with any investment officer of *IC* or its affiliates or with Advisor regarding the selection, quality, or rate of return of any specific investment or group of investments held in a Sub-account. Holder has no legal, equitable, direct, or indirect interest in any of the assets held by a Sub-account. Rather, Holder has only a contractual claim against *IC* to collect cash from *IC* in the form of death benefits, or cash surrender values under the Contract.

All decisions concerning the choice of Advisor or the choice of any of *IC*'s investment officers that are involved in the investment activities of Separate Account or any of the Sub-accounts, and any subsequent changes thereof, are made by *IC* in its sole and absolute discretion. Holder may not communicate directly or indirectly with *IC* concerning the selection or substitution of Advisor or the choice of any *IC*'s investment officers that are involved in the investment activities of Separate Account or any of the Sub-accounts.

Situation 2: The facts are the same as Situation 1 except that Holder purchases an annuity Contract ("Annuity").

LAW

Section 61(a) provides that the term "gross income" means all income from whatever source derived, including gains derived from dealings in property, interest and dividends.

A long standing doctrine of taxation provides that "taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid." *Corliss v. Bowers*, 281 U.S. 376 (1930). The incidence of taxation attributable to ownership of property is not shifted if the transferor continues to retain significant control over the property transferred, *Frank Lyon Company v. United States*, 435 U.S. 561 (1978); *Commissioner v. Sunnen*, 333 U.S. 591 (1948); *Helvering v. Clifford*, 309 U.S. 331 (1940), without regard to whether such control is exercised through specific retention of legal title, the creation of a new equitable but controlled interest, or the maintenance of effective benefit through the interposition of a subservient agency. *Christoffersen v. U.S.*, 749 F.2d 513 (8th Cir.), *rev'g* 578 F. Supp. 398 (N.D. Iowa 1984).

Rev. Rul. 77–85, 1977–1 C.B. 12, considers a situation in which the individual purchaser of a variable annuity contract retained the right to direct the custodian of the account supporting that variable annuity to sell, purchase, and exchange securities or other assets held in the custodial account. The purchaser also was able to exercise an owner's right to vote account securities either through the custodian or individually. The Service concluded that the purchaser possessed "significant incidents of ownership" over the assets held in the custodial account. The Service reasoned that if a purchaser of an "investment annuity" contract may select and control the investment assets in the separate account of the life insurance company issuing the contract, then the purchaser is treated as the owner of those assets for federal income tax purposes. Thus, any interest, dividends, or other income derived from the investment assets are included in the purchaser's gross income.

In Rev. Rul. 80–274, 1980–2 C.B. 27, the Service, applying Rev. Rul. 77–85, concludes that, if a purchaser of an annuity contract may select and control the certificates of deposit supporting the contract, then the purchaser is considered the owner of the certificates of deposit for federal income tax purposes. Similarly, Rev. Rul. 81–225, 1981–2 C.B. 12, concludes that investments in mutual fund shares to fund annuity contracts are considered to be owned by the purchaser of the annuity if the mutual fund shares are available for purchase by the general public. Rev. Rul. 81–225 also concludes that, if the mutual fund shares are available only through the purchase of an annuity contract, then the sole function of the fund is to provide an investment vehicle that allows the issuing insurance company to meet its obligations under its annuity contracts and the mutual fund shares are considered to be owned by the insurance company. Finally, in Rev.

[1] For these purposes, the term investment officer refers to anyone whose responsibilities include giving investment advice or making investment decisions relating to assets held in a Sub-account and to any person who directly or indirectly supervises the work performed by such individual.

Rul. 82–54, 1982–1 C.B. 11, the purchaser of certain annuity contracts could allocate premium payments among three funds and had an unlimited right to reallocate contract value among the funds prior to the maturity date of the annuity contract. Interests in the funds were not available for purchase by the general public, but were instead only available through purchase of an annuity contract. The Service concludes that the purchaser's ability to choose among general investment strategies (for example, between stock, bonds, or money market instruments) either at the time of the initial purchase or subsequent thereto, does not constitute control sufficient to cause the contract holders to be treated as the owners of the mutual fund shares.

In *Christoffersen v. U.S.*, the Eighth Circuit considered the federal income tax consequences of the ownership of the assets supporting a segregated asset account. The taxpayers in *Christoffersen* purchased a variable annuity contract that reflected the investment return and market value of assets held in an account that was segregated from the general asset account of the issuing insurance company. The taxpayers had the right to direct that their premium payments be invested in any one of six publicly traded mutual funds. The taxpayers could reallocate their investment among the funds at any time. The taxpayers also had the right upon seven days notice to withdraw funds, surrender the contract, or apply the accumulated value under the contract to provide annuity payments.

The Eighth Circuit held that, for federal income tax purposes, the taxpayers, not the issuing insurance company, owned the mutual fund shares that funded the variable annuity. The court concluded that the taxpayers "surrendered few of the rights of ownership or control over the assets of the sub-account," that supported the annuity contract. *Christoffersen*, 749 F.2d at 515. According to the court, "the payment of annuity premiums, management fees and the limitation of withdrawals to cash [did] not reflect a lack of ownership or control as the same requirements could be placed on traditional brokerage or management accounts." *Id.* at 515–16. Thus, the taxpayers were required to include in gross income any gains, dividends, or other income derived from the mutual fund shares.

Section 817, which was enacted by Congress as part of the Deficit Reduction Act of 1984 (Pub. L. No. 98–369) (the "1984 Act"), provides rules regarding the tax treatment of variable life insurance and annuity contracts. Section 817(d) defines a "variable contract" as a contract that provides for the allocation of all or part of the amounts received under the contract to an account that, pursuant to State law or regulation, is segregated from the general asset accounts of the company and that provides for the payment of annuities, or is a life insurance contract. In the legislative history of the 1984 Act, Congress expressed its intent to deny life insurance treatment to any variable contract if the assets supporting the contract include funds publicly available to investors:

> The conference agreement allows any diversified fund to be used as the basis of variable contracts so long as all shares of the funds are owned by one or more segregated asset accounts of insurance companies, but only if access to the fund is available exclusively through the purchase of a variable contract from an insurance company. . . . In authorizing Treasury to prescribe diversification standards, the conferees intend that the standards be designed to deny annuity or life insurance treatment for investments that are publicly available to investors . . .

H. R. Conf. Rep. No. 98–861, at 1055 (1984).

Section 817(h)(1) provides that a variable contract based on a segregated asset account shall not be treated as an annuity, endowment, or life insurance contract unless the segregated asset account is adequately diversified in accordance with regulations prescribed by the Secretary. If a segregated asset account is not adequately diversified, income earned by that segregated asset account is treated as ordinary income received or accrued by the policyholders.

Approximately two years after enactment of § 817(h), the Treasury Department issued proposed and temporary regulations prescribing the minimum level of diversification that must be met for an annuity or life insurance contract to be treated as a variable contract within the meaning of § 817(d). The preamble to the regulations stated as follows:

> The temporary regulations . . . do not provide guidance concerning the circumstances in which investor control of the investments of a segregated asset account may cause the investor, rather than the insurance company, to be treated as the owner of the assets in the account. For example, the temporary regulations provide that in appropriate cases a segregated asset account may include multiple sub-accounts, but do not specify the extent to which policyholders may direct their investments to particular sub-accounts without being treated as owners of the underlying assets. Guidance on this and other issues will be provided in regulations or revenue rulings under section 817(d), relating to the definition of variable contracts.

T.D. 8101, 1986–2 C.B. 97 [51 FR 32633] (Sept. 15, 1986). The text of the temporary regulations served as the text of proposed regulations in the notice of proposed rulemaking. *See* LR–295–84, 1986–2 C.B. 801 [51 FR 32664] (Sept. 15, 1986). The final regulations adopted, with certain revisions not relevant here, the text of the proposed regulations.

ANALYSIS

The determination of whether Holder possesses sufficient incidents of ownership over Sub-account assets to be deemed the owner of the assets supporting LIC and Annuity depends on all of the relevant facts and circumstances.

Holder may not select or direct a particular investment to be made by either the Separate Account or the Sub-accounts. Holder may not sell, purchase, or exchange assets held in the Separate Account or the Sub-accounts. All investment decisions concerning the Separate Account and the Sub-accounts are made by *IC* or Advisor in their sole and absolute discretion.

The investment strategies of the Sub-accounts currently available are sufficiently broad to prevent Holder from making particular investment decisions through investment in a Sub-account. Only *IC* may add or substitute Sub-accounts or investment strategies in the future. No arrangement, plan, contract, or agreement exists between Holder and *IC* or between Holder and Advisor regarding the specific investments or investment objective of the

Sub-accounts. In addition, Holder may not communicate directly or indirectly with Advisor or any of *IC*'s investment officers concerning the selection, quality, or rate of return of any specific investment or group of investments held by Separate Account or in a Sub-account.

Investment in the Sub-accounts is available solely through the purchase of a Contract, thus, Sub-accounts are not publicly available. The ability to allocate premiums and transfer funds among Sub-accounts alone does not indicate that Holder has control over either Separate Account or Sub-account assets sufficient to be treated as the owner of those assets for federal income tax purposes.

Based on all the facts and circumstances, Holder does not have direct or indirect control over the Separate Account or any Sub-account asset. Therefore, Holder does not possess sufficient incidents of ownership over the assets supporting either LIC or Annuity to be deemed the owner of the assets for federal income tax purposes. So long as LIC and Annuity continue to satisfy the diversification requirements of § 817(h) and *IC*'s and Holder's future conduct is consistent with the facts of this ruling, Holder will not be required to include the earnings on the assets held in Separate Account or any of the Sub-accounts in income under § 61(a).

HOLDING

Under the facts set forth above, the holder of a variable contract will not be considered to be the owner, for federal income tax purposes, of the assets that fund the variable contract. Therefore, any interest, dividends, or other income derived from the assets that fund the variable contract is not included in the holder's gross income in the year in which the interest, dividends, or other income is earned.

DRAFTING INFORMATION

The principal author of this revenue ruling is James Polfer of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this revenue ruling, contact Mr. Polfer at (202) 622–3970 (not a toll-free call).

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26 CFR 1.61–1: Gross income.
(Also §§ 801, 817, 7702; 1.817–5.)

Variable contract holder. This ruling holds that a variable contract holder is the owner of interests in a nonregistered partnership where interests in the nonregistered partnership are not available exclusively through the purchase of a life insurance or annuity contract. Rev. Rul. 81–225 clarified and amplified.

Rev. Rul. 2003–92

ISSUES

Under the facts set forth below, will the holder of a variable annuity or life insurance contract be considered to be the owner, for federal income tax purposes, of the partnership interests that fund the variable contract if interests in the partnerships are available for purchase by the general public? What are the income tax consequences to the holder of the contract if that holder is considered to be the owner of the partnership interests that fund the variable contract?

FACTS

Situation 1. *IC* is a life insurance company subject to tax under § 801 of the Internal Revenue Code. In states where it is authorized to do so, *IC* offers deferred variable annuity contracts. *IC* has developed a variable annuity contract ("Annuity") for sale only to "qualified purchasers"[1] that are "accredited investors"[2] or to no more than one hundred accredited investors. *IC* is not required to register Annuity under the federal security laws.

Contract Holder, an individual qualifying as both a qualified purchaser and an accredited investor, purchases Annuity from *IC*. Annuity contains a number of provisions common to deferred annuity contracts, including the right of Contract Holder to surrender Annuity in part or entirely for cash (subject to a surrender charge) and the right to convert (at future dates chosen by Contract Holder) the accumulated values under Annuity into a stream of periodic payments under one of several settlement options.

The assets supporting Annuity are held in a segregated asset account that is maintained separately from *IC*'s other accounts. The segregated asset account is divided into 10 sub-accounts ("Sub-accounts"). Each Sub-account's assets and liabilities are maintained separately from the assets and liabilities of other Sub-accounts. At the time of purchase, Contract Holder specifies the premium allocation among the available Sub-accounts. Contract Holder may change the allocation of subsequent premiums at any time.

Each Sub-account available under Annuity invests in interests in a partnership ("Partnership"). None of the Partnerships are publicly traded partnerships under § 7704. All of the Partnerships are exempt from registration under federal security laws. Interests in each Partnership are sold in private placement offerings and are sold only to qualified purchasers that are accredited investors or to no more than one hundred accredited investors.

Each Partnership has an investment manager that selects the Partnership's specific investments. Contract Holder may not act as an investment manager or independently own any interest in any Partnership offered under Annuity. In addition, Contract Holder will have no voting rights with respect to any Partnership interest held by any Sub-account.

Each Sub-account will at all times meet the asset diversification test set forth in § 1.817–5(b)(1) of the Income Tax Regulations.

Situation 2. The facts are the same as those in Situation 1, except *IC* offers, and Contract Holder purchases, a variable life insurance contract ("LIC") that qualifies as a life insurance contract under § 7702.

Situation 3. The facts are the same as those in Situation 1, except that (i) Contract Holder purchases both an Annuity and an LIC and (ii) interests in each Partnership are available for purchase only through the purchase of an Annuity,

[1] Under 15 U.S.C. § 80a–2(a)(51) a "qualified purchaser" is an individual, or other specified entity, that satisfies certain threshold financial requirements.

[2] The term "accredited investor," as defined by 15 U.S.C. § 77b(a)(15), and amplified by 17 CFR § 230.501(a), is also an investor that satisfies certain financial criteria. An accredited investor may be either an individual or certain enumerated entities. Because the criteria to be an accredited investor are similar to, but not identical to, the criteria that must be met to be a qualified purchaser it is possible for an accredited investor to also be a qualified purchaser. It is also possible for an investor to qualify only as either an accredited or qualified investor.

an LIC, or other variable contracts from insurance companies.

LAW

Section 61(a) provides that the term "gross income" means all income from whatever source derived, including gains derived from dealings in property, interest, and dividends.

Section 817, which was enacted by Congress as part of the Deficit Reduction Act of 1984 (Pub. L. No. 98–369) (the "1984 Act"), provides rules regarding the tax treatment of variable life insurance and annuity contracts. Section 817(d) defines a "variable contract" as a contract that provides for the allocation of all or part of the amounts received under the contract to an account that, pursuant to State law or regulation, is segregated from the general asset accounts of the company and that provides for the payment of annuities, or is a life insurance contract. In the legislative history of the 1984 Act Congress expressed its intent to deny life insurance treatment to any variable contract if the assets supporting the contract include funds publicly available to investors:

> The conference agreement allows any diversified fund to be used as the basis of variable contracts so long as all shares of the funds are owned by one or more segregated asset accounts of insurance companies, but only if access to the fund is available exclusively through the purchase of a variable contract from an insurance company. . . . In authorizing Treasury to prescribe diversification standards, the conferees intend that the standards be designed to deny annuity or life insurance treatment for investments that are publicly available to investors . . .

H. R. Conf. Rep. No. 98–861, at 1055 (1984).

Section 817(h)(1) provides that a variable contract based on a segregated asset account shall not be treated as an annuity, endowment, or life insurance contract unless the segregated asset account is adequately diversified in accordance with regulations prescribed by the Secretary. If a segregated asset account is not adequately diversified, income earned by that segregated asset account is treated as ordinary income received or accrued by the policyholders.

Approximately two years after enactment of § 817(h), the Treasury Department issued proposed and temporary regulations prescribing the minimum level of diversification that must be met for an annuity or life insurance contract to be treated as a variable contract within the meaning of § 817(d). The preamble to the regulations stated as follows:

> The temporary regulations . . . do not provide guidance concerning the circumstances in which investor control of the investments of a segregated asset account may cause the investor, rather than the insurance company, to be treated as the owner of the assets in the account. For example, the temporary regulations provide that in appropriate cases a segregated asset account may include multiple sub-accounts, but do not specify the extent to which policyholders may direct their investments to particular sub-accounts without being treated as owners of the underlying assets. Guidance on this and other issues will be provided in regulations or revenue rulings under section 817(d), relating to the definition of variable contracts.

51 FR 32633 (Sept. 15, 1986). The text of the temporary regulations served as the text of proposed regulations in the notice of proposed rulemaking. *See* 51 FR 32664 (Sept. 15, 1986). The final regulations adopted, with certain revisions not relevant here, the text of the proposed regulations.

Prior to enactment of § 817, the Service issued a number of revenue rulings regarding when the owner of an annuity contract will be treated as the owner of the assets that fund the annuity. In the revenue rulings, the Service relied on long standing tax principles. *See generally*, *Commissioner v. Sunnen*, 333 U.S. 591 (1948); *Helvering v. Clifford*, 309 U.S. 331 (1940); *Corliss v. Bowers*, 281 U.S. 376 (1930). The revenue rulings consider whether the contract owners described in each ruling have retained sufficient incidents of ownership, as described in cases cited above, over the assets or retain sufficient control over the assets to be treated as the owners of those assets.

Rev. Rul. 77–85, 1977–1 C.B. 12, concludes that if a purchaser of an "investment annuity" contract selects and controls the investment assets in the separate account of the issuing life insurance company, then the purchaser will be treated as the owner of those assets for federal income tax purposes. Thus, any interest, dividends, or other income derived from the investment assets are includible in the gross income of the purchaser. Similarly, Rev. Rul. 80–274, 1980–2 C.B. 27, holds that if a purchaser of an annuity contract may select and control the certificates of deposit supporting the contract, then the purchaser is treated as the owner of the certificates of deposit for federal income tax purposes. In Rev. Rul. 80–274, the insurance company could not dispose of the deposit or convert it into a different asset. The insurance company did, however, have the power to withdraw the deposit from a failing savings and loan association.

Rev. Rul. 81–225, 1981–2 C.B. 12, describes four situations in which investments in mutual fund shares to fund annuity contracts are treated as owned by the policyholder rather than by the issuing insurance company, and one situation in which the issuing insurance company is treated as the owner of the mutual fund shares. In Situation 1, the investment assets in the segregated account supporting the annuity contracts consisted solely of shares in a single, publicly available mutual fund managed by an independent investment advisor. Situation 2 is similar to Situation 1, except that the publicly available mutual fund was managed by the issuing insurance company or one of its affiliates. Situation 3 also is similar to Situation 1, except that the segregated asset account supporting the annuity contracts consisted of five sub-accounts. Each sub-account was invested in the shares of a different mutual fund. Shares of the mutual funds were offered for sale to the general public. The policyholder retained the right to allocate or reallocate funds among the five sub-accounts during the life of the annuity contract. Situation 4 is similar to Situation 2, except that the mutual fund did not sell shares directly to the public. The shares of the mutual fund were available only through the purchase of an annuity contract or by participation in an investment plan account of the type described in Rev. Rul. 70–525, 1970–2 C.B. 144. Situation 5 also was similar to Situation 2, except that the shares in the mutual fund were available only through the purchase of an annuity contract.

Rev. Rul. 81–225 concludes that the policyholders in Situations 1 through 4 had sufficient control and other incidents of ownership to be treated as the owners of the mutual fund shares for federal income tax purposes. The ruling reaches the opposite conclusion in Situation 5, because the sole function of the mutual fund in Situation 5 was to provide an investment vehicle that allows the issuing insurance company to meet its obligations under its annuity contracts and the insurance company possessed sufficient incidents of ownership to be treated as the owner of the underlying portfolio of assets of the mutual fund for federal income tax purposes.

In Rev. Rul. 82–54, 1982–1 C.B. 11, the purchasers of certain annuity contracts could direct the issuing insurance company to invest in the shares of any one or any combination of three mutual funds that were not available to the public. One mutual fund invested primarily in common stocks, another in bonds, and the third in money market investments. Policyholders could allocate their premium payments among the three funds and had an unlimited right to reallocate contract values among the funds prior to the maturity date of the annuity contract. The ruling concludes that the policyholders' ability to choose among general investment strategies (for example, between stock, bonds, or money market funds) either at the time of the initial purchase or subsequent thereto, did not constitute control sufficient to cause the policyholders to be treated as the owners of the mutual fund shares.

In *Christoffersen v. United States*, 749 F.2d 513 (8th Cir.), *rev'g* 578 F. Supp. 398 (N.D. Iowa 1984), the Eighth Circuit considered the federal income tax ownership of the assets supporting a segregated asset account. The taxpayers in *Christoffersen* purchased a variable annuity contract that reflected the investment return and market value of assets held in an account that was segregated from the general asset account of the issuing insurance company. The taxpayers had the right to direct that their premium payments be invested in any one or a combination of six publicly traded mutual funds. The taxpayers could reallocate their investment among the funds at any time. The taxpayers also had the right upon seven days notice to withdraw funds, surrender the contract, or apply the accumulated value under the contract to provide annuity payments.

The Eighth Circuit held that, for federal income tax purposes, the taxpayers, not the issuing insurance company, owned the mutual fund shares that funded the variable annuity. The court concluded that the taxpayers "surrender few of the rights of ownership or control over the assets of the sub-account" that supported the annuity contract. *Christoffersen*, 749 F.2d at 515. According to the court, "the payment of annuity premiums, management fees and the limitation of withdrawals to cash [did] not reflect the lack of ownership or control as the same requirements could be placed on traditional brokerage or management accounts." *Id.* at 515–16. Thus, the taxpayers were required to include in gross income any gains, dividends, or other income derived from the mutual fund shares.

ANALYSIS

In Situation 1, Sub-accounts hold interests in Partnerships available for purchase other than by purchasers of Annuity or other variable contracts from insurance companies. Therefore, for federal income tax purposes, Contract Holder is the owner of the interests in Partnerships held by Sub-accounts. As a result, pursuant to § 61(a), Contract Holder must include in its gross income any interest, dividends, or other income derived from the interests in the Partnerships in the year in which the interest, dividends, or other income is earned.

In Situation 2, Sub-accounts hold interests in Partnerships available for purchase other than by purchasers of LIC or other variable contracts from insurance companies. Therefore, for federal income tax purposes, Contract Holder is the owner of the interests in Partnerships held by Sub-accounts. As a result, pursuant to § 61(a), Contract Holder must include any interest, dividends, or other income derived from the Partnerships in gross income in the year in which the interest, dividends, or other income is earned.

In Situation 3, Sub-accounts hold interests in Partnerships available for purchase only by a purchaser of an Annuity, a LIC, or other variable contracts from insurance companies. Therefore, for federal income tax purposes, *IC* owns the interests in Partnerships that fund the Sub-accounts. As a result, pursuant to § 61(a), any interest, dividends, or other income derived from the Partnerships is not included in Contract Holder's gross income in the year in which the interest, dividends, or other income is earned.

HOLDINGS

Under the facts set forth above, the holder of a variable annuity or life insurance contract will be considered to be the owner, for federal income tax purposes, of the partnership interests that fund the variable contract if interests in the partnerships are available for purchase by the general public. If the holder of a variable annuity or life insurance contract is considered to be the owner of the partnership interests that fund the variable contract, pursuant to § 61(a), the contract holder must include any interest, dividends, or other income derived from the partnership interests in gross income in the year in which the interest, dividends, or other income is earned.

EFFECT ON OTHER REVENUE RULING

Rev. Rul. 81–225, 1981–2 C.B. 12 is hereby clarified and amplified.

DRAFTING INFORMATION

The principal author of this revenue ruling is James Polfer of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this revenue ruling, contact Mr. Polfer at (202) 622–3970 (not a toll-free call).

Section 72.—Annuities; Certain Proceeds of Endowment and Life Insurance Contracts

Under the facts stated below, is a direct transfer of a portion of the cash surrender value of an existing annuity contract for a new annuity contract issued by a second insurance company a tax-free exchange under section 1035 of the Internal Revenue Code. See Rev. Rul. 2003-76, page 355.

A revenue ruling describes the tax treatment of a cash distribution made in connection with a reduction

in the benefits of a life insurance contract. See Rev. Rul. 2003-95, page 358.

Notice addresses the taxation of certain tax-free exchanges of annuity contracts under section 72(e) and section 1035 of the Internal Revenue Code. This notice announces that Treasury and the Service are considering whether to exercise the authority granted under section 72(e)(11) to promulgate regulations that would prescribe the tax treatment of these transactions. See Notice 2003-51, page 361.

Section 129.—Dependent Care Assistance Programs

A child attains an age on his or her birthday for purposes of sections 21 (child and dependent care credit), 23 (adoption credit), 24 (child tax credit), 32 (earned income credit), 129 (excludable dependent care benefits), 131 (excludable foster care benefits), 137 (excludable adoption assistance benefits), and 151 (dependency exemptions). See Rev. Rul. 2003-72, page 346.

Section 131.—Certain Foster Care Payments

A child attains an age on his or her birthday for purposes of sections 21 (child and dependent care credit), 23 (adoption credit), 24 (child tax credit), 32 (earned income credit), 129 (excludable dependent care benefits), 131 (excludable foster care benefits), 137 (excludable adoption assistance benefits), and 151 (dependency exemptions). See Rev. Rul. 2003-72, page 346.

Section 137.—Adoption Assistance Programs

A child attains an age on his or her birthday for purposes of sections 21 (child and dependent care credit), 23 (adoption credit), 24 (child tax credit), 32 (earned income credit), 129 (excludable dependent care benefits), 131 (excludable foster care benefits), 137 (excludable adoption assistance benefits), and 151 (dependency exemptions). See Rev. Rul. 2003-72, page 346.

Section 151.—Allowance of Deductions for Personal Exemptions

26 CFR 1.151–2: Additional exemptions for dependents.

A child attains an age on his or her birthday for purposes of sections 21 (child and dependent care credit), 23 (adoption credit), 24 (child tax credit), 32 (earned income credit), 129 (excludable dependent care benefits), 131 (excludable foster care benefits), 137 (excludable adoption assistance benefits), and 151 (dependency exemptions). See Rev. Rul. 2003-72, page 346.

Section 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of August 2003. See Rev. Rul. 2003-94, page 357.

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

The adjusted applicable federal long-term rate is set forth for the month of August 2003. See Rev. Rul. 2003-94, page 357.

Section 412.—Minimum Funding Standards

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 2003. See Rev. Rul. 2003-94, page 357.

Section 461.—General Rule for Taxable Year of Deduction

26 CFR 1.461–1: General rule for taxable year of deduction.

Accrual of liability for California franchise tax. This ruling holds that, for federal income tax purposes, a taxpayer that uses an accrual method of accounting incurs a liability for California franchise tax in the taxable year following the taxable year in which the tax is incurred under the California Revenue and Tax Code. Rev. Rul. 79–410 amplified.

Rev. Rul. 2003–90

ISSUE

For taxable years beginning on or after January 1, 2000, when does a taxpayer using an accrual method of accounting incur a liability for California franchise tax for federal income tax purposes?

FACTS

X is a corporation that uses an accrual method of accounting and files its federal income tax return on a calendar year basis. X has conducted business in California continuously for several years and is required to pay a franchise tax imposed under § 23151 of the California Revenue & Taxation Code (Cal. Rev. & Tax. Code) (West 1998 & Supp. 2002). In 2002, X has net income attributable to California of $10,000. X remits payments of estimated California franchise tax of $884 during 2002. Under California law, X's franchise tax liability for 2002 is $884, determined on the basis of X's 2002 net income attributable to California of $10,000.

LAW AND ANALYSIS

Section 164(a) of the Internal Revenue Code allows a deduction for certain taxes paid or accrued during the taxable year including state franchise taxes imposed on corporations.

Section 461(a) provides that the amount of any deduction or credit is taken for the taxable year that is the proper taxable year under the method of accounting used in computing taxable income.

Section 1.461–1(a)(2)(i) of the Income Tax Regulations provides that under an accrual method of accounting, a liability is incurred in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. Section 1.461–4(g)(6)(i) generally provides that if the liability of a taxpayer is to pay a tax, economic performance occurs as the tax is paid to the governmental authority that imposed the tax.

However, § 461(d) provides that, in the case of a taxpayer whose taxable income is computed under an accrual method of accounting, to the extent the time for accruing a tax is earlier than it would have been but for any action of any taxing jurisdiction taken after December 31, 1960, the tax is to be treated as accruing at the time it would have accrued but for the action by the taxing jurisdiction. Section 1.461–1(d)(1) provides that any action by a taxing jurisdiction that results in the acceleration of the accrual of any tax is to be disregarded in determining the time for accruing the tax for purposes of the deduction allowed for the tax, with respect to both taxpayers upon which the tax is imposed at

the time of the action, and taxpayers upon which the tax is imposed at any time subsequent to the action.

Section 1.461–1(d)(1) further provides that, whenever an acceleration of the time for accruing a tax is to be disregarded, the taxpayer shall accrue the tax at the time the tax would have accrued but for the accelerating action (original accrual date). Section 1.461–1(d)(1) also provides that in the absence of any action of the taxing jurisdiction placing the time for accruing the tax at a time subsequent to the original accrual date, the taxpayer shall continue to accrue the tax as of the original accrual date for all future taxable years.

Section 1.461–1(d)(2)(iii) provides that the term "any action" includes the enactment or re-enactment of legislation, the adoption of an ordinance, the exercise of any taxing or administrative authority, or the taking of any other step, the result of which is an acceleration of the accrual event of any tax.

Cal. Rev. & Tax. Code § 23151 (West 1998 & Supp. 2002) imposes a franchise tax for the privilege of doing business as a corporation within California. For years beginning before January 1, 2000, the tax generally was measured by the net income of the year preceding the year for which the tax was imposed, subject to a minimum tax, with special rules for corporations commencing or ceasing business in California. Cal. Rev. & Tax. Code, § 23151.1 (West 1998 & Supp. 2002). The year in which the tax was imposed and payable was a corporation's "taxable year" ("California taxable year"). Cal. Rev. & Tax. Code § 23041(a) (West 1998 & Supp. 2002). The income year ("California income year") was defined as the "year upon the basis of which the net income is computed." Cal. Rev. & Tax. Code § 23042(a) (West 1998 & Supp. 2002). Thus, in the case of an ongoing corporation, the tax due for a California taxable year for the privilege of exercising the corporate franchise during the California taxable year was calculated based on the net income earned during the preceding year (the California income year).

Under pre-1961 California law, a corporation's liability for the franchise tax became fixed upon the corporation's exercise of the franchise in the California taxable year. *Central Investment Corporation v. Commissioner*, 9 T.C. 128 (1947), *aff'd* 167 F.2d 1000 (9th Cir. 1948). A corporation that ceased to do business in California had no liability to pay franchise tax measured by income earned in the final year of operation if the corporation did not exercise its franchise in the following California taxable year. Thus, under pre-1961 California law, a continuing corporation did not have a fixed liability to pay California franchise tax with respect to income earned in Year 1 (the California income year) until the corporation exercised its corporate franchise in Year 2 (the California taxable year). As a result, for purposes of § 1.461–1(a)(2), the corporation did not have a fixed liability in Year 1 for the California franchise tax with respect to income earned in Year 1, but rather the liability for California franchise tax with respect to income earned in Year 1 became fixed in Year 2, when the corporation exercised its corporate franchise. See *Hallmark Cards , Inc. v. Commissioner*, 90 T.C. 26 (1988).

Rev. Rul. 79–410, 1979–2 C.B. 213, addresses the timing of the deduction for California franchise tax liabilities and the application of § 461(d) to California law for years after 1972. Amendments to California law in 1971 and 1972 required a corporation ceasing to do business after December 31, 1972, to pay a franchise tax in its final year of operation based upon both the preceding year's net income and the net income earned in the corporation's final year. The ruling concludes that the 1971 and 1972 amendments caused the liability for California franchise tax to become fixed for purposes of § 1.461–1(a)(2) in the California income year. However, because the fixing of the liability in the California income year was earlier than when the liability became fixed under pre-1961 California law, the ruling concludes that, pursuant to § 461(d), the amendments are disregarded and the liability continues to be incurred for federal income tax purposes in the California taxable year, the taxable year in which the liability became fixed under pre-1961 California law. See also *Epoch Food Service, Inc. v. Commissioner*, 72 T.C. 1051, 1054 (1979).

For taxable years beginning on or after January 1, 2000, the Cal. Rev. & Tax. Code was amended to replace references to the term "income year" with the term "taxable year" ("redefined California taxable year"). Cal. Rev. & Tax. Code § 23042(b) (West Supp. 2002). As a result, the California franchise tax is measured by the net income of the year in which the tax is imposed and payable. Cal. Rev. & Tax. Code § 23151.1(c)(2) (West Supp. 2002). The transition year (2000) was the California taxable year under the former law with respect to income earned in 1999, and also the redefined California taxable year under the amendment for income earned in the first taxable year beginning on or after January 1, 2000. The accompanying legislative history states, however, that there was no intent to change the amount of tax or the timing of payment. See 2000 Cal. Stat. 862 (Sept. 29, 2000).

Under § 1.461–1(a)(2)(i), the liability for California franchise tax is established and the amount can be determined with reasonable accuracy in the taxable year that the net income is earned. However, when compared to pre-1961 California law, the 2000 amendment to the California law, like the 1971 and 1972 amendments, accelerates the accrual of the franchise tax for a continuing corporation from the taxable year following the taxable year in which the net income is earned to the taxable year in which the net income is earned. Thus, pursuant to § 461(d), the 2000 amendment must be disregarded and the liability for California franchise tax continues to be incurred for federal income tax purposes in the California taxable year, the taxable year in which the liability became fixed under pre-1961 California law.

Therefore, for taxable years beginning on or after January 1, 2000, X incurs a liability for California franchise tax for federal income tax purposes in the taxable year that follows the taxable year in which X earns the income on which the tax is measured. The California franchise tax of $884 that X pays in 2002, based on the $10,000 of net income that X earns in 2002, is deductible on X's federal income tax return for taxable year 2003.

HOLDING

For taxable years beginning on or after January 1, 2000, a taxpayer that uses an accrual method of accounting incurs a liability for California franchise tax for federal income tax purposes in the taxable year following the taxable year in which the

California franchise tax is incurred under the Cal. Rev. & Tax. Code, as amended.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 79–410 is amplified.

DRAFTING INFORMATION

The principal author of this revenue ruling is Sean M. Dwyer of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Mr. Dwyer at (202) 622–5020 (not a toll-free number).

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

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 2003. See Rev. Rul. 2003-94, page 357.

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

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 2003. See Rev. Rul. 2003-94, page 357.

Section 482.—Allocation of Income and Deductions Among Taxpayers

Federal short-term, mid-term, and long-term rates are set forth for the month of August 2003. See Rev. Rul. 2003-94, page 357.

Section 483.—Interest on Certain Deferred Payments

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 2003. See Rev. Rul. 2003-94, page 357.

Section 642.—Special Rules for Credits and Deductions

Federal short-term, mid-term, and long-term rates are set forth for the month of August 2003. See Rev. Rul. 2003-94, page 357.

Section 807.—Rules for Certain Reserves

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 2003. See Rev. Rul. 2003-94, page 357.

Section 817.—Treatment of Variable Contracts

A revenue ruling describes the tax treatment of the assets in a variable contract's segregated asset account. See Rev. Rul. 2003-91, page 347.

A revenue ruling describes the tax treatment of the assets in a variable contract's segregated asset account. See Rev. Rul. 2003-92, page 350.

Section 846.—Discounted Unpaid Losses Defined

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 2003. See Rev. Rul. 2003-94, page 357.

Section 856.—Definition of Real Estate Investment Trust

If a REIT leases space to a joint venture that includes a taxable REIT subsidiary of the REIT, do payments to the REIT from the joint venture qualify as rents from real property under section 856(d) of the Internal Revenue Code. See Rev. Proc. 2003-66, page 364.

Section 1031.—Exchange of Property Held for Productive Use or Investment

Under the facts stated below, is a direct transfer of a portion of the cash surrender value of an existing annuity contract for a new annuity contract issued by a second insurance company a tax-free exchange under section 1035 of the Internal Revenue Code. See Rev. Rul. 2003-76, page 355.

Notice addresses the taxation of certain tax-free exchanges of annuity contracts under section 72(e) and section 1035 of the Internal Revenue Code. This notice announces that Treasury and the Service are considering whether to exercise the authority granted under section 72(e)(11) to promulgate regulations that would prescribe the tax treatment of these transactions. See Notice 2003-51, page 361.

Section 1035.—Certain Exchanges of Insurance Policies

26 CFR 1.1035–1: Certain exchanges of insurance policies.
(Also Part I, §§ 72, 1031.)

Exchange of a portion of annuity contract. An exchange of a portion of an annuity contract into a new annuity contract is treated as a tax-free exchange under section 1035 of the Code. Investment in the contract and basis are allocated according to cash value immediately prior to the exchange using the rules of sections 72 and 1031.

Rev. Rul. 2003–76

ISSUES

Under the facts stated below, is a direct transfer of a portion of the cash surrender value of an existing annuity contract for a new annuity contract issued by a second insurance company a tax-free exchange under § 1035 of the Internal Revenue Code? What is the basis under § 1035 and the investment in the existing contract under § 72 after the transfer? What is the basis under § 1035 and the investment in the new annuity contract under § 72?

FACTS

A owns Contract B, an annuity contract issued by Company B. A is the obligee under Contract B. A contracts with Insurance Company C to issue Contract C, a new annuity contract. A assigns 60 percent of the cash surrender value of Contract B to Company C to be used to purchase Contract C. At no time during the transaction does A have access to the cash surrender value of Contract B that is transferred by Company B to Company C and used to purchase Contract C. No consideration other than the cash surrender value of Contract B that is transferred from Company B to Company C will be paid in this transaction. The terms of Contract B are unchanged by this transaction, and Contract B is not treated as newly issued.

LAW AND ANALYSIS

Section 1035(a)(3) provides that no gain or loss shall be recognized on the

exchange of an annuity contract for an annuity contract. Section 1.1035–1 of the Income Tax Regulations provides that the exchange, without recognition of gain or loss, of an annuity contract for another annuity contract under § 1035(a)(3) is limited to cases in which the same person or persons are the obligee or obligees under the contract received in the exchange as under the original contract.

The legislative history of § 1035 states that exchange treatment is appropriate for "individuals who have merely exchanged one insurance policy for another better suited to their needs and who have not actually realized gain." H.R. Rep. No. 1337, 83d Cong., 2d Sess. 81 (1954). In *Conway v. Commissioner*, 111 T.C. 350 (1998), *acq*., 1999–2 C.B. xvi, the Tax Court held that the direct exchange by an insurance company of a portion of an existing annuity contract to an unrelated insurance company for a new annuity contract was a tax-free exchange under § 1035. In that case, the transfer was made directly from the first insurance company to the unrelated insurance company, and none of the assets transferred in the transaction were received by the taxpayer.

Section 1035(d)(2) references § 1031 for the rules to determine the basis of property acquired in a § 1035 exchange. Section 1031(d) provides that property acquired in a § 1035 exchange has the same basis as that of the property exchanged, decreased by the amount of any money received by the taxpayer and increased by any gain (or decreased by any loss) recognized by the taxpayer on the exchange.

Section 1.1031(d)–1 provides, in part, that in a § 1035 exchange the basis of the property acquired is the same as the basis of the property transferred by the taxpayer with proper adjustments to the date of the exchange. Section 1.1031(j)–1(c) provides that, in the case of a multiple exchange of properties, the basis of properties received is the "aggregate adjusted basis of the properties transferred," which is then "allocated proportionately to each property received in the transaction." *Cf.* Section 1.1031(j)–1(d) ex. 5 (the basis of a single property transferred in a non-recognition transaction is allocated on a *pro rata* basis to the two properties received in the transaction). Section 1.61–6(a) echoes the allocation rule of § 1.1031(d)–1, providing that when a part of a larger property is sold, the basis of the entire property is equitably apportioned among the parts, and the gain realized or loss sustained on the part sold is the difference between the selling price and the basis allocated to such part.

Section § 72 governs the federal tax treatment of distributions from an annuity contract. When amounts received are not annuity payments, § 72(e)(6) defines the investment in the contract. (For purposes of § 72(b), which applies to annuity payments, § 72(c)(1) defines the investment in the contract in a similar, but not identical, manner). Section 72(e) sets forth rules regarding the tax treatment of distributions from annuity contracts. Under § 72(e)(2), distributions that are not amounts received as an annuity, including withdrawals and partial surrenders, result in income to the contract holder to the extent of the earnings in the contract and then in a recovery of the contract holder's investment in the contract.

After completion of the transaction, A still owns original Contract B, reduced in value to reflect the cash surrender value transferred to Company C for Contract C. A also owns new Contract C. Because the funds were transferred by Company B directly to Company C, A had no access to the funds during the transaction other than in the form of annuity contracts. Therefore, the transfer of a portion of Contract B to Company C for new Contract C is a tax-free exchange under § 1035. The continued existence of Contract B with its reduced cash value does not affect the tax-free character of the exchange.

Under § 1035(d), A's basis in Contract B immediately before the exchange is allocated ratably between Contract B and Contract C based on the percentage of the cash value retained in Contract B and the percentage of the cash value transferred to purchase Contract C. A's investment in Contract B immediately before the exchange is allocated ratably between Contract B and Contract C based on the percentage of the cash value retained in Contract B and the percentage of the cash value transferred to purchase Contract C.

HOLDINGS

(1) The direct transfer by A of a portion of the cash surrender value of Contract B to Company C for Contract C is a tax-free exchange under § 1035.

(2) After the transaction, pursuant to § 1035, A's basis in Contract C equals 60 percent of A's basis in Contract B immediately before the exchange. After the transaction, A's basis in Contract B equals 40 percent of A's basis in Contract B immediately before the exchange.

(3) After the transaction, pursuant to § 72, A's investment in Contract C equals 60 percent of A's investment in Contract B immediately before the exchange. After the transaction, A's investment in Contract B equals 40 percent of A's investment in Contract B immediately before the exchange.

TREATMENT OF CERTAIN PARTIAL EXCHANGES

Treasury and the Internal Revenue Service (the Service) are concerned that some taxpayers may enter into a partial exchange of a portion of one annuity contract for a new annuity contract as a means of reducing or avoiding tax that would otherwise be imposed under § 72(e). On August 18, 2003, Treasury and the Service published Notice 2003–51, 2003–33 I.R.B. 361, which announced that Treasury and the Service are considering whether to exercise the authority granted under § 72(e)(11) to promulgate regulations that would prescribe the tax treatment of these transactions. Notice 2003–51 provides interim guidance regarding the tax treatment of these transactions. Finally, Notice 2003–51 requests comments regarding the appropriate application of § 72(e)(11) to these transactions. Taxpayers should review Notice 2003–51 prior to entering into a partial exchange to determine whether their transaction is subject to the interim guidance provided by the notice.

DRAFTING INFORMATION

The principal author of this revenue ruling is Ann H. Logan of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this revenue ruling, contact her at (202) 622–3970 (not a toll-free call).

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

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

Federal rates; adjusted federal rates; adjusted federal long-term rate and the long-term exempt rate. For purposes of sections 382, 1274, 1288, and other sections of the Code, tables set forth the rates for August 2003.

Rev. Rul. 2003–94

This revenue ruling provides various prescribed rates for federal income tax purposes for August 2003 (the current month). Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Finally, Table 5 contains the federal rate for determining the present value of annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520.

REV. RUL. 2003–94 TABLE 1

Applicable Federal Rates (AFR) for August 2003

Period for Compounding

	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	1.21%	1.21%	1.21%	1.21%
110% AFR	1.33%	1.33%	1.33%	1.33%
120% AFR	1.46%	1.45%	1.45%	1.45%
130% AFR	1.58%	1.57%	1.57%	1.56%
Mid-Term				
AFR	2.70%	2.68%	2.67%	2.67%
110% AFR	2.97%	2.95%	2.94%	2.93%
120% AFR	3.25%	3.22%	3.21%	3.20%
130% AFR	3.51%	3.48%	3.46%	3.46%
150% AFR	4.06%	4.02%	4.00%	3.99%
175% AFR	4.74%	4.69%	4.66%	4.64%
Long-Term				
AFR	4.36%	4.31%	4.29%	4.27%
110% AFR	4.80%	4.74%	4.71%	4.69%
120% AFR	5.24%	5.17%	5.14%	5.12%
130% AFR	5.68%	5.60%	5.56%	5.54%

REV. RUL. 2003–94 TABLE 2

Adjusted AFR for August 2003

Period for Compounding

	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted *AFR*	1.08%	1.08%	1.08%	1.08%
Mid-term adjusted *AFR*	2.37%	2.36%	2.35%	2.35%
Long-term adjusted *AFR*	4.12%	4.08%	4.06%	4.05%

REV. RUL. 2003–94 TABLE 3

Rates Under Section 382 for August 2003

Adjusted federal long-term rate for the current month	4.12%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the month and the prior two months.)	4.35%

REV. RUL. 2003–94 TABLE 4

Appropriate Percentages Under Section 42(b)(2) for August 2003

Appropriate percentage for the 70% present value low-income housing credit	7.82%
Appropriate percentage for the 30% present value low-income housing credit	3.35%

REV. RUL. 2003–94 TABLE 5

Rate Under Section 7520 for August 2003

Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest	3.2%

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

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 2003. See Rev. Rul. 2003-94, page 357.

Section 7520.—Valuation Tables

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 2003. See Rev. Rul. 2003-94, page 357.

Section 7702.—Life Insurance Contract Defined

(Also Section 72.)

Life insurance contracts; distributions made in connection with a change in benefits. This ruling describes the rules of section 7702(f)(7) of the Code regarding the tax treatment of a cash distribution made in connection with a reduction in the benefits of a life insurance contract.

Rev. Rul. 2003–95

ISSUE

How is a cash distribution upon a change in the benefits of a life insurance contract taxed under § 7702(f)(7) of the Internal Revenue Code?

FACTS

Situation 1. In Year 1, *A* purchased a life insurance contract with a $350,000 death benefit. The contract is a life insurance contract under applicable state law and meets the cash value accumulation test prescribed in § 7702(a)(1) and § 7702(b). The contract is not a “modified endowment contract” as defined in § 7702A.

Through the end of Year 4, *A* paid total premiums of $45,000 with regard to the contract. At the end of the Year 4, when the cash surrender value of the contract was $60,000, *A* surrendered 60% of the contract and received a cash distribution of $36,000. The death benefit under the contract decreased to $140,000 as a result of the partial surrender. Based on *A*'s age at the time of the partial surrender,

the net single premium (determined under § 7702(b)) was $355 per $1000 of insurance coverage.

Situation 2. Same facts as Situation 1, except that the contract qualifies as a life insurance contract using the guideline premium/cash value corridor test of §§ 7702(a)(2), 7702(c), and 7702(d) rather than the cash value accumulation test. When the contract was issued, the guideline premium limitation was $80,500. Immediately after the partial surrender, the guideline premium limitation (determined under § 7702(c)(3)) was $265 per $1000 of insurance coverage and the cash value corridor percentage (determined under § 7702(d)) was 185.

Situation 3. Same facts as Situation 2, except that the partial surrender occurred 6 years after the issuance of the contract.

LAW AND ANALYSIS

Section 7702(f)(7)(B) provides that if the benefits under a life insurance contract are reduced during the 15-year period beginning on the issue date of the contract and a cash distribution is made to the policyholder as a result of the reduction in benefits, then § 72(e) (other than subsection (e)(5) thereof) applies to the portion of the cash distribution that does not exceed the applicable recapture ceiling. Under § 72(e)(2)(B), a distribution is included in gross income to the extent of the income on the contract. Income on the contract is the amount by which the contract's cash value (determined without regard to any surrender charge) immediately before the distribution exceeds the policyholder's investment in the contract (determined under § 72(e)(6)) at such time. *See* § 72(e)(3)(A). Accordingly, under § 7702(f)(7)(B), the gross income of a policyholder receiving a cash distribution upon a reduction in the benefits during the 15 year period following the issue date of the contract includes an amount equal to the lesser of— (i) the applicable recapture ceiling, (ii) the income on the contract, or (iii) the amount of the distribution. To the extent the distribution exceeds the amount included in gross income, the excess is treated as a tax-free recovery of investment in the contract. *See* § 72(e)(2)(B).

The applicable recapture ceiling under § 7702(f)(7) varies depending on when the reduction in benefits occurs and on which of the § 7702 tests is used to qualify the contract as a life insurance contract for federal tax purposes.

If the reduction in benefits occurs during the 5-year period beginning on the issue date of the contract and the contract qualifies as a life insurance contract by satisfying the cash value accumulation test, then § 7702(f)(7)(C)(i) provides that the applicable recapture ceiling equals the excess of— (1) the cash surrender value of the contract immediately before the reduction in benefits, over (2) the net single premium (determined under § 7702(b)) for the contract immediately after the reduction in benefits. If the contract qualifies as a life insurance contract under the guideline premium/cash value corridor test, then § 7702(f)(7)(C)(ii) provides that the applicable recapture ceiling is the greater of—

(1) the excess of— (A) the aggregate premiums paid under the contract immediately before the reduction in the contract's benefits, over (B) the adjusted guideline premium limitation for the contract; or

(2) the excess of— (A) the cash surrender value of the contract immediately before the reduction in the contract's benefits, over (B) the maximum cash value permitted under the cash value corridor of § 7702(d) immediately after the reduction of the contract's benefits.

The first and third of the four amounts required for this calculation, the aggregate premiums paid under the contract immediately before the reduction in the contract's benefits and the cash surrender value, are known facts. The second amount, the adjusted guideline premium limitation for the contract, is calculated by subtracting from the original guideline premium limitation a guideline premium limitation (determined under § 7702(c)(2)) for the decrease in the contract's benefits. The guideline premium limitation is determined as of the date of the reduction in benefits using the attained age of the insured on that date. S. Rep. No. 313, 99th Cong. 2d Sess. 989 (1986); 1986–3 (Vol. 3) C.B. 989. The fourth amount, the maximum cash value permitted under the cash value corridor of § 7702(d) immediately after the reduction of the contract's benefits, is calculated by dividing the death benefit of the contract immediately after the reduction by the applicable percentage set forth in § 7702(d).

If the reduction in benefits occurs more than 5 years but less than 16 years after the contract's issue date, a single recapture ceiling applies to all contracts. The recapture ceiling equals the excess of— (1) the cash surrender value of the contract immediately before the reduction, over (2) the maximum cash value that would be permitted under the cash value corridor of § 7702(d) immediately after the reduction of the contract's benefits. *See* § 7702(f)(7)(D).

In *Situation 1*, *A* received a $36,000 cash distribution upon the surrender of 60% of the benefits under the life insurance contract. Immediately before the surrender, the income on the contract was $15,000 [$60,000 − $45,000 = $15,000].

The partial surrender reduced the death benefit under *A*'s contract from $350,000 to $140,000. As the reduction in the benefits occurred within the 5-year period beginning on the issue date of the contract and the contract qualifies as a life insurance contract under the cash value accumulation test, the applicable recapture ceiling is determined under § 7702(f)(7)(C)(i). The recapture ceiling is the excess of the contract's $60,000 cash surrender value immediately before the reduction in benefits over the net single premium for the contract immediately after the reduction in benefits. On the date of the reduction in benefits, the net single premium was $355 per $1000 of insurance coverage. The net single premium for the contract's reduced death benefit was $49,700 [$140,000 × $355 ÷ $1,000 = $49,700]. The recapture ceiling, therefore, was $10,300 [$60,000 − $49,700 = $10,300].

Pursuant to § 7702(f)(7)(B), *A*'s gross income includes the portion of the distribution equal to the lesser of— (i) the applicable recapture ceiling ($10,300), (ii) the income on the contract ($15,000), or (iii) the amount of the distribution ($36,000). Accordingly, $10,300 is included in *A*'s gross income. The remaining $25,700 of the distribution is treated, under § 72(e)(5), as a return of a portion of the *A*'s $45,000 investment in the contract. *A*'s investment in the contract immediately after the partial surrender is $19,300 [$45,000 − $25,700 = $19,300]. *See* § 72(e)(6).

In *Situation 2*, the reduction in the benefits under *A*'s life insurance contract also occurred within the 5-year period beginning on the issue date of the contract. However, because the contract qualifies

as a life insurance contract using the guideline premium/cash value corridor test, the applicable recapture ceiling under § 7702(f)(7)(C)(ii) is the greater of—

(1) the excess of— (A) the aggregate premiums paid under the contract immediately before the reduction in the contract's benefits, over (B) the adjusted guideline premium limitation for the contract; or

(2) the excess of— (A) the cash surrender value of the contract immediately before the reduction in the contract's benefits, over (B) the maximum cash value permitted under the cash value corridor of § 7702(d) immediately after the reduction of the contract's benefits.

A paid aggregate premiums of $45,000 under the contract prior to the reduction of the contract's benefits. The adjusted guideline premium limitation for the contract immediately after the reduction of benefits is calculated by subtracting from the $80,500 original guideline premium limitation a guideline premium limitation for the amount of the decrease in the contract's death benefit. The partial surrender resulted in a $210,000 decrease in the death benefit under *A*'s contract. Immediately after the reduction in benefits, the guideline premium limitation was $265 per $1000 of insurance coverage. The guideline premium for the decrease in death benefits was $55,650 [$210,000 × $265 ÷ $1,000 = $55,650]. The adjusted guideline premium limitation for the contract immediately after the reduction in benefits, therefore, was $24,850 [$80,500 – $55,650 = $24,850]. The excess of the aggregate premiums paid under the contract over the adjusted guideline premium limitation was $20,150 [$45,000 – $24,850 = $20,150].

The cash surrender value of *A*'s contract immediately before the reduction in benefits was $60,000. Immediately after the reduction of benefits, the cash value corridor of § 7702(d) requires the contract's death benefit to be at least 185% of the contract's cash surrender value. The partial surrender reduced the contract's death benefit to $140,000. The maximum cash value permitted under the cash value corridor requirement, therefore, was $75,675 [$140,000 ÷ 1.85 = $75,675]. The cash surrender value of *A*'s contract immediately before the reduction in the contract's benefits was less than the maximum cash value permitted under the cash value corridor of § 7702(d) immediately after the reduction in benefits.

As the $20,150 excess of the aggregate premiums paid under the contract over the adjusted guideline premium limitation was greater than the $0 excess of the cash surrender value of the contract immediately before the reduction in the contract's benefits over the maximum cash value permitted under the cash value corridor immediately after the reduction of the contracts benefits, the recapture ceiling was $20,150.

Pursuant to § 7702(f)(7)(B), *A*'s gross income includes the portion of the distribution equal to the lesser of— (i) the applicable recapture ceiling ($20,150), (ii) the income on the contract ($15,000), or (iii) the amount of the distribution ($36,000). Accordingly, $15,000 is included in *A*'s gross income. The remaining $21,000 of the distribution is treated, under § 72(e)(5), as a return of a portion of the *A*'s $45,000 investment in the contract. *A*'s investment in the contract immediately after the partial surrender is $24,000 [$45,000 – $21,000 = $24,000].

In *Situation 3*, the reduction in the benefits under *A*'s life insurance contract occurred more than 5 years but less than 16 years after the contract's issue date. Under § 7702(f)(7)(D), the recapture ceiling equals the excess of— (1) the cash surrender value of the contract immediately before the reduction, over (2) the maximum cash value that would be permitted under the cash value corridor of § 7702(d) immediately after the reduction of the contracts benefits.

The cash surrender value of *A*'s contract immediately before the reduction in benefits was $60,000. The maximum permitted cash value under the cash value corridor requirement immediately after the reduction of benefits was $75,675 [$140,000 ÷ 1.85 = $75,675]. As the $60,000 cash surrender value of *A*'s contract immediately before the reduction in the contract's benefits was less than the $75,675 maximum cash value permitted under the cash value corridor requirement immediately after the reduction in benefits, the excess was $0. The applicable recapture ceiling, therefore, was $0.

Pursuant to section 7702(f)(7)(B), *A*'s gross income includes the portion of the distribution equal to the lesser of— (i) the applicable recapture ceiling ($0), (ii) the income on the contract ($15,000), or (iii) the amount of the distribution ($36,000). Accordingly, none of the $36,000 distribution is included in *A*'s gross income. The entire distribution is treated, under § 72(e)(5), as a return of a portion of the *A*'s $45,000 investment in the contract. *A*'s investment in the contract immediately after the partial surrender is $9,000 [$45,000 – $36,000 = $9,000].

HOLDING

In *Situation 1*, $10,300 of the cash distribution is included in *A*'s gross income. The remaining $25,700 of the distribution is treated as a return of a portion of the *A*'s $45,000 investment in the contract, which reduces *A*'s investment in the contract to $19,300.

In *Situation 2*, $15,000 of the cash distribution is included in *A*'s gross income. The remaining $21,000 of the distribution is treated as a return of a portion of the *A*'s $45,000 investment in the contract, which reduces *A*'s investment in the contract to $24,000.

In *Situation 3*, none of the cash distribution is included in *A*'s gross income. The entire $36,000 of the distribution is treated as a return of a portion of the *A*'s $45,000 investment in the contract, which reduces *A*'s investment in the contract to $9,000.

DRAFTING INFORMATION

The principal author of this revenue ruling is Stephen Hooe of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this revenue ruling, contact Kay Hossofsky at (202) 622–3970 (not a toll-free call).

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

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 2003. See Rev. Rul. 2003-94, page 357.

Part III. Administrative, Procedural, and Miscellaneous

Section 1035.—Certain Exchanges of Insurance Policies

Notice 2003–51

SECTION 1—PURPOSE

This notice addresses the taxation of certain tax-free exchanges of annuity contracts under § 72(e) and § 1035 of the Internal Revenue Code. This notice announces that Treasury and the Service are considering whether to exercise the authority granted under § 72(e)(11) to promulgate regulations that would prescribe the tax treatment of these transactions. This notice provides interim guidance regarding the tax treatment of these transactions. Finally, this notice requests comments regarding the appropriate application of § 72(e)(11) to these transactions.

SECTION 2—BACKGROUND

Section 1035(a)(3) provides that no gain or loss shall be recognized on the exchange of an annuity contract for another annuity contract. Section 1.1035–1 of the Income Tax Regulations provides that "the exchange, without recognition of gain or loss, of an annuity contract for another annuity contract under § 1035(a)(3) is limited to cases where the same person or persons are the obligee or obligees under the contract received in the exchange as under the original contract."

The legislative history of § 1035 states that exchange treatment is appropriate for "individuals who have merely exchanged one insurance policy for another better suited to their needs and who have not actually realized gain." H.R. Rep. No. 1337, 83d Cong., 2d Sess. 81 (1954). In *Conway v. Commissioner*, 111 T.C. 350 (1998), *acq*., 1999–2 C.B. xvi, the Tax Court held that the direct exchange by an insurance company of a portion of an existing annuity contract to an unrelated insurance company for a new annuity contract was a tax-free exchange under § 1035. In that case, the transfer was made directly from the first insurance company to the unrelated insurance company, and none of the assets transferred in the transaction were received by the taxpayer.

Section 1035(d)(2) cross-references § 1031 for the rules to determine the basis of property acquired in a § 1035 exchange. Section 1031(d) provides that property acquired in a § 1035 exchange has the same basis as that of the property exchanged, decreased by the amount of any money received by the taxpayer and increased by any gain (or decreased by any loss) recognized by the taxpayer on the exchange. Revenue Ruling 2003–76, 2003–33 I.R.B. 355, addresses a transaction in which a taxpayer transfers a portion of the cash value of an existing contract to a new insurance company in exchange for a new annuity contract (commonly referred to as "partial exchanges"). Rev. Rul. 2003–76 holds that the basis under § 1031 and investment in the contract under § 72 of the surviving contract immediately before the exchange is allocated ratably between the surviving contract and the newly issued contract.

Section 72(e) governs the federal tax treatment of distributions from an annuity contract. Section 72(e)(11) provides anti-abuse rules applicable to transactions governed by § 72(e). Section 72(e)(11)(B) grants the Secretary broad authority to publish regulations as necessary "to prevent avoidance of the purposes of [§ 72(e)]."

Section 72(q)(1) imposes a 10 percent penalty on withdrawals from, or surrenders of, annuity contracts. Section 72(q)(2) provides that distributions from an annuity contract will not be subject to the 10 percent penalty if the distribution is made after the taxpayer attains age 59-1/2, if the distribution is made on or after the death of the annuity holder, if the distribution is attributable to the taxpayer's becoming disabled, or if other conditions not relevant here are satisfied.

SECTION 3—TREATMENT OF CERTAIN PARTIAL EXCHANGES

Treasury and the IRS are concerned that some taxpayers may enter into a transaction similar to the transaction at issue in *Conway* (commonly referred to as a "partial exchange") to reduce or avoid the tax that would otherwise be imposed by § 72(e)(2). For example, if a taxpayer withdraws $100 from an annuity contract with a cash surrender value of $200 and investment in the contract of $80, the entire $100 of the withdrawal would be included in income pursuant to § 72(e)(2). However, if that same taxpayer assigned 50 percent of the cash surrender value of the annuity contract in a partial exchange, such that the cash surrender value of each contract after the exchange was $100 and the investment in each contract after the exchange was $40, and then surrendered either the existing annuity contract or the new annuity contract, under § 72(e)(2) only $60 would be included in income and $40 would be excluded as a return of investment in the contract.

Treasury and the Service are considering whether to exercise the regulatory authority of § 72(e)(11) to address the transaction described above to assure that such transactions do not become a vehicle for avoiding the rules of § 72(e). In particular, Treasury and the Service are considering whether such regulations should provide rules for determining when a partial exchange of an annuity contract followed by the surrender of, or distributions from, either the surviving annuity contract or the new annuity contract should be presumed to have been entered into for tax avoidance purposes. Specifically, Treasury and the Service are considering whether to treat surrenders or distributions that occur within 24 months of the date on which the partial exchange was completed as presumptively entered into for tax avoidance purposes. However, Treasury and the Service believe that taxpayers should be provided the opportunity to rebut any presumption by demonstrating that the surrender or withdrawal was not contemplated at the time the partial exchange was completed. Treasury and the Service are considering whether to treat any surrender or distribution that is not subject to the 10 percent penalty tax imposed by § 72(q)(1) because it is described in § 72(q)(2) as successfully rebutting any presumption. In addition, Treasury and the Service are considering whether other events, such as the safe harbors set forth in § 1.121–3T(e), for divorce, loss of employment and other similar events, should be treated as successfully rebutting any presumption.

SECTION 4—INTERIM GUIDANCE

Pending the publication of final regulations, the Service, using general principles of tax law, will consider all the facts and circumstances to determine whether a partial exchange and a subsequent withdrawal from, or surrender of, either the surviving annuity contract or the new annuity contract within 24 months of the date on which the partial exchange was completed should be treated as an integrated transaction, and thus whether the two contracts should be viewed as a single contract to determine the tax treatment of a surrender or withdrawal under § 72(e). *See Helvering v. LeGeirse*, 312 U.S. 531 (1941) (concluding that, in substance, annuity contracts and the life insurance contracts purchased by the taxpayer were integrated contracts). However, if a taxpayer demonstrates that one of the conditions of § 72(q)(2), or any other similar life event, such as a divorce or the loss of employment, occurred between the partial exchange and the surrender or distribution, and that the surrender or distribution was not contemplated at the time of the partial exchange, the taxpayer will not be treated as having entered into the partial exchange and the surrender or distribution for tax avoidance purposes.

SECTION 5—REQUEST FOR COMMENTS

Treasury and the Service request comments regarding the need for regulations under § 72(e)(11) to prevent the use of partial exchange transactions as a means of avoiding the tax imposed by § 72(e). In addition, Treasury and the Service request comments regarding whether the principles outlined in Section 3 appropriately address Treasury's and the Service's concern without significantly limiting the ability of taxpayers to use partial exchanges to acquire annuity contracts that "are better suited to their needs" as contemplated by Congress. Treasury and the Service also request comments regarding any other similar transactions that any regulations under § 72(e)(11) should address.

DRAFTING INFORMATION

The principal author of this notice is Ann H. Logan of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this notice, contact her at (202) 622–3970 (not a toll-free call).

Coverdell Education Savings Accounts

Notice 2003–53

This notice provides guidance regarding certain reporting requirements and transition rules applicable to Coverdell Education Savings Accounts ("CESAs") described in section 530 of the Internal Revenue Code.

Section 530(h) provides that the trustee or custodian of a CESA shall make reports to the Secretary and to the beneficiary of the CESA with respect to contributions, distributions, and such other matters as the Secretary may require in the time and manner required by the Secretary.

For calendar years before 2003, CESA trustees and custodians were required to report on Form 1099–R (*Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*) gross distributions from CESAs during the calendar year, together with other information including the name, address and TIN of the beneficiary. For calendar years after 2002, CESA trustees and custodians are required to report on Form 1099–Q (*Payments From Qualified Education Programs (Under Sections 529 and 530)*) not only gross distributions from CESAs during the calendar year (as they did on Form 1099–R), but also the earnings and basis portions of the distributions, and certain other information. Gross distributions reportable on Form 1099–Q include transfers from the CESA trustee to a section 529 qualified tuition program (QTP) or to another CESA (trustee-to-trustee transfers).

The Internal Revenue Service (IRS) has received comments concerning changes to the reporting requirements for distributions from CESAs. Commentators have stated that a financial institution that acts as trustee or custodian of CESAs may not have collected historical account information that would enable the financial institution to determine the basis and earnings portions of gross distributions for a taxable year. Further, even if a financial institution has collected its own historical basis and earnings information for the CESAs it holds, the financial institution may not have the basis and earnings information for amounts that were transferred to the financial institution from CESAs managed by other financial institutions. Commentators also asked whether gross distributions required to be reported on Form 1099–Q include trustee-to-trustee transfers. Commentators indicated that the records of a financial institution that acts as trustee or custodian of CESAs may not establish whether a CESA distribution was sent to a CESA or QTP at another financial institution or directly to the beneficiary. Commentators requested additional time to allow financial institutions to implement appropriate recordkeeping and reporting procedures.

Modifications to reporting for 2003

The IRS is modifying the reporting requirements relating to CESAs. If a trustee or custodian is unable to calculate the earnings and basis portions of a gross distribution from a CESA made in 2003, the trustee or custodian will satisfy the reporting requirements of section 530(h) if the trustee or custodian provides in a timely manner a Form 1099–Q that includes:

- Gross distributions, including the amount of any excess contributions and earnings thereon distributed to a participant during the calendar year, in box 1;
- All other required information except for earnings and basis information in boxes 2 and 3, which should be left blank unless the gross distribution includes a distribution of earnings on excess contributions;
- The amount of any earnings on excess contributions in box 2, computed using the method for calculating the net income attributable to IRA contributions that are distributed as a returned contribution pursuant to section 408(d)(4) of the Code under Notice 2000–39, 2000–2 C.B. 132, and Proposed section 1.408–11, Income Tax Regulations;
- If earnings on excess contributions are reported in box 2, an indication in the

empty box below boxes 5 and 6 that the amount in box 2 includes earnings on excess contributions;

- The fair market value of the CESA (appropriately labeled) as of December 31, 2003, in the empty box below boxes 5 and 6; and
- A cross reference in the empty box below boxes 5 and 6 to Publication 970 (*Tax Benefits for Education*), as provided in the instructions to Form 1099–Q, so that recipients will know how to calculate the earnings portion of the gross distribution.

If the trustee or custodian does not have records indicating whether a gross distribution from a CESA made in 2003 was a trustee-to-trustee transfer, the trustee or custodian may leave box 4 of Form 1099–Q blank.

These modifications allow additional time for CESA trustees or custodians to implement recordkeeping procedures to enable them to report basis and earnings information, and to identify trustee-to-trustee transfers. The IRS expects to publish further guidance about required reporting for CESA distributions made in 2004 and future years. These modifications remain in effect until further guidance is issued. These modifications do not apply to QTPs, which are required to report distributions, including trustee-to-trustee transfers, in accordance with Notice 2001–81, 2001–2 C.B. 617.

Request for Comments

The IRS recognizes that to report basis and earnings information for 2004 and future years, trustees and custodians that have not previously collected this information with respect to existing CESAs will need to use information from various sources to establish basis and earnings. The IRS invites comments on sources of information that should be considered satisfactory for this purpose, including Forms 5498 (*IRA and Coverdell ESA Contribution Information*) filed by other trustees or custodians, account statements from financial institutions, and other forms of documentation. The IRS invites comments on an appropriate rule for determining basis and earnings if documentation is not available. The IRS also invites comments on other CESA reporting matters that may be appropriate for additional guidance.

Comments should reference Notice 2003–53. Please send written comments by October 17, 2003, to: CC:PA:RU (Notice 2003–53), 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 4 p.m. to CC:PA:RU (Notice 2003–53), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington DC. Comments may also be sent via e-mail to *notice.comments@irscounsel.treas.gov*. Comments will be available for public inspection.

DRAFTING INFORMATION

The principal author of this notice is Monice Rosenbaum of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this notice, contact Ms. Rosenbaum at (202) 622–6070 (not a toll-free number).

Common Trust Fund Straddle Tax Shelter

Notice 2003–54

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

FACTS

The transaction involves the use of a common trust fund (CTF) that invests in economically offsetting gain and loss positions in foreign currencies and allocates the gains to one or more tax indifferent parties and the losses to another taxpayer. For example, in the transaction, a bank (Bank) forms a CTF. The CTF's plan provides for monthly valuation dates and for the computation of income and loss on a monthly basis. Two tax indifferent investors, through grantor trusts (Investors' Trusts), each invest money in the CTF. The CTF then invests the money in economically offsetting positions in foreign currencies, which become offsetting gain and loss positions as a result of market price movements. The CTF sells the gain position and allocates the gain proportionately to the Investors' Trusts.

The next month, an investor (Taxpayer) who desires a tax loss uses a grantor trust (Taxpayer's Trust) to invest in the CTF. Taxpayer's Trust makes a large investment for an 80 percent share of the CTF. Consequently, the shares of the CTF's portfolio owned by the Investors' Trusts are diminished to 10 percent each. The CTF then sells the loss position. For tax purposes, the loss is allocated proportionately among Taxpayer's Trust and Investors' Trusts. Taxpayer's Trust is allocated 80 percent of the tax loss and Investors' Trusts are each allocated 10 percent of the tax loss under the accounting rules provided in § 1.584–2(c)(2) of the Income Tax Regulations.

ANALYSIS

The transaction described in this notice has been designed to use economically offsetting positions, one or more tax indifferent parties, and the CTF accounting rules of § 584 of the Internal Revenue Code to allow Taxpayer to claim a noneconomic loss. The Service intends to challenge the purported tax benefits from this transaction on a number of grounds.

The offsetting positions entered into by the CTF did not have any effect on the CTF's net economic position or non-tax objectives and did not serve any non-tax objectives of the CTF or afford it a reasonable prospect for profit. Therefore, the losses purportedly resulting from this transaction are not allowable. *See ACM Partnership v. Commissioner*, 157 F.3d 231, 260 (3d Cir. 1998), *cert. denied*, 526 U.S. 1017 (1999). In addition, the Service may disallow the loss of an individual under § 165(c)(2) by asserting that the loss was not incurred in a transaction undertaken for profit. *See Smith v. Commissioner*, 78 T.C. 350 (1982) and *Fox v.*

Commissioner, 82 T.C. 1001 (1984) (disallowing losses from straddle transactions). Further, the Service may, under appropriate circumstances, assert that the CTF does not meet the requirements of § 584, including the requirement that it be operated in conformity with the rules and regulations of the Comptroller of the Currency, as set forth in 12 CFR § 9.18 (2003). In that event, the Service will recharacterize such a CTF as a partnership and reallocate the gains and losses in accordance with the economics of the transaction and the interests of the participants. *See* § 704(b). In addition, the Service may challenge the allowance of the loss deduction based on other statutory provisions, including § 988, and judicial doctrines.

Transactions that are the same as, or substantially similar to, the transaction described in this notice are identified as "listed transactions" for purposes of § 1.6011–4(b)(2) of the Income Tax Regulations and §§ 301.6111–2(b)(2) and 301.6112–1(b)(2) of the Procedure and Administration Regulations. The transaction described in this notice and the transactions described in Notice 2002–50, 2002–28 I.R.B. 98 (Partnership Straddle Tax Shelter), and Notice 2002–65, 2002–41 I.R.B. 690 (Passthrough Entity Straddle Tax Shelter), are substantially similar transactions. For purposes of §§ 1.6011–4(b)(2), 301.6111–2(b)(2), and 301.6112–1(b)(2), a transaction will be considered the same as, or substantially similar to, the transaction described in this notice even if the gain and loss legs of the economically offsetting positions are triggered in separate taxable years, or a trust other than a grantor trust is used. Further, it should be noted that, independent of their classification as "listed transactions" for purposes of §§ 1.6011–4(b)(2), 301.6111–2(b)(2), and 301.6112–1(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 (§§ 1.6011–4, 301.6111–1T, 301.6111–2 and 301.6112–1).

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

The principal author of this notice is Tara P. Volungis of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice, contact Ms. Volungis at (202) 622–3080 (not a toll-free call).

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26 CFR 601.201: Rulings and determination letters. (Also Part I, § 856, 1.856–4.)

Rev. Proc. 2003–66

SECTION 1. PURPOSE

This revenue procedure describes conditions under which payments to a real estate investment trust (REIT) from a joint venture between a taxable REIT subsidiary of the REIT (TRS) and a third party that is not related either to the TRS or the REIT for space at a property owned by the REIT will be treated as rents from real property under § 856(d) of the Internal Revenue Code.

SECTION 2. BACKGROUND

.01 A TRS may form a joint venture with one or more third parties to provide services to tenants of the TRS' parent REIT. To facilitate the services that are provided to tenants, the joint venture may lease space at the property where it is providing services to tenants.

.02 To qualify as a REIT, an entity must derive at least 95 percent of its gross income from sources listed in § 856(c)(2) and at least 75 percent of its gross income from sources listed in § 856(c)(3). "Rents from real property" are among the sources listed in both of those sections.

.03 Section 856(d)(1) defines rents from real property (subject to exclusions provided in § 856(d)(2)) to include rents from interests in real property, charges for services customarily rendered in connection with the rental of real property, and rent attributable to certain leased personal property.

.04 Section 856(d)(2)(B) provides, in part, that except as provided in § 856(d)(8), the term "rents from real property" does not include any amount received or accrued directly or indirectly from any person if the REIT owns, directly or indirectly: (i) in the case of any person that is a corporation, stock of such person possessing 10 percent or more of the total combined voting power of all classes of stock entitled to vote, or 10 percent or more of the total value of shares of all classes of stock of such person; or (ii) in the case of any person that is not a corporation, an interest of 10 percent or more in the assets or net profits of such person. Section 856(d)(5) provides that for purposes of § 856(d), the rules prescribed in section 318(a) apply for determining the ownership of stock, assets, or net profits of any person, except as modified by subparagraphs (A) and (B) of §856(d)(5).

.05 Section 856(d)(8)(A) provides that amounts paid to a REIT by a TRS shall not be excluded from rents from real property by reason of § 856(d)(2)(B) if at least 90 percent of the leased space of the property is rented to persons other than TRSs of the REIT and other than related parties described in § 856(d)(2)(B), but only to the extent that the amounts paid to the REIT by the TRS as rents from real property are substantially comparable to such rents paid by the other tenants of the REIT's property for comparable space.

SECTION 3. SCOPE

This revenue procedure applies to a REIT that leases space to a joint venture between a TRS of the REIT and a third party that is unrelated to either the TRS or the REIT and is treated as a partnership for federal income tax purposes, if the REIT would be treated under §856(d)(2) as having an interest of 10 percent or more in the assets or net profits of the joint venture.

SECTION 4. PROCEDURE

The Internal Revenue Service will treat rents from a joint venture that qualifies under Section 3 of this revenue procedure as rents from real property if amounts paid to the REIT by the joint venture as rents from real property are substantially comparable to such rents paid by the other tenants of the REIT's property for comparable space and at least 90 percent of the leased space of the REIT's property is rented to persons other than (i) TRSs of the REIT and (ii) related parties described in § 856(d)(2)(B) (including joint ventures that qualify under Section 3 of this revenue procedure).

SECTION 5. EFFECTIVE DATE

This revenue procedure is effective for leases in effect or entered into on or after January 1, 2001.

DRAFTING INFORMATION

The principal author of this revenue procedure is Jonathan D. Silver of the Office of the Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue procedure, contact Mr. Silver at (202) 622–3920 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking and Notice of Public Hearing

Section 42 Carryover and Stacking Rule Amendments

REG–131997–02

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations that amend several existing regulations concerning the low-income housing tax credit. These proposed regulations primarily reflect changes to the law made by the Community Renewal Tax Relief Act of 2000 and affect owners of low-income housing projects who claim the credit and the State or local housing credit agencies who administer the credit. This document also contains a notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments, requests to speak, and outlines of topics to be discussed at the public hearing scheduled for September 23, 2003, must be received by September 5, 2003.

ADDRESSES: Send submissions to: CC:PA:RU (REG–131997–02), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:PA:RU (REG–131997–02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC.

Alternatively, taxpayers may submit comments electronically directly to the IRS Internet site at *www.irs.gov/regs*. The public hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Lauren R. Taylor, (202) 622–3040, or Christopher J. Wilson, (808) 539–2874; concerning submission of comments, the hearing, or to be placed on the building access list to attend the hearing, Guy Traynor, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

The Community Renewal Tax Relief Act of 2000 (Public Law 106–554) (2000 Act) amended various provisions in section 42 of the Internal Revenue Code (Code), including provisions relating to the time for meeting the 10 percent basis requirement for carryover allocations under section 42(h)(1)(E) and (F), and the order in which housing credit dollar amounts are allocated from the different components of a State's housing credit ceiling under section 42(h)(3)(C). To conform the existing regulations to these changes, the proposed regulations contain amendments to §1.42–6 (Buildings qualifying for carryover allocations) and §1.42–14 (Allocation rules for post-1989 State housing credit ceiling amounts) of the Income Tax Regulations (26 CFR part 1).

The proposed regulations also amend §1.42–6 and §1.42–8 (Election of appropriate percentage month) by removing the requirements that certain documents (for example, carryover allocation documents, election statements, and binding agreements) be attached to a taxpayer's income tax return when it is filed. These amendments help to facilitate the electronic filing of income tax returns.

Explanation of Provisions

Buildings Qualifying for Carryover Allocations

Section 42 provides for a low-income housing credit that may be claimed as part of the general business credit under section 38. In general, the credit is allowable only if the owner of a qualified low-income building receives a housing credit allocation from a State or local housing credit agency (Agency) of the jurisdiction where the building is located.

In general, an allocation must be made not later than the close of the calendar year in which the building is placed in service. Under section 42(h)(1)(E), an allocation (carryover allocation) may be made to a "qualified building" that has not yet been placed in service, provided the building is placed in service not later than the close of the second calendar year following the calendar year of the allocation. Prior to the 2000 Act changes, section 42(h)(1)(E)(ii) defined a qualified building as any building that is part of a project if the taxpayer's basis in the project (as of the close of the calendar year of the allocation) is more than 10 percent of the taxpayer's reasonably expected basis in the project (as of the close of the second calendar year following the calendar year of the allocation). If the taxpayer failed to meet this 10 percent basis requirement by the close of the calendar year of the allocation, the carryover allocation was not valid and was treated as if it had not been made.

The 2000 Act amended the definition of a qualified building to provide that the 10 percent basis requirement must be met by the later of: (1) the date which is 6 months after the date that the allocation was made, or (2) the close of the calendar year in which the allocation is made. The proposed regulations amend the existing regulations to reflect this change. Thus, the proposed regulations provide that for carryover allocations made before July 1, a taxpayer must meet the 10 percent basis requirement as of the close of the calendar year of allocation. For carryover allocations made after June 30, a taxpayer must meet the 10 percent basis requirement by the close of the date that is 6 months after the date the allocation is made. In addition, the proposed regulations provide that an allocation made before July 1 will be invalid and will be treated as if it had not been made if the 10 percent basis requirement is not met by the close of the calendar year of the allocation. An allocation made after June 30 will be treated as validly made in the calendar year of the allocation but returned to the Agency the following calendar year if the 10 percent basis requirement is not met by the close of the date that is 6 months after the date the allocation is made.

The proposed regulations also facilitate the electronic filing of income tax returns by removing the requirement of

§1.42–6(d)(4)(i) that a taxpayer file a copy of the carryover allocation with its income tax return for the first taxable year a credit is claimed.

Election of Appropriate Percentage Month

Section 42(a) provides that the amount of the low-income housing credit for any taxable year in the 10-year credit period is the applicable percentage of the qualified basis of each qualified low-income building. Section 42(b)(2)(A) provides that, for any qualified low-income building placed in service by the taxpayer after 1987, the applicable percentage is the appropriate percentage prescribed by the Secretary for the month the building is placed in service, unless the taxpayer otherwise elects.

The taxpayer may elect to use the appropriate percentage for the month in which the taxpayer and the Agency enter into an agreement with respect to the building (which is binding on the Agency, the taxpayer, and all successors in interest) as to the housing credit dollar amount to be allocated to the building. In the case of a substantially bond-financed building (as described in section 42(h)(4)(B)), the taxpayer may elect to use the appropriate percentage for the month in which the tax-exempt obligations are issued. In either case, the election must be made no later than the 5th day after the close of the month elected by the taxpayer. An election, once made, is irrevocable.

The proposed regulations facilitate the electronic filing of income tax returns by removing the requirements of §1.42–8(a)(6)(i) and §1.42–8(b)(4)(i) that a taxpayer file a copy of the election statement (and, in the case of §1.42–8(a)(6)(i), the binding agreement) with its income tax return for the first taxable year that credit is claimed.

Allocation Rules for Post-1989 State Housing Credit Ceiling Amounts

Under section 42(h), the aggregate housing credit dollar amount that an Agency may allocate for any calendar year is limited to the State housing credit ceiling (Credit Ceiling) apportioned to the Agency for that calendar year. Prior to the 2000 Act changes, section 42(h)(3)(C) provided that the Credit Ceiling of any State for any calendar year was an amount equal to the sum of: (a) $1.25 multiplied by the State population (the population component); (b) the unused Credit Ceiling, if any, of the State for the preceding calendar year (the unused carryforward component); (c) the amount of Credit Ceiling returned in the calendar year (the returned credit component); plus (d) the amount, if any, allocated to the State by the Secretary under section 42(h)(3)(D) from a national pool of unused credit (the national pool component).

Read together, sections 42(h)(3)(C) and 42(h)(3)(D)(ii) provide rules governing the order in which credit is allocated from the various components of the Credit Ceiling (the stacking rule). Prior to the 2000 Act changes the stacking rule provided that credit was allocated first from the sum of the population and returned credit components, then from the unused carryforward component, and finally, from the national pool component. In addition, unlike unallocated credit attributable to the population and returned credit components, unallocated credit attributable to the national pool component could not be carried forward, and therefore, was not included in the unused carryforward component of the following calendar year's Credit Ceiling.

The 2000 Act increased the size of the population component to the greater of (1) $1.75 ($1.50 for 2001) multiplied by the State population, or (2) $2,000,000, with these amounts being increased by a cost-of-living adjustment for calendar years after 2002. The proposed regulations amend the existing regulations to reflect this change.

The 2000 Act also amended the returned credit component of a Credit Ceiling for any calendar year to include credits from a carryover allocation made in the prior calendar year where a taxpayer fails to satisfy the 10 percent basis requirement by a date after the close of the calendar year of the allocation. The proposed regulations amend the final regulations to reflect this change.

Finally, the 2000 Act amended the stacking rule to provide that credit is allocated first from the unused carryforward component, then from the sum of the population, returned credit, and national pool components. The 2000 Act also amended the computation of the unused carryforward component. The proposed regulations amend the existing regulations to reflect these changes and clarify that under the 2000 Act changes, amounts remaining unallocated from the national pool component in a calendar year are included as part of the unused carryforward component of the following calendar year's Credit Ceiling.

Proposed Effective Date

The proposed regulations that reflect the changes made by the 2000 Act will be effective for housing credit dollar amounts allocated after the date these regulations are published as final regulations in the **Federal Register**. However, the proposed regulations that reflect the changes made by the 2000 Act may be applied by Agencies and taxpayers for housing credit dollar amounts allocated after December 31, 2000, and before the effective date of the final regulations. The proposed regulations that facilitate the electronic filing of income tax returns will be effective for forms filed 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. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a new collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. The collection of information contained in this notice of proposed rulemaking has been previously reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1102. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments

(preferably a signed original and eight (8) copies) that are submitted timely to the IRS. Comments are requested on all aspects of the proposed regulations. In addition, comments are specifically requested on the clarity of the proposed regulations and how they can be revised to be more easily understood. All comments will be available for public inspection and copying.

A public hearing has been scheduled for September 23, 2003, at 10 a.m. in room 4718, 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 at the Constitution Avenue entrance 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" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments and an outline of the topics to be discussed (with the time to be devoted to each topic) by September 5, 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 authors of these regulations are Christopher J. Wilson and Lauren R. Taylor, Office of the Associate Chief Counsel (Passthroughs and Special Industries), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.42–6 is amended by:

1. Revising paragraph (a).

2. Amending Example 1. of paragraph (b)(4) by removing the word "September" and by adding the word "May" in its place; by removing the date "1993" each place it appears and by adding the date "2003" in its place; and by removing the date "1995" and adding the date "2005" in its place.

3. Revising Example 2. of paragraph (b)(4).

4. Revising paragraph (c)(1).

5. Amending the first and last sentences of paragraph (c)(2) by removing the language "by the close of the calendar year of the allocation" and adding the language "by the close of the calendar year of the allocation (for allocations made before July 1) or by the close of the date that is 6 months after the date the allocation is made (for allocations made after June 30)" in its place.

6. Revising paragraph (c)(3).

7. Revising paragraph (d)(2)(viii).

8. Revising paragraph (d)(4)(i).

9. Amending paragraph (d)(4)(ii) by removing the language ", 'Carryover Allocation of the Low-Income Housing Credit,'".

10. Amending the first sentence of paragraph (e)(2) by removing the language "before the close of the calendar year of the allocation" and adding the language "by the close of the calendar year of the allocation (for allocations made before July 1) or by the close of the date that is 6 months after the date the allocation is made (for allocations made after June 30)" in its place.

The revisions read as follows:

§1.42–6. Buildings qualifying for carryover allocations.

(a) *Carryover allocations*— (1) *In general*. A carryover allocation is an allocation that meets the requirements of section 42(h)(1)(E) or (F). If the requirements of section 42(h)(1)(E) or (F) that are required to be satisfied by the close of a calendar year are not satisfied, the allocation is not valid and is treated as if it had not been made for that calendar year. For example, if a carryover allocation fails to satisfy a requirement in §1.42–6(d) for making an allocation, such as failing to be signed or dated by an authorized official of an allocating agency by the close of a calendar year, the allocation is not valid and is treated as if it had not been made for that calendar year.

(2) *10 percent basis requirement*. A carryover allocation may only be made with respect to a qualified building. A qualified building is any building which is part of a project if, by the date specified under paragraph (a)(2)(i) or (ii) of this section, a taxpayer's basis in the project is more than 10 percent of the taxpayer's reasonably expected basis in the project as of the close of the second calendar year following the calendar year the allocation is made. For purposes of meeting the 10 percent basis requirement, the determination of whether a building is part of a single-building project or multi-building project is based on whether the carryover allocation is made under section 42(h)(1)(E) (building-based allocation) or section 42(h)(1)(F) (project-based allocation).

(i) *Allocation made before July 1*. If a carryover allocation is made before July 1 of a calendar year, a taxpayer must meet the 10 percent basis requirement by the close of that calendar year. If a taxpayer does not meet the 10 percent basis requirement by the close of the calendar year, the carryover allocation is not valid and is treated as if it had not been made.

(ii) *Allocation made after June 30*. If a carryover allocation is made after June 30 of a calendar year, a taxpayer must meet the 10 percent basis requirement by the close of the date that is 6 months after the date the allocation was made. If a taxpayer does not meet the 10 percent basis requirement by the close of the required date, the carryover allocation must be returned to the Agency. Unlike a carryover allocation made before July 1, if a taxpayer does not meet the 10 percent basis requirement by the close of the required date, the carryover allocation is treated as a valid allocation for the calendar year of allocation, but is included in the "returned credit component" for purposes of determining the State housing credit ceiling under section 42(h)(3)(C) for the calendar year following the calendar year of the allocation. See §1.42–14(d)(1).

(b) * * *

(4) * * *

(iii) * * *

Example 2. (i) *Facts.* D, an accrual-method taxpayer, received a carryover allocation from Agency, the state housing credit agency of State X, on September 12, 2003. As of that date, D has not begun construction of the low-income housing building D plans to build and D does not have basis in the land on which D plans to build the building. From September 12, 2003, to the close of March 12, 2004, D incurs some costs related to the planned building, including architects' fees. As of the close of March 12, 2004, these costs do not exceed 10 percent of D's reasonably expected basis in the single-building project as of the close of 2005.

(ii) *Determination of whether building is qualified.* Because D's carryover-allocation basis as of the close of March 12, 2004, is not more than 10 percent of D's reasonably expected basis in the single-building project, the building is not a qualified building for purposes of section 42(h)(1)(E)(ii) and paragraph (a) of this section. Accordingly, the carryover allocation to D must be returned to the Agency. The allocation is valid for purposes of determining the amount of credit allocated by Agency from State X's 2003 State housing credit ceiling, but is included in the returned credit component of State X's 2004 housing credit ceiling.

(c) *Verification of basis by Agency*—(1) *Verification requirement.* An Agency that makes a carryover allocation to a taxpayer must verify that the taxpayer has met the 10 percent basis requirement of paragraph (a)(2) of this section.

(2) * * *

(3) *Time of verification.*—(i) *Allocations made before July 1.* For a carryover allocation made before July 1, an Agency may require that the basis certification be submitted to or received by the Agency prior to the close of the calendar year of allocation or within a reasonable time following the close of the calendar year of allocation. The Agency will need to verify basis as provided in paragraph (c)(2) of this section to accurately complete the Form 8610, "*Annual Low-Income Housing Credit Agencies Report*," and the Schedule A (Form 8610), "*Carryover Allocation of Low-Income Housing Credit*," for the calendar year of the allocation. If the basis certification is not timely made, or supporting documentation is lacking, inadequate, or does not actually support the certification, the Agency should notify the taxpayer and try to get adequate documentation. If the Agency cannot verify before the Form 8610 is filed that the taxpayer has satisfied the 10 percent basis requirement for a carryover allocation made before July 1, the allocation is not valid and is treated as if it had not been made and the carryover allocation should not be reported on the Schedule A (Form 8610).

(ii) *Allocations made after June 30.* An Agency may require that the basis certification be submitted to or received by the Agency prior to the close of the date that is 6 months after the date the allocation was made or within a reasonable period of time following the close of the date that is 6 months after the date the allocation was made. The Agency will need to verify basis as provided in paragraph (c)(2) of this section. If the basis certification is not timely made, or supporting documentation is lacking, inadequate, or does not actually support the certification, the Agency should notify the taxpayer and try to get adequate documentation. If the Agency cannot verify that the taxpayer has satisfied the 10 percent basis requirement for a carryover allocation made after June 30, the allocation must be returned to the Agency. The carryover allocation is a valid allocation for the calendar year of the allocation, but is included in the returned credit component of the State housing credit ceiling for the calendar year following the calendar year of the allocation.

(d) * * *

(2) * * *

(viii) For carryover allocations made before July 1, the taxpayer's basis in the project (land and depreciable basis) as of the close of the calendar year of the allocation and the percentage that basis bears to the reasonably expected basis in the project (land and depreciable basis) as of the close of the second calendar year following the calendar year of allocation;

* * * * *

(4) *Recordkeeping requirements*—(i) *Taxpayer.* When an allocation is made pursuant to section 42(h)(1)(E) or (F), the taxpayer must retain a copy of the allocation document. The Form 8609 that reflects the allocation must be filed for the first taxable year that the credit is claimed and for each taxable year thereafter throughout the compliance period, whether or not a credit is claimed for the taxable year.

* * * * *

Par. 3. Section 1.42–8 is amended by:

1. Revising the second sentence of paragraph (a)(6)(i).

2. Revising paragraph (a)(6)(ii).

3. Redesignating the year "1993" as "2003" and the year "1994" as "2004" each place it appears in paragraph (a)(7), Example 1 and Example 2.

4. In *Example 1.* of paragraph (a)(7), revising the second to the last sentence of (ii), removing the second sentence of (iii), and revising (iv).

5. In *Example 2.* of paragraph (a)(7), removing the third sentence of (iii) and revising (iv).

6. Removing the third sentence of paragraph (b)(4)(i).

7. Revising paragraph (b)(4)(ii).

The revisions read as follows:

§1.42–8 Election of appropriate percentage month.

(a) * * *

(6) *Procedures*—(i) *Taxpayer.* * * * The taxpayer must retain a copy of the binding agreement and the election statement.

(ii) *Agency.* The Agency must retain the original of the binding agreement and election statement and, to the extent required by Schedule A (Form 8610), "*Carryover Allocation of Low-Income Housing Credit*," account for the binding agreement and election statement on that schedule.

(7) * * *

Example 1. * * *

(ii) * * * Because allocations were made for the building in two separate calendar years, Agency must issue two Forms 8609, "*Low-Income Housing Credit Allocation Certification*," to X. * * *

* * * * *

(iv) Agency retains the original of the binding agreement, election statement, and 2003 carryover allocation document. Agency accounts for the binding agreement, election statement, and 2003 carryover allocation on the Schedule A (Form 8610) that it files for the 2003 calendar year. After the building is placed in service in 2004, and assuming other necessary requirements for issuing a Form 8609 are met (for example, taxpayer has certified all sources and uses of funds and development costs for the building under §1.42–17), Agency issues to X a copy of the Form 8609 reflecting the 2003 carryover allocation of $100,000. Agency accounts for the Form 8609 on the first Form 8610 that it files following the date the Form 8609 is issued to X. Agency also issues to X a copy of the Form 8609 reflecting the $50,000 allocation made in 2004 and accounts for the 2004 allocation on the Form 8610, "*Annual Low-Income Housing Credit Agencies Report*," that it files for the 2004 calendar year. Agency retains copies of the Forms 8609 that are issued to X.

Example 2. * * *

* * * * *

(iv) Agency retains the original of the binding agreements, election statements, and carryover allocation documents. Agency accounts for the binding

agreement, election statement, and 2003 carryover allocation on the Schedule A (Form 8610) that it files for the 2003 calendar year. Agency also accounts for the binding agreement, election statement, and 2004 carryover allocation on the Schedule A (Form 8610) that it files for the 2004 calendar year. After each separate new building is placed in service, and assuming other necessary requirements for issuing a Form 8609 are met (for example, taxpayer has certified all sources and uses of funds and development costs for the building under §1.42–17), the Agency will issue to X a copy of the Form 8609 reflecting the 2003 carryover allocation of $70,000 and a copy of the Form 8609 reflecting the 2004 carryover allocation of $50,000, respectively. Agency accounts for each Form 8609 on the Form 8610 that reflects the calendar year each Form 8609 is issued. Agency retains copies of the Forms 8609 that are issued to X.

(b) * * *

(4) * * *

(ii) *Agency*. The Agency must retain the original of the election statement and a copy of the Form 8609 that reflects the election statement. The Agency must file an additional copy of the Form 8609 with the Agency's Form 8610 that reflects the calendar year the Form 8609 is issued.

Par. 4. Section 1.42–12 is amended by revising paragraph (a) to read as follows:

§1.42–12 Effective dates and transitional rules.

(a) *Effective dates*—(1) *In general*. Except as provided in paragraphs (a)(2) and (a)(3) of this section, the rules set forth in §§1.42–6 and 1.42–8 through 1.42–12 are effective May 2, 1994. However, binding agreements, election statements, and carryover allocation documents entered into before May 2, 1994, that follow the guidance set forth in Notice 89–1, 1989–1 C.B. 620 (see §601.601(d)(2)(ii)(b) of this chapter), need not be changed to conform to the rules set forth in §§1.42–6 and 1.42–8 through 1.42–12.

(2) *Community Renewal Tax Relief Act of 2000*. *In general*. Paragraphs (a), (b)(4)(iii) Example 1 and Example 2, (c), (d)(2)(viii), and (e)(2) of § 1.42–6 are effective for housing credit dollar amounts allocated after the date these regulations are published as final regulations in the **Federal Register**. However, the rules in paragraphs (a), (b)(4)(iii) Example 1 and Example 2, (c), (d)(2)(viii), and (e)(2) of §1.42–6 may be applied by Agencies and taxpayers for housing credit dollar amounts allocated after December 31, 2000, and on or before the date these regulations are published as final regulations in the **Federal Register**. Otherwise, subject to the applicable effective dates of the corresponding statutory provisions, the rules that apply for housing credit dollar amounts allocated on or before the date these regulations are published as final regulations in the **Federal Register** are contained in §1.42–6 in effect on and before these regulations are published as final regulations in the **Federal Register** (see 26 CFR part 1 revised as of April 1, 2003).

(3) *Electronic filing simplification changes*. Section 1.42–6(d)(4) and §1.42–8(a)(6)(i), (a)(6)(ii), (a)(7) *Example 1* and *Example 2*, (b)(4)(i), and (b)(4)(ii) are effective for forms filed after the date these regulations are published as final regulations in the **Federal Register**. The rules that apply for forms filed on or before the date these regulations are published as final regulations in the **Federal Register** are contained in § 1.42–6 and 1.42–8 in effect on and before these regulations are published as final regulations in the **Federal Register** (see 26 CFR part 1 revised as of April 1, 2003).

* * * * *

Par. 5. Section 1.42–14 is amended by:

1. Revising the section heading and paragraph (a).
2. Removing paragraph (c).
3. Redesignating paragraph (b) as paragraph (c).
4. Adding a new paragraph (b).
5. Adding a new sentence at the end of paragraph (d)(2)(iv)(A).
6. Removing the second to the last sentence of paragraph (e).
7. Revising paragraph (g).
8. Revising paragraph (i)(2).
9. Revising paragraph (k).
10. Revising paragraph (l).

The revisions and addition read as follows:

§1.42–14. Allocation rules for post–2000 State housing credit ceiling amount.

(a) *State housing credit ceiling*— (1) *In general*. The State housing credit ceiling for a State for any calendar year after 2000 is comprised of four components. The four components are—

(i) The unused State housing credit ceiling, if any, of the State for the preceding calendar year (the unused carryforward component);

(ii) The greater of—

(A) $1.75 ($1.50 for calendar year 2001) multiplied by the State population, or

(B) $2,000,000 (the population component);

(iii) The amount of State housing credit ceiling returned in the calendar year (the returned credit component); plus

(iv) The amount, if any, allocated to the State by the Secretary under section 42(h)(3)(D) from a national pool of unused credit (the national pool component).

(2) *Cost of Living Adjustment*.—(i) *General rule*. For any calendar year after 2002, the $2,000,000 and $1.75 amounts in paragraph (a)(1)(ii) of this section are each increased by an amount equal to—

(A) the dollar amount, multiplied by

(B) the cost-of-living adjustment determined under section 1(f)(3) for the calendar year by substituting "calendar year 2001" for "calendar year 1992" in section 1(f)(3)(B).

(ii) *Rounding*. Any increase resulting from the application of paragraph (a)(2)(i) of this section which, in the case of the $2,000,000 amount, is not a multiple of $5,000, is rounded to the next lowest multiple of $5,000, and which, in the case of the $1.75 amount, is not a multiple of 5 cents, is rounded to the next lowest multiple of 5 cents.

(b) *The unused carryforward component*. The unused carryforward component of the State housing credit ceiling for any calendar year is the unused State housing credit ceiling, if any, of the State for the preceding calendar year. The unused State housing credit ceiling for any calendar year is the excess, if any, of—

(1) the sum of the population, returned credit, and national pool components for the calendar year, over

(2) the aggregate housing credit dollar amount allocated for the calendar year reduced by the housing credit dollar amounts allocated from the unused carryforward component for the calendar year.

* * * * *

(d) * * *

(2) * * *

(iv) * * *

(A) *Building not qualified within required time period*. * * * Also, a build-

ing that has received a post-June 30 carryover allocation is not qualified within the required time period if the taxpayer does not meet the 10 percent basis requirement by the date that is 6 months after the date the allocation was made (as described in § 1.42–6(a)(2)(ii)).

* * * * *

(g) *Stacking Order*. Credit is treated as allocated from the various components of the State housing credit ceiling in the following order. The first credit allocated for any calendar year is treated as credit from the unused carryforward component of the State housing credit ceiling for the calendar year. After all of the credit in the unused carryforward component has been allocated, any credit allocated is treated as allocated from the sum of the population, returned credit, and national pool components of the State housing credit ceiling.

* * * * *

(i) * * *

(2) *Unused housing credit carryover*. The unused housing credit carryover of a State for any calendar year is the excess, if any, of—

(i) the unused carryforward component of the State housing credit ceiling for the calendar year, over

(ii) the total housing credit dollar amount allocated for the calendar year.

* * * * *

(k) *Examples*.—(1) The operation of the rules of this section is illustrated by the following examples. Unless otherwise stated in an example, Agency A is the sole Agency authorized to make allocations of housing credit dollar amounts in State M, all of Agency A's allocations are valid, and for calendar year 2003, Agency A has available for allocation a State housing credit ceiling consisting of the following housing credit dollar amounts:

A.	unused carryforward component	$50
B.	population component	$110
C.	returned credit component	$10
D.	national pool component	$0
Total		$170

(2) In addition, the $10 of returned credit component was returned before October 1, 2003.

Example 1—(i) *Additional facts*. By the close of 2003, Agency A had allocated $80 of the State M housing credit ceiling. Of the $80 allocated, $17 was allocated to projects involving qualified nonprofit organizations.

(ii) *Application of stacking rules*. The $80 of allocated credit is first treated as allocated from the unused carryforward component of the State housing credit ceiling. The $80 of allocated credit exceeds the $50 attributable to the unused carryforward component by $30. Because the unused carryforward component is fully utilized no credit will be forfeited by State M to the 2004 National Pool. The remaining $30 of allocated credit will next be treated as allocated from the $120 in credit determined by aggregating the population, returned credit, and national pool components ($110 + 10 + 0 = $120). The $90 of unallocated credit remaining in State M's 2003 State housing credit ceiling ($120 - 30 = $90) represents the unused carryforward component of State M's 2004 State housing credit ceiling. Under paragraph (i)(3) of this section, State M does not qualify for credit from the 2004 National Pool.

(iii) *Nonprofit set-aside*. Agency A allocated exactly the amount of credit to projects involving qualified nonprofit organizations as necessary to meet the nonprofit set-aside requirement ($17, 10% of the $170 ceiling).

Example 2—(i) *Additional facts*. By the close of 2003, Agency A had allocated $40 of the State M housing credit ceiling. Of the $40 allocated, $20 was allocated to projects involving qualified nonprofit organizations.

(ii) *Application of stacking rules*. The $40 of allocated credit is first treated as allocated from the unused carryforward component of the State housing credit ceiling. Because the $40 of allocated credit does not exceed the $50 attributable to the unused carryforward component, the remaining components of the State housing credit ceiling are unaffected. The $10 remaining in the unused carryforward component is assigned to the Secretary for inclusion in the 2004 National Pool. The $120 in credit determined by the aggregating the population, returned credit, and national pool components becomes the unused carryforward component of State M's 2004 State housing credit ceiling. Under paragraph (i)(3) of this section, State M does not qualify for credit from the 2004 National Pool.

(iii) *Nonprofit set-aside*. Agency A allocated $3 more credit to projects involving qualified nonprofit organizations than necessary to meet the nonprofit set-aside requirement. This does not reduce the application of the 10% nonprofit set-aside requirement to the State M housing credit ceiling for calendar year 2004.

Example 3—(i) *Additional fact*. None of the applications for credit that Agency A received for 2003 are for projects involving qualified nonprofit organizations.

(ii) *Nonprofit set-aside*. Because at least 10% of the State housing credit ceiling must be set aside for projects involving a qualified nonprofit organization, Agency A can allocate only $153 of the $170 State housing credit ceiling for calendar year 2003 ($170 - 17 = $153). If Agency A allocates $153 of credit, the credit is treated as allocated $50 from the unused carryforward component and $103 from the sum of the population, returned credit, and national pool components. The $17 of unallocated credit that is set aside for projects involving qualified nonprofit organizations becomes the unused carryforward component of State M's 2004 State housing credit ceiling. Under paragraph (i)(3) of this section, State M does not qualify for credit from the 2004 National Pool.

Example 4—(i) *Additional facts*. The $10 of returned credit component was returned prior to October 1, 2003. However, a $40 credit that had been allocated in calendar year 2002 to a project involving a qualified nonprofit organization was returned to the Agency by a mutual consent agreement dated November 15, 2003. By the close of 2003, Agency A had allocated $170 of the State M's housing credit ceiling, including $17 of credit to projects involving qualified nonprofit organizations.

(ii) *Effect of three-month rule*. Under the three-month rule of paragraph (d)(2)(iii) of this section, Agency A may treat all or part of the $40 of previously allocated credit as returned on January 1, 2004. If Agency A treats all of the $40 amount as having been returned in calendar year 2004, the State M housing credit ceiling for 2003 is $170. This entire amount, including the $17 nonprofit set-aside, has been allocated in 2003. Under paragraph (i)(3) of this section, State M qualifies for the 2004 National Pool.

(iii) *If three-month rule not used*. If Agency A treats all of the $40 of previously allocated credit as returned in calendar year 2003, the State housing credit ceiling for the 2003 calendar year will be $210 of which $50 will be attributable to the returned credit component ($10 + $40 = $50). Because credit amounts allocated to a qualified nonprofit organization in a prior calendar year that are returned in a subsequent calendar year do not retain their nonprofit character, the nonprofit set-aside for calendar year 2003 is $21 (10% of the $210 State housing credit ceiling). The $170 that Agency A allocated during 2003 is first treated as allocated from the unused carryforward component of the State housing credit ceiling. The $170 of allocated credit exceeds the $50 attributable to the unused carryforward component by $120. Because the unused carryforward component is fully utilized, no credit will be forfeited by State M to the 2004 National Pool. The remaining $120 of allocated credit will next be treated as allocated from the $160 in credit determined by aggregating the population, returned credit, and national pool components ($110 + 50 + 0 = $160). The $40 of unallocated credit (which includes $4 of unallocated credit from the $21 nonprofit set-aside) remaining in State M's 2003 housing credit ceiling ($160 - 120 = $40) represents the unused carryforward component of State M's 2004 housing credit ceiling. Under paragraph (i)(3) of this section, State M does not qualify for credit from the 2004 National Pool.

(l) *Effective dates*—(1) *In general*. Except as provided in paragraph (l)(2), the rules set forth in this section are effective January 1, 1994.

(2) *Community Renewal Tax Relief Act of 2000 changes*. Paragraphs (a), (b), (c),

(e), (i)(2) and (k) of this section are effective for housing credit dollar amounts allocated after the date these regulations are published as final regulations in the **Federal Register**. However, paragraphs (a), (b), (c), (e), (i)(2) and (k) of this section may be applied by Agencies and taxpayers for housing credit dollar amounts allocated after December 31, 2000, and on or before the date these regulations are published as final regulations in the **Federal Register**. Otherwise, subject to the applicable effective dates of the corresponding statutory provisions, the rules that apply for housing credit dollar amounts allocated on or before the date these regulations are published as final regulations in the **Federal Register** are contained in this section in effect on and before these regulations are published as final regulations in the **Federal Register** (see 26 CFR part 1 revised as of April 1, 2003).

Robert E. Wenzel,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on July 3, 2003, 8:45 a.m., and published in the issue of the Federal Register for July 7, 2003, 68 F.R. 40218)

Announcement of Disciplinary Actions Involving Attorneys, Certified Public Accountants, Enrolled Agents, and Enrolled Actuaries — Suspensions, Censures, Disbarments, and Resignations

Announcement 2003-50

Under Title 31, Code of Federal Regulations, Part 10, attorneys, certified public accountants, enrolled agents, and enrolled actuaries may not accept assistance from, or assist, any person who is under disbarment or suspension from practice before the Internal Revenue Service if the assistance relates to a matter constituting practice before the Internal Revenue Service and may not knowingly aid or abet another person to practice before the Internal Revenue Service during a period of suspension, disbarment, or ineligibility of such other person.

To enable attorneys, certified public accountants, enrolled agents, and enrolled actuaries to identify persons to whom these restrictions apply, the Director, Office of Professional Responsibility will announce in the Internal Revenue Bulletin their names, their city and state, their professional designation, the effective date of disciplinary action, and the period of suspension. This announcement will appear in the weekly Bulletin at the earliest practicable date after such action and will continue to appear in the weekly Bulletins for five successive weeks.

Suspensions From Practice Before the Internal Revenue Service After Notice and an Opportunity for a Proceeding

Under Title 31, Code of Federal Regulations, Part 10, after notice and an opportunity for a proceeding before an administrative law judge, the following individuals have been placed under suspension from practice before the Internal Revenue Service:

Name	Address	Designation	Effective Date
Arnold, John	Clovis, CA	Enrolled Agent	February 13, 2003 to August 12, 2003

Disbarments From Practice Before the Internal Revenue Service After Notice and an Opportunity for a Proceeding

Under Title 31, Code of Federal Regulations, Part 10, after notice and an opportunity for a proceeding before an administrative law judge, the following individuals have been disbarred from practice before the Internal Revenue Service:

Name	Address	Designation	Effective Date
Kalajian, Thomas	Laguna Hills, CA	CPA	October 2, 2002
Messman, Carla	Outing, MN	Enrolled Agent	January 9, 2003

Consent Suspensions From Practice Before the Internal Revenue Service

Under Title 31, Code of Federal Regulations, Part 10, an attorney, certified public accountant, enrolled agent, or enrolled actuary, in order to avoid the institution or conclusion of a proceeding for his or her disbarment or suspension from practice before the Internal Revenue Service, may offer his or her consent to suspension from such practice. The Director, Office of Professional Responsibility, in his discretion, may suspend an attorney, certified public accountant, enrolled agent or enrolled actuary in accordance with the consent offered.

The following individuals have been placed under consent suspension from practice before the Internal Revenue Service:

Name	Address	Designation	Date of Suspension
Kemp, Bart	Sonoma, CA	Attorney	March 15, 2003 to November 15, 2003
Marks, Gary	Hewlett, NY	CPA	March 24, 2003 to March 23, 2004
Fehl, Kenneth	Palo Alto, CA	Attorney	April 1, 2003 to March 31, 2004
Cohen, Peter	Edison, NJ	CPA	April 3, 2003 to May 2, 2005
Kohn, Michael	St. Louis, MO	Attorney	Indefinite from April 30, 2003
Sogamoso, Carlos	Bellflower, CA	Enrolled Agent	Indefinite from May 1, 2003
Huston, James	Kingman, AZ	CPA	May 1, 2003 to April 30, 2006
Halleran, Edward	Carle Place, NY	Enrolled Agent	Indefinite from May 1, 2003

Name	Address	Designation	Date of Suspension
Marshall, E. Peter	Glens Falls, NY	CPA	May 1, 2003 to April 30, 2006
Bell, Rosanna	Irvington, NY	CPA	Indefinite from May 8, 2003
Kingsley, Steven	Weston, CT	CPA	Indefinite from May 15, 2003
Schawe, Rudolph	Brenham, TX	Enrolled Agent	May 22, 2003 to October 21, 2004
Scheve, Michael	Baltimore, MD	CPA	Indefinite from May 27, 2003
McKenzie, Dawna	Fort Smith, AR	Enrolled Agent	Indefinite from June 2, 2003
Suen, Ming	San Francisco, CA	Enrolled Agent	Indefinite from June 3, 2003
Reyes, Ruperto	Placentia, CA	Enrolled Agent	June 10, 2003 to December 9, 2005
Garmo, Georgis	W. Bloomfield, MI	CPA	Indefinite from June 10, 2003
Holmes, James L.	Burlington, NC	Enrolled Agent	Indefinite from June 18, 2003
Brooks, Sandra	San Diego, CA	Enrolled Agent	Indefinite from June 20, 2003
Malley, Wayne	Cupertino, CA	Enrolled Agent	Indefinite from June 27, 2003
Leininger, Barbara	Lutz, FL	Enrolled Agent	Indefinite from June 27, 2003

Expedited Suspensions From Practice Before the Internal Revenue Service

Under Title 31, Code of Federal Regulations, Part 10, the Director, Office of Professional Responsibility, is authorized to immediately suspend from practice before the Internal Revenue Service any practitioner who, within five years from the date the expedited proceeding is instituted (1) has had a license to practice as an attorney, certified public accountant, or actuary suspended or revoked for cause or (2) has been convicted of certain crimes.

The following individuals have been placed under suspension from practice before the Internal Revenue Service by virtue of the expedited proceeding provisions:

Name	Address	Designation	Date of Suspension
Radwick, Peter	Woodinville, WA	CPA	Indefinite from March 10, 2003
Jellinger, Richard	Anoka, MN	Attorney	Indefinite from March 10, 2003
Deen, Billy	Mansfield, TX	CPA	Indefinite from March 10, 2003
Dougherty Jr, William	Newport News, VA	Attorney	Indefinite from March 10, 2003
Abood, Norman	Oregon, OH	Attorney	Indefinite from March 10, 2003
Matis, Vendel	Redlands, CA	Attorney	Indefinite from March 31, 2003
Workman, Andrew	Panama City, FL	CPA	Indefinite from March 31, 2003
Bagwell, Jr., Noel	Cunningham, TN	Attorney	Indefinite from March 31, 2003
O'Brien, Brien	Sioux City, IA	Attorney	Indefinite from March 31, 2003
Boykoff, Franklin	Pleasantville, NY	Attorney	Indefinite from March 31, 2003
McKinnon, Marva	Statesville, NC	Attorney	Indefinite from March 31, 2003
Bailey, Scott K.	Eden Prairie, MN	Attorney	Indefinite from March 31, 2003

Name	Address	Designation	Date of Suspension
Kim, Kun	Atlanta, GA	CPA	Indefinite from March 31, 2003
Massari III, Domenic	Tampa, FL	Attorney	Indefinite from May 12, 2003
Haugabrook II, Tyrone	Valdosta, GA	Attorney	Indefinite from May 19, 2003
Wester, Joseph	Montgomery, AL	CPA	Indefinite from May 19, 2003
Smercina, David	Solon, OH	CPA	Indefinite from May 19, 2003
Pullings, Retna	Washington, DC	Attorney	Indefinite from May 19, 2003
Boyd, James	Mendota Heights, MN	Attorney	Indefinite from May 20, 2003
Spindler, Judith	Omaha, NE	Attorney	Indefinite from May 20, 2003
Wintroub, Edward	Omaha, NE	Attorney	Indefinite from May 20, 2003
Brinker, Peter	Omaha, NE	Attorney	Indefinite from May 21, 2003
Valdes, Alfredo	Old Greenwich, CT	CPA	Indefinite from May 21, 2003
Cruise, Michael	Lincoln, NE	Attorney	Indefinite from May 22, 2003
Schoppert, Thomas	Minot, ND	Attorney	Indefinite from June 2, 2003
White, Paul	Smithfield, NC	Enrolled Agent	Indefinite from June 2, 2003
Brier, Michael	Providence, RI	CPA	Indefinite from June 16, 2003

Resignations of Enrolled Agents

Under Title 31, Code of Federal Regulations, Part 10, an enrolled agent, in order to avoid the institution or conclusion of a proceeding for his or her disbarment or suspension from practice before the Internal Revenue Service, may offer his or her resignation as an enrolled agent. The Director, Office of Professional Responsibility, in his discretion, may accept the offered resignation.

The Director, Office of Professional Responsibility, has accepted offers of resignation as an enrolled agent from the following individuals:

Name	Address	Date of Designation
Evans, Caroline	Tiverton, RI	May 7, 2003

Censure Issued by Consent

Under Title 31, Code of Federal Regulations, Part 10, in lieu of a proceeding being instituted or continued, an attorney, certified public accountant, enrolled agent, or enrolled actuary, may offer his or her consent to the issuance of a censure. Censure is a public reprimand.

The following individuals have consented to the issuance of a Censure:

Name	Address	Designation	Date of Censure
Pargas, Carlos B.	Miami, FL	CPA	March 19, 2003
Malkasian, Gary	Sacramento, CA	CPA	March 27, 2003
Wilcox, Ronald E.	Mt. Carmel, IL	CPA	April 29, 2003
Wood, David T.	Shawneetown, IL	CPA	May 27, 2003

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 laws 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 a 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.—Statement 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 current actions on previously published items in Internal Revenue Bulletins 2003-1 through 2003-26 is in Internal Revenue Bulletin 2003-27, dated July 7, 2003.

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