

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. 96-9, page 5.

LIFO; price indexes; department stores. The November 1995 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, November 30, 1995.

Rev. Rul. 96-10, page 27.

Basis of partner's interest; sale between partnerships. Partners' bases in their partnership interests are decreased to reflect losses on the sale of partnership property to a related partnership that are disallowed under section 707(b)(1) of the Internal Revenue Code. Partners' bases in their partnership interests are increased to reflect gain from the sale of partnership property that is not recognized under sections 267(d) and 707(b)(1) of the Code.

Rev. Rul. 96-11, page 28.

Charitable contribution by partnership. A charitable contribution of property by a partnership reduces each partner's basis in the partnership by the amount of the partner's share of the partnership's basis in the property contributed.

T.D. 8632, page 6.

Final regulations relating to qualified cost sharing arrangements under section 482 of the Code.

EMPLOYMENT TAX

T.D. 8636, page 64.

Final regulations under sections 6011, 6051, 6071, and 6081 of the Code concerning the time for furnishing wage statements to employees and for filing

wage statements with the Social Security Administration upon the termination of an employer's operations.

T.D. 8637, page 29.

IA-33-95, page 99.

Final, temporary, and proposed regulations relating to backup withholding, statement mailing requirements, and due diligence.

EXCISE TAX

Rev. Rul. 96-8, page 62.

Two COBRA premium issues. Guidance is given on two premium issues that arise under the continuation coverage requirements for group health plans in section 4980B of the Code.

ADMINISTRATIVE

Notice 96-4, page 69.

Partial withdrawal of proposed regulations INTL-52-86, 1988-1 C.B. 892, prescribing rules for official statements to recipients of dividends and patronage dividends paid after December 31, 1983.

Rev. Proc. 96-17, page 69.

Reportin agents; Form 8655. This procedure provides instructions for preparing and submitting Form 8655, Reporting Agent Authorization for Magnetic Tape and Electronic Filers. Rev. Proc. 89-19 superseded; Rev. Procs. 94-59, 94-18, 93-46, and 89-48 superseded in part.

Rev. Proc. 96-18, page 73.

Magnetic tape reporting; Forms 940, 941, and 945. This procedure provides requirements under which a re-

(Continued on page 4)

Finding Lists begin on page 104.

Mission of the Service

The purpose of the Internal Revenue Service is to collect the proper amount of tax revenue at the least cost; serve the public by continually improving the

quality of our products and services; and perform in a manner warranting the highest degree of public confidence in our integrity, efficiency and fairness.

Statement of Principles of Internal Revenue Tax Administration

The function of the Internal Revenue Service is to administer the Internal Revenue Code. Tax policy for raising revenue is determined by Congress.

With this in mind, it is the duty of the Service to carry out that policy by correctly applying the laws enacted by Congress; to determine the reasonable meaning of various Code provisions in light of the Congressional purpose in enacting them; and to perform this work in a fair and impartial manner, with neither a government nor a taxpayer point of view.

At the heart of administration is interpretation of the Code. It is the responsibility of each person in the Service, charged with the duty of interpreting the law, to try to find the true meaning of the statutory provision and not to adopt a strained construction in the belief that he or she is "protecting the revenue." The revenue is properly protected only when we ascertain and apply the true meaning of the statute.

The Service also has the responsibility of applying and administering the law in a reasonable, practical manner. Issues should only be raised by examining officers when they have merit, never arbitrarily or for trading purposes. At the same time, the examining officer should never hesitate to raise a meritorious issue. It is also important that care be exercised not to raise an issue or to ask a court to adopt a position inconsistent with an established Service position.

Administration should be both reasonable and vigorous. It should be conducted with as little delay as possible and with great courtesy and considerateness. It should never try to overreach, and should be reasonable within the bounds of law and sound administration. It should, however, be vigorous in requiring compliance with law and it should be relentless in its attack on unreal tax devices and fraud.

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 of a permanent nature are consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

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

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

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

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.

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

Part II.—Treaties and Tax Legislation.

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

Part III.—Administrative, Procedural, and Miscellaneous.

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

Part IV.—Items of General Interest.

With the exception of the Notice of Proposed Rulemaking and the disbarment and suspension list included in this part, none of these announcements are consolidated in the Cumulative Bulletins.

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

The Bulletin Index-Digest System, a research and reference service supplementing the Bulletin, may be obtained from the Superintendent of Documents on a subscription basis. It consists of four Services: Service No. 1, Income Tax; Service No. 2, Estate and Gift Taxes; Service No. 3, Employment Taxes; Service No. 4, Excise Taxes. Each Service consists of a basic volume and a cumulative supplement that provides (1) finding lists of items published in the Bulletin, (2) digests of revenue rulings, revenue procedures, and other published items, and (3) indexes of Public Laws, Treasury Decisions, and Tax Conventions.

The contents of this publication are not copyrighted and may be reprinted freely. A citation of the Internal Revenue Bulletin as the source would be appropriate.

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

HIGHLIGHTS OF THIS ISSUE—Continued

ADMINISTRATIVE—Continued

Reporting agent can furnish information required by the following forms by magnetic tape: Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return; Form 941, Employer's Quarterly Federal Tax Return; and Form 945, Annual Return of Withheld Federal Income Tax. Rev. Procs. 93-46, 94-18, and 94-59 superseded.

Rev. Proc. 96-19, page 80.

Electronic filing; Form 941. This procedure provides requirements under which a taxpayer, or a reporting agent preparing Form 941, Employer's Quarterly Federal Tax Return, for groups of taxpayers, can furnish the required information electronically through the Electronic Filing Program for Form 941.

Rev. Proc. 96-20, page 88.

On-Line Service Electronic Filing Program; Form 1040. Participants in the 1996 On-Line Filing Program for the

Form 1040 series are informed of their obligations to the Service and other participants. Rev. Proc. 95-13 superseded.

Rev. Proc. 96-21, page 96.

Making the single-entity election. This procedure describes the manner and time for consolidated groups to make the retroactive single-entity election under section 1.1221-2(g)(5)(i) of the Income Tax Regulations for purposes of the definition of a hedging transaction. See T.D. 8653.

T.D. 8633, page 20.

Final regulations under sections 671, 2702, 6012, and 6109 of the Code relating to grantor trust reporting requirements.

Announcement 96-5, page 99.

This announcement identifies the Taxpayer Bill of Rights 2 proposals that Treasury and the IRS have already adopted administratively or will soon do so and describes similar regulatory and guidance projects.

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

Section 170.—Charitable Contributions and Gifts

26 CFR 1.170A-1: Charitable Contributions and Gifts

If a partnership makes a charitable contribution of property, are the partners' bases in their partnership interests decreased to reflect the contribution. See Rev. Rul. 96-11, page 28.

Section 267.—Losses, Expenses, and Interest with respect to Transactions between Related Taxpayers.

26 CFR 1.267(d)-1: Amount of gain where loss previously disallowed.

If gain from the sale of partnership property is not recognized due to §§ 707(b)(1) and 267(d) of the Internal Revenue Code, are the partners' bases in their partnership interests increased under

§ 705(a)(1) to reflect that gain? See Rev. Rul. 96-10, page 27.

§ 472.—Last-in, First-out Inventories

26 CFR 1.472-1: Last-in, first-out inventories.

LIFO; price indexes; department stores. The November 1995 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, November 30, 1995.

Rev. Rul. 96-9

The following Department Store Inventory Price Indexes for November 1995 were issued by the Bureau of

Labor Statistics on December 14, 1995. The indexes are accepted by the Internal Revenue Service, under § 1.472-1(k) of the Income Tax Regulations and Rev. Proc. 86-46, 1986-2 C.B. 739, for appropriate application to inventories of department stores employing the retail inventory and last-in, first-out inventory methods for tax years ended on, or with reference to, November 30, 1995.

The Department Store Inventory Price Indexes are prepared on a national basis and include (a) 23 major groups of departments, (b) three special combinations of the major groups—soft goods, durable goods, and miscellaneous goods, and (c) a store total, which covers all departments, including some not listed separately, except for the following: candy, foods, liquor, tobacco, and contract departments.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS (January 1941 = 100, unless otherwise noted)

Groups	Nov. 1994	Nov. 1995	Percent Change from Nov. 1994 to Nov. 1995 ¹
1. Piece Goods.....	486.9	509.3	4.6
2. Domestic and Draperies.....	641.4	632.0	-1.5
3. Women's and Children's Shoes.....	640.6	637.8	-0.4
4. Men's Shoes.....	914.2	921.8	0.8
5. Infants' Wear.....	623.0	636.8	2.2
6. Women's Underwear.....	529.5	527.8	-0.3
7. Women's Hosiery.....	281.1	288.2	2.5
8. Women's and Girls' Accessories.....	578.0	559.8	-3.1
9. Women's Outerwear and Girls' Wear.....	432.0	419.3	-2.9
10. Men's Clothing.....	614.9	623.7	1.4
11. Men's Furnishings.....	577.5	572.7	-0.8
12. Boys' Clothing and Furnishings.....	486.9	485.5	-0.3
13. Jewelry.....	1007.9	1001.1	-0.7
14. Notions.....	748.5	776.6	3.8
15. Toilet Articles and Drugs.....	852.9	875.3	2.6
16. Furniture and Bedding.....	637.5	661.2	3.7
17. Floor Coverings.....	553.8	555.4	0.3
18. Housewares.....	781.1	248.7	0.1
19. Major Appliances.....	248.4	248.7	0.1
20. Radio and Television.....	84.3	79.9	-5.2
21. Recreation and Education ²	115.3	113.4	-1.6
22. Home Improvements ²	120.8	121.9	0.9
23. Auto Accessories ²	106.3	107.0	0.7

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE
INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS
(January 1941 = 100, unless otherwise noted)—Continued

Groups	Nov. 1994	Nov. 1995	Percent Change from Nov. 1994 to Nov. 1995 ¹
Groups 1—15: Soft Goods.....	598.6	595.2	-0.6
Groups 16—20: Durable Goods	464.1	465.0	0.2
Groups 21—23: Misc. Goods ²	114.4	113.5	-0.8
Store Total ³	552.1	550.7	-0.3

¹Absence of a minus sign before percentage change in this column signifies price increase.

²Indexes on a January 1986=100 base.

³The store total index covers all departments, including some not listed separately, except for the following: candy, foods, liquor, tobacco, and contract departments.

DRAFTING INFORMATION

The principal author of this revenue ruling is Stan Michaels of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Mr. Michaels on (202) 622-4970 (not a toll-free call).

Section 702.—Income and Credits of Partner

26 CFR 1.702-1: Income and Credits of Partner

If a partnership makes a charitable contribution of property, are the partners' bases in their partnership interests decreased to reflect the contribution. See Rev. Rul. 96-11, page 28.

Section 482.—Allocation of Income and Deductions Among Taxpayers

26 CFR 1.482-0: Outline of regulations under section 482.

T.D. 8632

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1, 301 and 602

Section 482 Cost Sharing Regulations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains

final regulations relating to qualified cost sharing arrangements under section 482 of the Internal Revenue Code. These regulations reflect changes to section 482 made by the Tax Reform Act of 1986, and provide guidance to revenue agents and taxpayers implementing the changes.

DATES: These regulations are effective January 1, 1996.

These regulations are applicable for taxable years beginning on or after January 1, 1996.

FOR FURTHER INFORMATION

CONTACT: Lisa Sams of the Office of Associate Chief Counsel (International), IRS (202) 622-3840 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1364. Responses to these collections of information are required to determine whether an intangible development arrangement is a qualified cost sharing arrangement and who are the participants in such arrangement.

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

The estimated average annual burden per recordkeeper is 8 hours. The estimated average annual burden per respondent is 0.5 hour.

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

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

Background

Section 482 was amended by the Tax Reform Act of 1986, Public Law 99-514, 100 Stat. 2085, 2561, et. seq. (1986-3 C.B. (Vol. 1) 1, 478). On January 30, 1992, a notice of proposed rulemaking concerning the section 482 amendment in the context of cost sharing was published in the Federal Register (INTL-0372-88, 57 FR 3571 [1992-1 C.B. 1164]).

Written comments were received with respect to the notice of proposed rulemaking, and a public hearing was held on August 31, 1992. After consideration of all the comments, the proposed regulations under section 482 are adopted as revised by this Treasury

decision, and the corresponding temporary regulations (which contain the cost sharing regulations as in effect since 1968) are removed.

Explanation of Provisions

Introduction

The Tax Reform Act of 1986 (the Act) amended section 482 to require that consideration for intangible property transferred in a controlled transaction be commensurate with the income attributable to the intangible. The Conference Committee report to the Act indicated that in revising section 482, Congress did not intend to preclude the use of bona fide research and development cost sharing arrangements as an appropriate method of allocating income attributable to intangibles among related parties. The Conference Committee report stated, however, that in order for cost sharing arrangements to produce results consistent with the commensurate-with-income standard, (a) a cost sharer should be expected to bear its portion of all research and development costs, on unsuccessful as well as successful products, within an appropriate product area, and the costs of research and development at all relevant development stages should be shared, (b) the allocation of costs generally should be proportionate to profit as determined before deduction for research and development, and (c) to the extent that one party contributes funds toward research and development at a significantly earlier point in time than another (or is otherwise putting its funds at risk to a greater extent than the other) that party should receive an appropriate return on its investment. See H.R. Rep. 99-281, 99th Cong., 2d Sess. (1986) at II-638.

The Conference Committee report to the Act recommended that the IRS conduct a comprehensive study and consider whether the regulations under section 482 (issued in 1968) should be modified in any respect.

The White Paper

In response to the Conference Committee's directive, the IRS and the Treasury Department issued a study of intercompany pricing [Notice 88-123 (1988-2 C.B. 458)] on October 18, 1988 (the White Paper). The White Paper suggested that most bona fide

cost sharing arrangements should have certain provisions. For example, the White Paper stated that most product areas covered by cost sharing arrangements should be within three-digit Standard Industrial Classification codes, that most participants should be assigned exclusive geographic rights in developed intangibles (and should predict benefits and divide costs accordingly) and that marketing intangibles should be excluded from bona fide cost sharing arrangements.

Comments on the White Paper indicated that, in practice, there was a great deal of variety in the terms of bona fide cost sharing arrangements, and that if the White Paper's suggestions were incorporated in regulations, the regulations would unduly restrict the availability of cost sharing.

The 1992 proposed regulations

The IRS issued proposed cost sharing regulations on January 30, 1992 (INTL-0372-88, 57 FR 3571). In general, the proposed regulations allowed more flexibility than anticipated by the White Paper, relying on anti-abuse tests rather than requiring standard cost sharing provisions.

The proposed regulations stated that in order to be qualified, a cost sharing arrangement had to meet the following five requirements: (1) the arrangement had to have two or more eligible participants, (2) the arrangement had to be recorded in writing contemporaneously with the formation of the cost sharing arrangement, (3) the eligible participants had to share the costs and risks of intangible development in return for a specified interest in any intangible produced, (4) the arrangement had to reflect a reasonable effort by each eligible participant to share costs and risks in proportion to anticipated benefits from using developed intangibles, and (5) the arrangement had to meet certain administrative requirements. The key requirements were that participants had to be eligible and that costs and risks had to be proportionate to benefits.

Under the proposed regulations, only a controlled taxpayer that would use developed intangibles in the active conduct of its trade or business was eligible to participate in a cost sharing arrangement. This requirement was considered necessary to ensure that controlled foreign entities were not

established simply to participate in cost sharing arrangements without performing any other meaningful function, and to ensure that each participant's share of anticipated benefits was measurable.

The proposed regulations allowed costs to be divided based on any measurement that would reasonably predict cost sharing benefits (e.g., anticipated units of production or anticipated sales). However, the basis for measuring anticipated benefits and dividing costs was checked by a cost-to-operating-income ratio. The method for dividing costs was presumed to be unreasonable if a U.S. participant's ratio of shared costs to operating income attributable to developed intangibles was grossly disproportionate to the cost-to-operating-income ratio of the other participants.

If a U.S. participant's cost-to-operating-income ratio was not grossly disproportionate, a section 482 allocation could still be made under three circumstances: (a) if the cost-to-operating-income ratio was disproportionate (allocation of costs), (b) if the pool of costs shared was too broad or too narrow, so that the U.S. participant was paying for research that it would not use (allocation of costs), or (c) if the cost-to-operating-income ratio was substantially disproportionate, such that a transfer of an intangible could be deemed to have occurred (allocation of income).

Under the proposed regulations, the IRS could also make an allocation of income to reflect a buy-in or buy-out event, that is, a transfer of an intangible that could occur, for example, when a participant joined or left a cost sharing arrangement.

Comments on the 1992 proposed regulations

The 1992 proposed cost sharing regulations were generally well received. However, there were five areas of particular concern to commenters. The first was the mechanical use of cost-to-operating-income ratios as a standard for measuring the reasonableness of an effort to share costs in proportion to anticipated benefits. Commenters noted that operating income attributable to developed intangibles was difficult to measure, and that other bases for measuring benefits might produce more reliable results. Commenters also believed that the

ratios might be overused, leading to adjustments to costs in every year, and to many deemed transfers of intangibles. In addition, commenters stated that the ratios did not provide any certainty that a cost sharing arrangement would not be disregarded, since a “grossly disproportionate” ratio was not numerically defined.

The second area of concern was the eligible participant requirement. Commenters argued that separate research entities (with no separate active trade or business) should be allowed to participate in cost sharing arrangements, as should marketing affiliates. Commenters also argued that transfers of intangibles to unrelated entities should not disqualify a participant, and that foreign-to-foreign transfers should not necessarily be monitored. Some comments also stated that controlled entities should be able to participate even if their cost sharing payments would be characterized differently for purposes of foreign law.

The third area of concern was the regulations’ requirement that every participant be able to benefit from every intangible developed under a cost sharing arrangement. Commenters stated that the regulations should allow both single-product cost sharing arrangements and umbrella cost sharing arrangements (*i.e.*, cost sharing arrangements under which a broad category of a controlled group’s research and development would be covered).

The fourth area of concern was the buy-in and buy-out rules. There were some suggestions for clarifying and simplifying the rules. For example, comments urged that the regulations provide that one participant’s abandonment of its rights would not necessarily confer benefits on the other participants, and that a new participant need not always make a buy-in payment when joining a cost sharing arrangement. Suggestions for simplifying the rules generally consisted of proposed safe harbors for valuing intangibles.

The final general area of concern was the administrative requirements. Several commenters suggested that annual adjustments to the method used to share costs should not be required. Commenters also suggested that taxpayers not be required to attach their cost sharing arrangements to their returns, and that the time period for producing records be increased.

In addition to these general areas of concern, commenters noted that there

should be more guidance about when the IRS would deem a cost sharing arrangement to exist. Commenters also argued that existing cost sharing arrangements should be grandfathered, or that there should be a longer transition period. Commenters suggested that financial accounting rules be used to calculate costs to be shared, and that the IRS address the impact of currency fluctuations on the cost-to-operating-income ratios. Finally, commenters asked that the regulations clarify that a cost sharing arrangement would not be deemed to create a partnership or a U.S. trade or business.

The final regulations

Without fundamentally altering the policies of the 1992 proposed regulations, the final regulations reflect numerous modifications in response to the comments described above. They also reflect the approach of the final section 482 regulations relating to transfers of tangible and intangible property.

Section 1.482-7(a)(1) defines a cost sharing arrangement as an agreement for sharing costs in proportion to reasonably anticipated benefits from the individual exploitation of interests in the intangibles that are developed. In order to claim the benefits of the safe harbor, a taxpayer must also satisfy certain formal requirements (enumerated in §1.482-7(b)). The district director may apply the cost sharing rules to any arrangement that in substance constitutes a cost sharing arrangement, notwithstanding any failure to satisfy particular requirements of the safe harbor. It is further provided that a qualified cost sharing arrangement, or an arrangement treated in substance as such, will not be treated as a partnership. (A corresponding provision is added to §301.7701-3 pertaining to the definition of a partnership.) Neither will a foreign participant be treated as engaged in a trade or business within the United States solely by virtue of its participation in such an arrangement.

Section 1.482-7(a)(2) restates the general rule of cost sharing in a manner intended to emphasize its limitation on allocations: no section 482 allocation will be made with respect to a qualified cost sharing arrangement, except to make each controlled participant’s share of the intangible development costs equal to its share of reasonably anticipated benefits.

Section 1.482-7(b) contains the requirements for a qualified cost sharing arrangement. This provision substantially tracks the proposed regulations. A modification was made in the second requirement which now directs that the arrangement provide a method to calculate each controlled participant’s share of intangible development costs, based on factors that can reasonably be expected to reflect anticipated benefits. The new standard is intended to ensure that cost sharing arrangements will not be disregarded by the IRS as long as the factors upon which an estimate of benefits was based were reasonable, even if the estimate proved to be inaccurate.

Section 1.482-7(b)(4) requires that a cost sharing arrangement be set forth in writing and contain a number of specified provisions, including the interest that each controlled participant will receive in any intangibles developed pursuant to the arrangement. The intangibles developed under a cost sharing arrangement are referred to as the “covered intangibles.” It is possible that the research activity undertaken may result in development of intangible property that was not foreseen at the inception of the cost sharing arrangement; any such property is also included within the definition of the term covered intangibles. The prescriptive rules in relation to the scope of the intangible development area under the proposed regulations are eliminated in favor of a flexible definition that encompasses any research and development actually undertaken under the cost sharing arrangement.

Section 1.482-7(c) provides rules for being a participant in a qualified cost sharing arrangement. Unlike the proposed regulations, the final regulations permit participation by unrelated persons, which are referred to as “uncontrolled participants.” Controlled taxpayers may be participants, referred to as “controlled participants,” if they satisfy the conditions set forth in these rules. These qualification rules replace the proposed regulations’ concept of “eligible participant.” The tax treatment of controlled taxpayers that do not qualify as controlled participants provided in §1.482-7(c)(4) essentially tracks the treatment provided for ineligible participants under the proposed regulations.

The requirements for being a controlled participant are basically the same as in the proposed regulations. In

particular, a controlled participant must use or reasonably expect to use covered intangibles in the active conduct of a trade or business. Thus, an entity that chiefly provides services (e.g., as a contract researcher) may not be a controlled participant. These provisions are necessary for the reason that they are necessary to the proposed regulations: to prevent foreign controlled entities from being established simply to participate in cost sharing arrangements. In accordance with §1.482-7(c)(4) mentioned above, service entities (such as contract researchers) may furnish research and development services to the members of a qualified cost sharing arrangement, with the appropriate consideration for such assistance in the research and development undertaken in the intangible development area being governed by the rules in §1.482-4(f)(3)(iii) (Allocations with respect to assistance provided to the owner). In the case of a controlled research entity, the appropriate arm's length compensation would generally be determined under the principles of §1.482-2(b) (Performance of services for another). Each controlled participant would be deemed to incur as part of its intangible development costs a share of such compensation equal to its share of reasonably anticipated benefits.

As under the proposed regulations, the activity of another person may be attributed to a controlled taxpayer for purposes of meeting the active conduct requirement. However, modified language is adopted to be more precise concerning the intended requirements for attribution. These requirements were phrased in the proposed regulations as bearing the risk and receiving the benefits of the attributed activity. Under the final regulations, the attribution will be made only in cases in which the controlled taxpayer exercises substantial managerial and operational control over the attributed activities.

As under the proposed regulations, a principal purpose to use cost sharing to accomplish a transfer or license of covered intangibles to uncontrolled or controlled taxpayers will defeat satisfaction of the active conduct requirement. However, a principal purpose will not be implied where there are legitimate business reasons for subsequently licensing covered intangibles.

The subgroup rules of the proposed regulations are eliminated. Their major purpose is accomplished by a simpler

provision (see the discussion of §1.482-7(h)). In addition, the final regulations treat all members of a consolidated group as a single participant.

Section 1.482-7(d) defines intangible development costs as operating expenses other than depreciation and amortization expense, plus an arm's length charge for tangible property made available to the cost sharing arrangement. Costs to be shared include all costs relating to the intangible development area, which, as noted, comprises any research actually undertaken under the cost sharing arrangement. As under the proposed regulations, the district director may adjust the pool of costs shared in order to properly reflect costs that relate to the intangible development area.

Section 1.482-7(e) defines anticipated benefits as additional income generated or costs saved by the use of covered intangibles. The pool of benefits may also be adjusted in order to properly reflect benefits that relate to the intangible development area.

Section 1.482-7(f) governs cost allocations by the district director in order to make a controlled participant's share of costs equal to its share of reasonably anticipated benefits. Anticipated benefits of uncontrolled participants will be excluded from anticipated benefits in calculating the benefits shares of controlled participants. A share of reasonably anticipated benefits will be determined using the most reliable estimate of benefits. This rule echoes the best method rule for determining the most reliable measure of an arm's length result under §1.482-1(c).

The reliability of an estimate of benefits principally depends on two factors: the reliability of the basis for measuring benefits used and the reliability of the projections used. The cost-to-operating-income ratio used in the proposed regulations to check the reasonableness of an effort to share costs in proportion to anticipated benefits has not been included in the final regulations. Rather, the final regulations provide that an allocation of costs or income may be made if the taxpayer did not use the most reliable estimate of benefits, which depends on the facts and circumstances of each case.

Section 1.482-7(f)(3)(ii) provides that in estimating a controlled participant's share of benefits, the most reliable basis for measuring anticipated

benefits must be used, taking into account the factors set forth in §1.482-1(c)(2)(ii). The measurement basis used must be consistent for all controlled participants. The regulations provide that benefits may be measured directly or indirectly. In addition, regardless of whether a direct or indirect basis of measurement is employed, it may be necessary to make adjustments to account for material differences in the activities that controlled participants perform in connection with exploitation of covered intangibles, such as between wholesale and retail distribution.

Section 1.482-7(f)(3)(iii) describes the scope of various indirect bases for measuring benefits, such as units, sales, and operating profit. Indirect bases other than those enumerated may be employed as long as they bear a relationship to benefits.

Section 1.482-7(f)(3)(iv) discusses projections used to estimate benefits. Projections required for this purpose generally include a determination of the time period between the inception of the research and development and the receipt of benefits, a projection of the time over which benefits will be received, and a projection of the benefits anticipated for each year in which it is anticipated that the intangible will generate benefits. However, the regulations note that in certain circumstances, current annual benefit shares may be used in lieu of projections.

Section 1.482-7(f)(3)(iv)(B) states that a significant divergence between projected and actual benefit shares may indicate that the projections were not reliable. A significant divergence is defined as divergence in excess of 20% between projected and actual benefit shares. If there is a significant divergence, which is not due to an unforeseeable event, then the district director may use actual benefits as the most reliable basis for measuring benefits. Conversely, no allocation will be made based on a divergence that is not considered significant as long as the estimate is made using the most reliable basis for measuring benefits.

For purposes of the 20% test, all non-U.S. controlled participants are treated as a single controlled participant in order that a divergence by a foreign controlled participant with a very small share of the total costs will not necessarily trigger an allocation (section 1.482-7(f)(3)(iv)(D), *Example 8*, il-

illustrates this rule). Section 1.482-7(f)-(3)(iv)(B) and (C) notes that adjustments among foreign controlled participants will only be made if the adjustment will have a substantial U.S. tax impact, for example, under subpart F.

Section 1.482-7(f)(4) states that cost allocations must be reflected for tax purposes in the year in which costs were incurred. This reflects a change from the rule in the 1992 proposed regulations, which stated that cost allocations would be included in income in the taxable year under review, even if the costs to be allocated were incurred in a prior taxable year. The purpose of the change was to match up cost adjustments with the year to which they relate in accordance with the clear reflection of income principle of section 482.

Section 1.482-7(g) provides buy-in and buy-out rules that are similar to the rules in the proposed regulations. However, some of the clarifications suggested by commenters have been incorporated in these rules. A “substantially disproportionate” cost-to-operating-income ratio will no longer trigger an adjustment to income under these rules. However, if, after any cost allocations authorized by §1.482-7(a)(2), the economic substance of the arrangement is inconsistent with the terms of the arrangement over a period of years (for example, through a consistent pattern of one controlled participant bearing an inappropriately high or low share of the cost of intangible development), then the district director may impute an agreement consistent with the course of conduct. In that case, one or more of the participants would be deemed to own a greater interest in covered intangibles than provided under the arrangement, and must receive buy-in payments from the other participants.

The rules do not provide safe harbor methods for valuing intangibles, but rely on the intangible valuation rules of §§1.482-1 and 1.482-4 through 1.482-6. To the extent some participants furnish a disproportionately greater amount of existing intangibles to the arrangement, they must be compensated by royalties by the participants who furnish a disproportionately lesser amount of existing intangibles to the arrangement. Buy-in payments owed are netted against payments owing, and only the net payment is treated as a royalty. No implication is intended that

netting of cross royalties is permissible outside of the qualified cost sharing safe harbor rules.

Section 1.482-7(h) provides rules regarding the character of payments made pursuant to a qualified cost sharing arrangement. Cost sharing payments received are generally treated as reductions of research and development expense. A net approach is applied to foster simplicity and generally preserve the character of items actually incurred by a participant to the extent not reimbursed. In addition, for purposes of the research credit determined under section 41, cost sharing payments among controlled participants will be treated as provided for intra-group transactions in §1.41-8(e). Finally, any payment that in substance constitutes a cost sharing payment will be treated as such, regardless of its characterization under foreign law. This rule is intended to enable foreign entities to participate in cost sharing arrangements with U.S. controlled participants even if foreign law does not recognize cost sharing. This rule obviated the main reason for the subgroup rules which, as noted, have accordingly been eliminated.

Section 1.482-7(i) requires that controlled participants must use a consistent accounting method for measuring costs and benefits, and must translate foreign currencies on a consistent basis. To the extent that the accounting method materially differs from U.S. generally accepted accounting principles, any such material differences must be documented, as provided in §1.482-7(j)(2)(iv).

Section 1.482-7(j) provides simplified recordkeeping and reporting requirements. It is anticipated that many of the background documents necessary for purposes of this section will be kept pursuant to section 6662(e) and the regulations thereunder.

Section 1.482-7(k) provides that this regulation is effective for taxable years beginning on or after January 1, 1996.

Section 1.482-7(l) allows a one-year transition period for taxpayers to conform their cost sharing arrangements with the requirements of the final regulations. A longer period was not considered necessary, given the increased flexibility and the reduced number of administrative requirements of the final regulations.

Special Analyses

It has been determined that this Treasury decision is not a significant

regulatory action as defined in EO 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) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

Drafting Information

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

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1, 301 and 602 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority for part 1 is amended by adding an entry for section 1.482-7 to read as follows:

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

Section 1.482-7 is also issued under 26 U.S.C. 482. * * *

Par. 2. Section 1.482-0 is amended by:

1. Removing the entry for §1.482-7T.
2. Adding the entry for §1.482-7 to read as follows:

§1.482-0 Outline of regulations under 482.

* * * * *

§1.482-7 Sharing of costs.

- (a) In general.
 - (1) Scope and application of the rules in this section.
 - (2) Limitation on allocations.
 - (3) Cross references.
- (b) Qualified cost sharing arrangement.

- (c) Participant.
 - (1) In general.
 - (2) Active conduct of a trade or business.
 - (i) Trade or business.
 - (ii) Active conduct.
 - (iii) Examples.
 - (3) Use of covered intangibles in the active conduct of a trade or business.
 - (i) In general.
 - (ii) Example.
 - (4) Treatment of a controlled taxpayer that is not a controlled participant.
 - (i) In general.
 - (ii) Example.
 - (5) Treatment of consolidated group.
- (d) Costs.
 - (1) Intangible development costs.
 - (2) Examples.
- (e) Anticipated benefits.
 - (1) Benefits.
 - (2) Reasonably anticipated benefits.
- (f) Cost allocations.
 - (1) In general.
 - (2) Share of intangible development costs.
 - (i) In general.
 - (ii) Example.
 - (3) Share of reasonably anticipated benefits.
 - (i) In general.
 - (ii) Measure of benefits.
 - (iii) Indirect bases for measuring anticipated benefits.
 - (A) Units used, produced or sold.
 - (B) Sales.
 - (C) Operating profit.
 - (D) Other bases for measuring anticipated benefits.
 - (E) Examples.
 - (iv) Projections used to estimate anticipated benefits.
 - (A) In general.
 - (B) Unreliable projections.
 - (C) Foreign-to-foreign adjustments.
 - (D) Examples.
 - (4) Timing of allocations.
- (g) Allocations of income, deductions or other tax items to reflect transfers of intangibles (buy-in).
 - (1) In general.
 - (2) Pre-existing intangibles.
 - (3) New controlled participant.
 - (4) Controlled participant relinquishes interests.

- (5) Conduct inconsistent with the terms of a cost sharing arrangement.
- (6) Failure to assign interests under a qualified cost sharing arrangement.
- (7) Form of consideration.
 - (i) Lump sum payments.
 - (ii) Installment payments.
 - (iii) Royalties.
- (8) Examples.
- (h) Character of payments made pursuant to a qualified cost sharing arrangement.
 - (1) In general.
 - (2) Examples.
- (i) Accounting requirements.
- (j) Administrative requirements.
 - (1) In general.
 - (2) Documentation.
 - (3) Reporting requirements.
- (k) Effective date.
- (l) Transition rule.

* * * * *

Par. 3. Section 1.482-7 is added to read as follows:

§1.482-7 Sharing of costs.

(a) *In general*—(1) *Scope and application of the rules in this section.* A cost sharing arrangement is an agreement under which the parties agree to share the costs of development of one or more intangibles in proportion to their shares of reasonably anticipated benefits from their individual exploitation of the interests in the intangibles assigned to them under the arrangement. A taxpayer may claim that a cost sharing arrangement is a qualified cost sharing arrangement only if the agreement meets the requirements of paragraph (b) of this section. Consistent with the rules of §1.482-1(d)(3)(ii)(B) (Identifying contractual terms), the district director may apply the rules of this section to any arrangement that in substance constitutes a cost sharing arrangement, notwithstanding a failure to comply with any requirement of this section. A qualified cost sharing arrangement, or an arrangement to which the district director applies the rules of this section, will not be treated as a partnership to which the rules of subchapter K apply. See §301.7701-3(e) of this chapter. Furthermore, a participant that is a foreign corporation or nonresident alien individual will not be treated as engaged in trade or business

within the United States solely by reason of its participation in such an arrangement. See generally §1.864-2(a).

(2) *Limitation on allocations.* The district director shall not make allocations with respect to a qualified cost sharing arrangement except to the extent necessary to make each controlled participant's share of the costs (as determined under paragraph (d) of this section) of intangible development under the qualified cost sharing arrangement equal to its share of reasonably anticipated benefits attributable to such development, under the rules of this section. If a controlled taxpayer acquires an interest in intangible property from another controlled taxpayer (other than in consideration for bearing a share of the costs of the intangible's development), then the district director may make appropriate allocations to reflect an arm's length consideration for the acquisition of the interest in such intangible under the rules of §§1.482-1 and 1.482-4 through 1.482-6. See paragraph (g) of this section. An interest in an intangible includes any commercially transferable interest, the benefits of which are susceptible of valuation. See §1.482-4(b) for the definition of an intangible.

(3) *Cross references.* Paragraph (c) of this section defines participant. Paragraph (d) of this section defines the costs of intangible development. Paragraph (e) of this section defines the anticipated benefits of intangible development. Paragraph (f) of this section provides rules governing cost allocations. Paragraph (g) of this section provides rules governing transfers of intangibles other than in consideration for bearing a share of the costs of the intangible's development. Rules governing the character of payments made pursuant to a qualified cost sharing arrangement are provided in paragraph (h) of this section. Paragraph (i) of this section provides accounting requirements. Paragraph (j) of this section provides administrative requirements. Paragraph (k) of this section provides an effective date. Paragraph (l) provides a transition rule.

(b) *Qualified cost sharing arrangement.* A qualified cost sharing arrangement must—

- (1) Include two or more participants;
- (2) Provide a method to calculate each controlled participant's share of intangible development costs, based on

factors that can reasonably be expected to reflect that participant's share of anticipated benefits;

(3) Provide for adjustment to the controlled participants' shares of intangible development costs to account for changes in economic conditions, the business operations and practices of the participants, and the ongoing development of intangibles under the arrangement; and

(4) Be recorded in a document that is contemporaneous with the formation (and any revision) of the cost sharing arrangement and that includes—

(i) A list of the arrangement's participants, and any other member of the controlled group that will benefit from the use of intangibles developed under the cost sharing arrangement;

(ii) The information described in paragraphs (b)(2) and (b)(3) of this section;

(iii) A description of the scope of the research and development to be undertaken, including the intangible or class of intangibles intended to be developed;

(iv) A description of each participant's interest in any covered intangibles. A covered intangible is any intangible property that is developed as a result of the research and development undertaken under the cost sharing arrangement (intangible development area);

(v) The duration of the arrangement; and

(vi) The conditions under which the arrangement may be modified or terminated and the consequences of such modification or termination, such as the interest that each participant will receive in any covered intangibles.

(c) *Participant*—(1) *In general*. For purposes of this section, a participant is a controlled taxpayer that meets the requirements of this paragraph (c)(1) (controlled participant) or an uncontrolled taxpayer that is a party to the cost sharing arrangement (uncontrolled participant). See §1.482-1(i)(5) for the definitions of controlled and uncontrolled taxpayers. A controlled taxpayer may be a controlled participant only if—

(i) Uses or reasonably expects to use covered intangibles in the active conduct of a trade or business, under the rules of paragraphs (c)(2) and (c)(3) of this section;

(ii) Substantially complies with the accounting requirements described in paragraph (i) of this section; and

(iii) Substantially complies with the administrative requirements described in paragraph (j) of this section.

(2) *Active conduct of a trade or business*—(i) *Trade or business*. The rules of §1.367(a)-2T(b)(2) apply in determining whether the activities of a controlled taxpayer constitute a trade or business. For this purpose, the term *controlled taxpayer* must be substituted for the term *foreign corporation*.

(ii) *Active conduct*. In general, a controlled taxpayer actively conducts a trade or business only if it carries out substantial managerial and operational activities. For purposes only of this paragraph (c)(2), activities carried out on behalf of a controlled taxpayer by another person may be attributed to the controlled taxpayer, but only if the controlled taxpayer exercises substantial managerial and operational control over those activities.

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

Example 1. Foreign Parent (FP) enters into a cost sharing arrangement with its U.S. Subsidiary (USS) to develop a cheaper process for manufacturing widgets. USS is to receive the right to exploit the intangible to make widgets in North America, and FP is to receive the right to exploit the intangible to make widgets in the rest of the world. However, USS does not manufacture widgets; rather, USS acts as a distributor for FP's widgets in North America. Because USS is simply a distributor of FP's widgets, USS does not use or reasonably expect to use the manufacturing intangible in the active conduct of its trade or business, and thus USS is not a controlled participant.

Example 2. The facts are the same as in *Example 1*, except that USS contracts to have widgets it sells in North America made by a related manufacturer (that is not a controlled participant) using USS' cheaper manufacturing process. USS purchases all the manufacturing inputs, retains ownership of the work in process as well as the finished product, and bears the risk of loss at all times in connection with the operation. USS compensates the manufacturer for the manufacturing functions it performs and receives substantially all of the intangible value attributable to the cheaper manufacturing process. USS exercises substantial managerial and operational control over the manufacturer to ensure USS's requirements are satisfied concerning the timing, quantity, and quality of the widgets produced. USS uses the manufacturing intangible in the active conduct of its trade or business, and thus USS is a controlled participant.

(3) *Use of covered intangibles in the active conduct of a trade or business*—

(i) *In general*. A covered intangible will not be considered to be used, nor will the controlled taxpayer be considered to reasonably expect to use it, in the active conduct of the controlled

taxpayer's trade or business if a principal purpose for participating in the arrangement is to obtain the intangible for transfer or license to a controlled or uncontrolled taxpayer.

(ii) *Example*. The following example illustrates the absence of such a principal purpose:

Example. Controlled corporations A, B, and C enter into a qualified cost sharing arrangement for the purpose of developing a new technology. Costs are shared equally among the three controlled taxpayers. A, B, and C have the exclusive rights to manufacture and sell products based on the new technology in North America, South America, and Europe, respectively. When the new technology is developed, C expects to use it to manufacture and sell products in most of Europe. However, for sound business reasons, C expects to license to an unrelated manufacturer the right to use the new technology to manufacture and sell products within a particular European country owing to its relative remoteness and small size. In these circumstances, C has not entered into the arrangement with a principal purpose of obtaining covered intangibles for transfer or license to controlled or uncontrolled taxpayers, because the purpose of licensing the technology to the unrelated manufacturer is relatively insignificant in comparison to the overall purpose of exploiting the European market.

(4) *Treatment of a controlled taxpayer that is not a controlled participant*—

(i) *In general*. If a controlled taxpayer that is not a controlled participant (within the meaning of this paragraph (c)) provides assistance in relation to the research and development undertaken in the intangible development area, it must receive consideration from the controlled participants under the rules of §1.482-4(f)(3)(iii) (Allocations with respect to assistance provided to the owner). For purposes of paragraph (d) of this section, such consideration is treated as an operating expense and each controlled participant must be treated as incurring a share of such consideration equal to its share of reasonably anticipated benefits (as defined in paragraph (f)(3) of this section).

(ii) *Example*. The following example illustrates this paragraph (c)(4):

Example. (i) U.S. Parent (USP), one foreign subsidiary (FS), and a second foreign subsidiary constituting the group's research arm (R+D) enter into a cost sharing agreement to develop manufacturing intangibles for a new product line A. USP and FS are assigned the exclusive rights to exploit the intangibles respectively in the United States and Europe, where each presently manufactures and sells various existing product lines. R+D, whose activity consists solely in carrying out research for the group, is assigned the rights to exploit the new technology in Asia,

where no group member presently operates, but which is reliably projected to be a major market for product A. R+D will license the Asian rights to an unrelated third party. It is reliably projected that the shares of reasonably anticipated benefits of USP and FS (*i.e.*, not taking R+D into account) will be 66 2/3% and 33 1/3%, respectively. The parties' agreement provides that USP and FS will reimburse 40% and 20%, respectively, of the intangible development costs incurred by R+D with respect to the new intangible.

(ii) R+D does not qualify as a controlled participant within the meaning of paragraph (c) of this section. Therefore, R+D is treated as a service provider for purposes of this section and must receive arm's length consideration for the assistance it is deemed to provide to USP and FS, under the rules of §1.482-4(f)(3)(iii). Such consideration must be treated as intangible development costs incurred by USP and FS in proportion to their shares of reasonably anticipated benefits (*i.e.*, 66 2/3% and 33 1/3%, respectively). R+D will not be considered to bear any share of the intangible development costs under the arrangement.

(iii) The Asian rights nominally assigned to R+D under the agreement must be treated as being held by USP and FS in accordance with their shares of the intangible development costs (*i.e.*, 66 2/3% and 33 1/3%, respectively). See paragraph (g)(6) of this section. Thus, since under the cost sharing agreement the Asian rights are owned by R+D, the district director may make allocations to reflect an arm's length consideration owed by R+D to USP and FS for these rights under the rules of §§1.482-1 and 1.482-4 through 1.482-6.

(5) *Treatment of consolidated group.* For purposes of this section, all members of the same affiliated group (within the meaning of section 1504(a)) that join in the filing of a consolidated return for the taxable year under section 1501 shall be treated as one taxpayer.

(d) *Costs*—(1) *Intangible development costs.* For purposes of this section, a controlled participant's costs of developing intangibles for a taxable year mean all of the costs incurred by that participant related to the intangible development area, plus all of the cost sharing payments it makes to other controlled and uncontrolled participants, minus all of the cost sharing payments it receives from other controlled and uncontrolled participants. Costs incurred related to the intangible development area consist of the following items: operating expenses as defined in §1.482-5(d)(3), other than depreciation or amortization expense, plus (to the extent not included in such operating expenses, as defined in §1.482-5(d)(3)) the charge for the use of any tangible property made available to the qualified cost sharing arrangement. If tangible property is made

available to the qualified cost sharing arrangement by a controlled participant, the determination of the appropriate charge will be governed by the rules of §1.482-2(c) (Use of tangible property). Intangible development costs do not include the consideration for the use of any intangible property made available to the qualified cost sharing arrangement. See paragraph (g)(2) of this section. If a particular cost contributes to the intangible development area and other areas or other business activities, the cost must be allocated between the intangible development area and the other areas or business activities on a reasonable basis. In such a case, it is necessary to estimate the total benefits attributable to the cost incurred. The share of such cost allocated to the intangible development area must correspond to covered intangibles' share of the total benefits. Costs that do not contribute to the intangible development area are not taken into account.

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

Example 1. Foreign Parent (FP) and U.S. Subsidiary (USS) enter into a qualified cost sharing arrangement to develop a better mousetrap. USS and FP share the costs of FP's research and development facility that will be exclusively dedicated to this research, the salaries of the researchers, and reasonable overhead costs attributable to the project. They also share the cost of a conference facility that is at the disposal of the senior executive management of each company but does not contribute to the research and development activities in any measurable way. In this case, the cost of the conference facility must be excluded from the amount of intangible development costs.

Example 2. U.S. Parent (USP) and Foreign Subsidiary (FS) enter into a qualified cost sharing arrangement to develop a new device. USP and FS share the costs of a research and development facility, the salaries of researchers, and reasonable overhead costs attributable to the project. USP also incurs costs related to field testing of the device, but does not include them in the amount of intangible development costs of the cost sharing arrangement. The district director may determine that the field testing costs are intangible development costs that must be shared.

(e) *Anticipated benefits*—(1) *Benefits.* Benefits are additional income generated or costs saved by the use of covered intangibles.

(2) *Reasonably anticipated benefits.* For purposes of this section, a controlled participant's reasonably anticipated benefits are the aggregate benefits that it reasonably anticipates that it will derive from covered intangibles.

(f) *Cost allocations*—(1) *In general.* For purposes of determining whether a

cost allocation authorized by paragraph (a)(2) of this section is appropriate for a taxable year, a controlled participant's share of intangible development costs for the taxable year under a qualified cost sharing arrangement must be compared to its share of reasonably anticipated benefits under the arrangement. A controlled participant's share of intangible development costs is determined under paragraph (f)(2) of this section. A controlled participant's share of reasonably anticipated benefits under the arrangement is determined under paragraph (f)(3) of this section. In determining whether benefits were reasonably anticipated, it may be appropriate to compare actual benefits to anticipated benefits, as described in paragraph (f)(3)(iv) of this section.

(2) *Share of intangible development costs*—(i) *In general.* A controlled participant's share of intangible development costs for a taxable year is equal to its intangible development costs for the taxable year (as defined in paragraph (d) of this section), divided by the sum of the intangible development costs for the taxable year (as defined in paragraph (d) of this section) of all the controlled participants.

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

Example. (i) U.S. Parent (USP), Foreign Subsidiary (FS), and Unrelated Third Party (UTP) enter into a cost sharing arrangement to develop new audio technology. In the first year of the arrangement, the controlled participants incur \$2,250,000 in the intangible development area, all of which is incurred directly by USP. In the first year, UTP makes a \$250,000 cost sharing payment to USP, and FS makes a \$800,000 cost sharing payment to USP, under the terms of the arrangement. For that year, the intangible development costs borne by USP are \$1,200,000 (its \$2,250,000 intangible development costs directly incurred, minus the cost sharing payments it receives of \$250,000 from UTP and \$800,000 from FS); the intangible development costs borne by FS are \$800,000 (its cost sharing payment); and the intangible development costs borne by all of the controlled participants are \$2,000,000 (the sum of the intangible development costs borne by USP and FS of \$1,200,000 and \$800,000, respectively). Thus, for the first year, USP's share of intangible development costs is 60% (\$1,200,000 divided by \$2,000,000), and FS's share of intangible development costs is 40% (\$800,000 divided by \$2,000,000).

(ii) For purposes of determining whether a cost allocation authorized by paragraph §1.482-7(a)(2) is appropriate for the first year, the district director must compare USP's and FS's shares of intangible development costs for that year to their shares of reasonably anticipated benefits. See paragraph (f)(3) of this section.

(3) *Share of reasonably anticipated benefits*—(i) *In general.* A controlled

participant's share of reasonably anticipated benefits under a qualified cost sharing arrangement is equal to its reasonably anticipated benefits (as defined in paragraph (e)(2) of this section), divided by the sum of the reasonably anticipated benefits (as defined in paragraph (e)(2) of this section) of all the controlled participants. The anticipated benefits of an uncontrolled participant will not be included for purposes of determining each controlled participant's share of anticipated benefits. A controlled participant's share of reasonably anticipated benefits will be determined using the most reliable estimate of reasonably anticipated benefits. In determining which of two or more available estimates is most reliable, the quality of the data and assumptions used in the analysis must be taken into account, consistent with §1.482-1(c)(2)(ii) (Data and assumptions). Thus, the reliability of an estimate will depend largely on the completeness and accuracy of the data, the soundness of the assumptions, and the relative effects of particular deficiencies in data or assumptions on different estimates. If two estimates are equally reliable, no adjustment should be made based on differences in the results. The following factors will be particularly relevant in determining the reliability of an estimate of anticipated benefits—

(A) The reliability of the basis used for measuring benefits, as described in paragraph (f)(3)(ii) of this section; and

(B) The reliability of the projections used to estimate benefits, as described in paragraph (f)(3)(iv) of this section.

(ii) *Measure of benefits.* In order to estimate a controlled participant's share of anticipated benefits from covered intangibles, the amount of benefits that each of the controlled participants is reasonably anticipated to derive from covered intangibles must be measured on a basis that is consistent for all such participants. See paragraph (f)(3)(iii)-(E), *Example 8*, of this section. Anticipated benefits are measured either on a direct basis, by reference to estimated additional income to be generated or costs to be saved by the use of covered intangibles, or on an indirect basis, by reference to certain measurements that reasonably can be assumed to be related to income generated or costs saved. Such indirect bases of measurement of anticipated benefits are described in paragraph (f)(3)(iii) of this section. A controlled participant's an-

ticipated benefits must be measured on the most reliable basis, whether direct or indirect. In determining which of two bases of measurement of reasonably anticipated benefits is most reliable, the factors set forth in §1.482-1(c)(2)(ii) (Data and assumptions) must be taken into account. It normally will be expected that the basis that provided the most reliable estimate for a particular year will continue to provide the most reliable estimate in subsequent years, absent a material change in the factors that affect the reliability of the estimate. Regardless of whether a direct or indirect basis of measurement is used, adjustments may be required to account for material differences in the activities that controlled participants undertake to exploit their interests in covered intangibles. See *Example 6* of paragraph (f)(3)(iii)(E) of this section.

(iii) *Indirect bases for measuring anticipated benefits.* Indirect bases for measuring anticipated benefits from participation in a qualified cost sharing arrangement include the following:

(A) *Units used, produced or sold.* Units of items used, produced or sold by each controlled participant in the business activities in which covered intangibles are exploited may be used as an indirect basis for measuring its anticipated benefits. This basis of measurement will be more reliable to the extent that each controlled participant is expected to have a similar increase in net profit or decrease in net loss attributable to the covered intangibles per unit of the item or items used, produced or sold. This circumstance is most likely to arise when the covered intangibles are exploited by the controlled participants in the use, production or sale of substantially uniform items under similar economic conditions.

(B) *Sales.* Sales by each controlled participant in the business activities in which covered intangibles are exploited may be used as an indirect basis for measuring its anticipated benefits. This basis of measurement will be more reliable to the extent that each controlled participant is expected to have a similar increase in net profit or decrease in net loss attributable to covered intangibles per dollar of sales. This circumstance is most likely to arise if the costs of exploiting covered intangibles are not substantial relative to the revenues generated, or if the principal effect of using covered intangibles is to increase the controlled

participants' revenues (e.g., through a price premium on the products they sell) without affecting their costs substantially. Sales by each controlled participant are unlikely to provide a reliable basis for measuring benefits unless each controlled participant operates at the same market level (e.g., manufacturing, distribution, etc.).

(C) *Operating profit.* Operating profit of each controlled participant from the activities in which covered intangibles are exploited may be used as an indirect basis for measuring its anticipated benefits. This basis of measurement will be more reliable to the extent that such profit is largely attributable to the use of covered intangibles, or if the share of profits attributable to the use of covered intangibles is expected to be similar for each controlled participant. This circumstance is most likely to arise when covered intangibles are integral to the activity that generates the profit and the activity could not be carried on or would generate little profit without use of those intangibles.

(D) *Other bases for measuring anticipated benefits.* Other bases for measuring anticipated benefits may, in some circumstances, be appropriate, but only to the extent that there is expected to be a reasonably identifiable relationship between the basis of measurement used and additional income generated or costs saved by the use of covered intangibles. For example, a division of costs based on employee compensation would be considered unreliable unless there were a relationship between the amount of compensation and the expected income of the controlled participants from the use of covered intangibles.

(E) *Examples.* The following examples illustrate this paragraph (f)(3)(iii):

Example 1. Foreign Parent (FP) and U.S. Subsidiary (USS) both produce a feedstock for the manufacture of various high-performance plastic products. Producing the feedstock requires large amounts of electricity, which accounts for a significant portion of its production cost. FP and USS enter into a cost sharing arrangement to develop a new process that will reduce the amount of electricity required to produce a unit of the feedstock. FP and USS currently both incur an electricity cost of X% of its other production costs and rates for each are expected to remain similar in the future. How much the new process, if it is successful, will reduce the amount of electricity required to produce a unit of the feedstock is uncertain, but it will be about the same amount for both companies. Therefore, the cost savings each company is expected to

achieve after implementing the new process are similar relative to the total amount of the feedstock produced. Under the cost sharing arrangement FP and USS divide the costs of developing the new process based on the units of the feedstock each is anticipated to produce in the future. In this case, units produced is the most reliable basis for measuring benefits and dividing the intangible development costs because each participant is expected to have a similar decrease in costs per unit of the feedstock produced.

Example 2. The facts are the same as in *Example 1*, except that USS pays X% of its other production costs for electricity while FP pays 2X% of its other production costs. In this case, units produced is not the most reliable basis for measuring benefits and dividing the intangible development costs because the participants do not expect to have a similar decrease in costs per unit of the feedstock produced. The district director determines that the most reliable measure of benefit shares may be based on units of the feedstock produced if FP's units are weighted relative to USS' units by a factor of 2. This reflects the fact that FP pays twice as much as USS as a percentage of its other production costs for electricity and, therefore, FP's savings per unit of the feedstock would be twice USS's savings from any new process eventually developed.

Example 3. The facts are the same as in *Example 2*, except that to supply the particular needs of the U.S. market USS manufactures the feedstock with somewhat different properties than FP's feedstock. This requires USS to employ a somewhat different production process than does FP. Because of this difference, it will be more costly for USS to adopt any new process that may be developed under the cost sharing agreement. In this case, units produced is not the most reliable basis for measuring benefit shares. In order to reliably determine benefit shares, the district director offsets the reasonably anticipated costs of adopting the new process against the reasonably anticipated total savings in electricity costs.

Example 4. U.S. Parent (USP) and Foreign Subsidiary (FS) enter into a cost sharing arrangement to develop new anesthetic drugs. USP obtains the right to use any resulting patent in the U.S. market, and FS obtains the right to use the patent in the European market. USP and FS divide costs on the basis of anticipated operating profit from each patent under development. USP anticipates that it will receive a much higher profit than FS per unit sold because drug prices are uncontrolled in the U.S., whereas drug prices are regulated in many European countries. In this case, the controlled taxpayers' basis for measuring benefits is the most reliable.

Example 5. (i) Foreign Parent (FP) and U.S. Subsidiary (USS) both manufacture and sell fertilizers. They enter into a cost sharing arrangement to develop a new pellet form of a common agricultural fertilizer that is currently available only in powder form. Under the cost sharing arrangement, USS obtains the rights to produce and sell the new form of fertilizer for the U.S. market while FP obtains the rights to produce and sell the fertilizer for the rest of the world. The costs of developing the new form of fertilizer are divided on the basis of the anticipated sales of fertilizer in the participants' respective markets.

(ii) If the research and development is successful the pellet form will deliver the fertilizer

more efficiently to crops and less fertilizer will be required to achieve the same effect on crop growth. The pellet form of fertilizer can be expected to sell at a price premium over the powder form of fertilizer based on the savings in the amount of fertilizer that needs to be used. If the research and development is successful, the costs of producing pellet fertilizer are expected to be approximately the same as the costs of producing powder fertilizer and the same for both FP and USS. Both FP and USS operate at approximately the same market levels, selling their fertilizers largely to independent distributors.

(iii) In this case, the controlled taxpayers' basis for measuring benefits is the most reliable.

Example 6. The facts are the same as in *Example 5*, except that FP distributes its fertilizers directly while USS sells to independent distributors. In this case, sales of USS and FP are not the most reliable basis for measuring benefits unless adjustments are made to account for the difference in market levels at which the sales occur.

Example 7. Foreign Parent (FP) and U.S. Subsidiary (USS) enter into a cost sharing arrangement to develop materials that will be used to train all new entry-level employees. FP and USS determine that the new materials will save approximately ten hours of training time per employee. Because their entry-level employees are paid on differing wage scales, FP and USS decide that they should not divide costs based on the number of entry-level employees hired by each. Rather, they divide costs based on compensation paid to the entry-level employees hired by each. In this case, the basis used for measuring benefits is the most reliable because there is a direct relationship between compensation paid to new entry-level employees and costs saved by FP and USS from the use of the new training materials.

Example 8. U.S. Parent (USP), Foreign Subsidiary 1 (FS1) and Foreign Subsidiary 2 (FS2) enter into a cost sharing arrangement to develop computer software that each will market and install on customers' computer systems. The participants divide costs on the basis of projected sales by USP, FS1, and FS2 of the software in their respective geographic areas. However, FS1 plans for sound business reasons not only to sell but also to license the software, and FS1's licensing income (which is a percentage of the licensees' sales) is not counted in the projected benefits. In this case, the basis used for measuring the benefits of each participant is not the most reliable because all of the benefits received by participants are not taken into account. In order to reliably determine benefit shares, FS1's projected benefits from licensing must be included in the measurement on a basis that is the same as that used to measure its own and the other participants' projected benefits from sales (e.g., all participants might measure their benefits on the basis of operating profit).

(iv) *Projections used to estimate anticipated benefits—(A) In general.*

The reliability of an estimate of anticipated benefits also depends upon the reliability of projections used in making the estimate. Projections required for this purpose generally include a determination of the time period between the inception of the research and

development and the receipt of benefits, a projection of the time over which benefits will be received, and a projection of the benefits anticipated for each year in which it is anticipated that the intangible will generate benefits. A projection of the relevant basis for measuring anticipated benefits may require a projection of the factors that underlie it. For example, a projection of operating profits may require a projection of sales, cost of sales, operating expenses, and other factors that affect operating profits. If it is anticipated that there will be significant variation among controlled participants in the timing of their receipt of benefits, and consequently benefit shares are expected to vary significantly over the years in which benefits will be received, it may be necessary to use the present discounted value of the projected benefits to reliably determine each controlled participant's share of those benefits. If it is not anticipated that benefit shares will significantly change over time, current annual benefit shares may provide a reliable projection of anticipated benefit shares. This circumstance is most likely to occur when the cost sharing arrangement is a long-term arrangement, the arrangement covers a wide variety of intangibles, the composition of the covered intangibles is unlikely to change, the covered intangibles are unlikely to generate unusual profits, and each controlled participant's share of the market is stable.

(B) *Unreliable projections.* A significant divergence between projected benefit shares and actual benefit shares may indicate that the projections were not reliable. In such a case, the district director may use actual benefits as the most reliable measure of anticipated benefits. If benefits are projected over a period of years, and the projections for initial years of the period prove to be unreliable, this may indicate that the projections for the remaining years of the period are also unreliable and thus should be adjusted. Projections will not be considered unreliable based on a divergence between a controlled participant's projected benefit share and actual benefit share if the amount of such divergence for every controlled participant is less than or equal to 20% of the participant's projected benefit share. Further, the district director will not make an allocation based on such divergence if the difference is due to an extraordinary event, beyond the

control of the participants, that could not reasonably have been anticipated at the time that costs were shared. For purposes of this paragraph, all controlled participants that are not U.S. persons will be treated as a single controlled participant. Therefore, an adjustment based on an unreliable projection will be made to the cost shares of foreign controlled participants only if there is a matching adjustment to the cost shares of controlled participants that are U.S. persons. Nothing in this paragraph (f)(3)(iv)(B) will prevent the district director from making an allocation if the taxpayer did not use the most reliable basis for measuring anticipated benefits. For example, if the taxpayer measures anticipated benefits based on units sold, and the district director determines that another basis is more reliable for measuring anticipated benefits, then the fact that actual units sold were within 20% of the projected unit sales will not preclude an allocation under this section.

(C) *Foreign-to-foreign adjustments.* Notwithstanding the limitations on adjustments provided in paragraph (f)(3)(iv)(B) of this section, adjustments to cost shares based on an unreliable projection also may be made solely among foreign controlled participants if the variation between actual and projected benefits has the effect of substantially reducing U.S. tax.

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

Example 1. (i) Foreign Parent (FP) and U.S. Subsidiary (USS) enter into a cost sharing arrangement to develop a new car model. The participants plan to spend four years developing the new model and four years producing and selling the new model. USS and FP project total sales of \$4 billion and \$2 billion, respectively, over the planned four years of exploitation of the new model. Cost shares are divided for each year based on projected total sales. Therefore, USS bears 66 2/3% of each year's intangible development costs and FP bears 33 1/3% of such costs.

(ii) USS typically begins producing and selling new car models a year after FP begins producing and selling new car models. The district director determines that in order to reflect USS' one-year lag in introducing new car models, a more reliable projection of each participant's share of benefits would be based on a projection of all four years of sales for each participant, discounted to present value.

Example 2. U.S. Parent (USP) and Foreign Subsidiary (FS) enter into a cost sharing arrangement to develop new and improved household cleaning products. Both participants have sold household cleaning products for many years and have stable market shares. The products under development are unlikely to

produce unusual profits for either participant. The participants divide costs on the basis of each participant's current sales of household cleaning products. In this case, the participants' future benefit shares are reliably projected by current sales of cleaning products.

Example 3. The facts are the same as in *Example 2*, except that FS's market share is rapidly expanding because of the business failure of a competitor in its geographic area. The district director determines that the participants' future benefit shares are not reliably projected by current sales of cleaning products and that FS's benefit projections should take into account its growth in sales.

Example 4. Foreign Parent (FP) and U.S. Subsidiary (USS) enter into a cost sharing arrangement to develop synthetic fertilizers and insecticides. FP and USS share costs on the basis of each participant's current sales of fertilizers and insecticides. The market shares of the participants have been stable for fertilizers, but FP's market share for insecticides has been expanding. The district director determines that the participants' projections of benefit shares are reliable with regard to fertilizers, but not reliable with regard to insecticides; a more reliable projection of benefit shares would take into account the expanding market share for insecticides.

Example 5. U.S. Parent (USP) and Foreign Subsidiary (FS) enter into a cost sharing arrangement to develop new food products, dividing costs on the basis of projected sales two years in the future. In year 1, USP and FS project that their sales in year 3 will be equal, and they divide costs accordingly. In year 3, the district director examines the participants' method for dividing costs. USP and FS actually accounted for 42% and 58% of total sales, respectively. The district director agrees that sales two years in the future provide a reliable basis for estimating benefit shares. Because the differences between USP's and FS's actual and projected benefit shares are less than 20% of their projected benefit shares, the projection of future benefits for year 3 is reliable.

Example 6. The facts are the same as in *Example 5*, except that the in year 3 USP and FS actually accounted for 35% and 65% of total sales, respectively. The divergence between USP's projected and actual benefit shares is greater than 20% of USP's projected benefit share and is not due to an extraordinary event beyond the control of the participants. The district director concludes that the projection of anticipated benefit shares was unreliable, and uses actual benefits as the basis for an adjustment to the cost shares borne by USP and FS.

Example 7. U.S. Parent (USP), a U.S. corporation, and its foreign subsidiary (FS) enter a cost sharing arrangement in year 1. They project that they will begin to receive benefits from covered intangibles in years 4 through 6, and that USP will receive 60% of total benefits and FS 40% of total benefits. In years 4 through 6, USP and FS actually receive 50% each of the total benefits. In evaluating the reliability of the participants' projections, the district director compares these actual benefit shares to the projected benefit shares. Although USP's actual benefit share (50%) is within 20% of its projected benefit share (60%), FS's actual benefit share (50%) is not within 20% of its projected benefit share (40%). Based on this discrepancy, the district director may conclude that the participants' projections were not reliable and may use actual

benefit shares as the basis for an adjustment to the cost shares borne by USP and FS.

Example 8. Three controlled taxpayers, USP, FS1 and FS2 enter into a cost sharing arrangement. FS1 and FS2 are foreign. USP is a United States corporation that controls all the stock of FS1 and FS2. The participants project that they will share the total benefits of the covered intangibles in the following percentages: USP 50%; FS1 30%; and FS2 20%. Actual benefit shares are as follows: USP 45%; FS1 25%; and FS2 30%. In evaluating the reliability of the participants' projections, the district director compares these actual benefit shares to the projected benefit shares. For this purpose, FS1 and FS2 are treated as a single participant. The actual benefit share received by USP (45%) is within 20% of its projected benefit share (50%). In addition, the non-US participants' actual benefit share (55%) is also within 20% of their projected benefit share (50%). Therefore, the district director concludes that the participants' projections of future benefits were reliable, despite the fact that FS2's actual benefit share (30%) is not within 20% of its projected benefit share (20%).

Example 9. The facts are the same as in *Example 8*. In addition, the district director determines that FS2 has significant operating losses and has no earnings and profits, and that FS1 is profitable and has earnings and profits. Based on all the evidence, the district director concludes that the participants arranged that FS1 would bear a larger cost share than appropriate in order to reduce FS1's earnings and profits and thereby reduce inclusions USP otherwise would be deemed to have on account of FS1 under subpart F. Pursuant to §1.482-7 (f)(3)(iv)(C), the district director may make an adjustment solely to the cost shares borne by FS1 and FS2 because FS2's projection of future benefits was unreliable and the variation between actual and projected benefits had the effect of substantially reducing USP's U.S. income tax liability (on account of FS1 subpart F income).

Example 10. (i) (A) Foreign Parent (FP) and U.S. Subsidiary (USS) enter into a cost sharing arrangement in 1996 to develop a new treatment for baldness. USS's interest in any treatment developed is the right to produce and sell the treatment in the U.S. market while FP retains rights to produce and sell the treatment in the rest of the world. USS and FP measure their anticipated benefits from the cost sharing arrangement based on their respective projected future sales of the baldness treatment. The following sales projections are used:

Sales (\$ millions)

Year	USS	FP
1997	5	10
1998	20	20
1999	30	30
2000	40	40
2001	40	40
2002	40	40
2003	40	40
2004	20	20
2005	10	10
2006	5	5

(B) In 1997, the first year of sales, USS is projected to have lower sales than FP due to lags in U.S. regulatory approval for the baldness treatment. In each subsequent year USS and FP are projected to have equal sales. Sales are

projected to build over the first three years of the period, level off for several years, and then decline over the final years of the period as new and improved baldness treatments reach the market.

(ii) To account for USS's lag in sales in the first year, the present discounted value of sales over the period is used as the basis for measuring benefits. Based on the risk associated with this venture, a discount rate of 10 percent is selected. The present discounted value of projected sales is determined to be approximately \$154.4 million for USS and \$158.9 million for FP. On this basis USS and FP are projected to obtain approximately 49.3% and 50.7% of the benefit, respectively, and the costs of developing the baldness treatment are shared accordingly.

(iii) (A) In the year 2002 the district director examines the cost sharing arrangement. USS and FP have obtained the following sales results through the year 2001:

Sales (\$ millions)		
Year	USS	FP
1997	0	17
1998	17	35
1999	25	41
2000	38	41
2001	39	41

(B) USS's sales initially grew more slowly than projected while FP's sales grew more quickly. In each of the first three years of the period the share of total sales of at least one of the parties diverged by over 20% from its projected share of sales. However, by the year 2001 both parties' sales had leveled off at approximately their projected values. Taking into account this leveling off of sales and all the facts and circumstances, the district director determines that it is appropriate to use the original projections for the remaining years of sales. Combining the actual results through the year 2001 with the projections for subsequent years, and using a discount rate of 10%, the present discounted value of sales is approximately \$141.6 million for USS and \$187.3 million for FP. This result implies that USS and FP obtain approximately 43.1% and 56.9%, respectively, of the anticipated benefits from the baldness treatment. Because these benefit shares are within 20% of the benefit shares calculated based on the original sales projections, the district director determines that, based on the difference between actual and projected benefit shares, the original projections were not unreliable. No adjustment is made based on the difference between actual and projected benefit shares.

Example 11. (i) The facts are the same as in *Example 10*, except that the actual sales results through the year 2001 are as follows:

Sales (\$ millions)		
Year	USS	FP
1997	0	17
1998	17	35
1999	25	44
2000	34	54
2001	36	55

(ii) Based on the discrepancy between the projections and the actual results and on consideration of all the facts, the district director determines that for the remaining years the following sales projections are more reliable than the original projections:

Year	Sales (\$ millions)	
	USS	FP
2002	36	55
2003	36	55
2004	18	28
2005	9	14
2006	4.5	7

(iii) Combining the actual results through the year 2001 with the projections for subsequent years, and using a discount rate of 10%, the present discounted value of sales is approximately \$131.2 million for USS and \$229.4 million for FP. This result implies that USS and FP obtain approximately 35.4% and 63.6%, respectively, of the anticipated benefits from the baldness treatment. These benefit shares diverge by greater than 20% from the benefit shares calculated based on the original sales projections, and the district director determines that, based on the difference between actual and projected benefit shares, the original projections were unreliable. The district director adjusts costs shares for each of the taxable years under examination to conform them to the recalculated shares of anticipated benefits.

(4) *Timing of allocations.* If the district director reallocates costs under the provisions of this paragraph (f), the allocation must be reflected for tax purposes in the year in which the costs were incurred. When a cost sharing payment is owed by one member of a qualified cost sharing arrangement to another member, the district director may make appropriate allocations to reflect an arm's length rate of interest for the time value of money, consistent with the provisions of §1.482-2(a) (Loans or advances).

(g) *Allocations of income, deductions or other tax items to reflect transfers of intangibles (buy-in)*—(1) *In general.* A controlled participant that makes intangible property available to a qualified cost sharing arrangement will be treated as having transferred interests in such property to the other controlled participants, and such other controlled participants must make buy-in payments to it, as provided in paragraph (g)(2) of this section. If the other controlled participants fail to make such payments, the district director may make appropriate allocations, under the provisions of §§1.482-1 and 1.482-4 through 1.482-6, to reflect an arm's length consideration for the transferred intangible property. Further, if a group of controlled taxpayers participates in a qualified cost sharing arrangement, any change in the controlled participants' interests in covered intangibles, whether by reason of entry of a new participant or otherwise by reason of transfers (including deemed transfers) of interests among existing

participants, is a transfer of intangible property, and the district director may make appropriate allocations, under the provisions of §§1.482-1 and 1.482-4 through 1.482-6, to reflect an arm's length consideration for the transfer. See paragraphs (g)(3), (4), and (5) of this section. Paragraph (g)(6) of this section provides rules for assigning unassigned interests under a qualified cost sharing arrangement.

(2) *Pre-existing intangibles.* If a controlled participant makes pre-existing intangible property in which it owns an interest available to other controlled participants for purposes of research in the intangible development area under a qualified cost sharing arrangement, then each such other controlled participant must make a buy-in payment to the owner. The buy-in payment by each such other controlled participant is the arm's length charge for the use of the intangible under the rules of §§1.482-1 and 1.482-4 through 1.482-6, multiplied by the controlled participant's share of reasonably anticipated benefits (as defined in paragraph (f)(3) of this section). A controlled participant's payment required under this paragraph (g)(2) is deemed to be reduced to the extent of any payments owed to it under this paragraph (g)(2) from other controlled participants. Each payment received by a payee will be treated as coming pro rata out of payments made by all payors. See paragraph (g)(8), *Example 4*, of this section. Such payments will be treated as consideration for a transfer of an interest in the intangible property made available to the qualified cost sharing arrangement by the payee. Any payment to or from an uncontrolled participant in consideration for intangible property made available to the qualified cost sharing arrangement will be shared by the controlled participants in accordance with their shares of reasonably anticipated benefits (as defined in paragraph (f)(3) of this section). A controlled participant's payment required under this paragraph (g)(2) is deemed to be reduced by such a share of payments owed from an uncontrolled participant to the same extent as by any payments owed from other controlled participants under this paragraph (g)(2). See paragraph (g)(8), *Example 5*, of this section.

(3) *New controlled participant.* If a new controlled participant enters a qualified cost sharing arrangement and acquires any interest in the covered

intangibles, then the new participant must pay an arm's length consideration, under the provisions of §§1.482-1 and 1.482-4 through 1.482-6, for such interest to each controlled participant from whom such interest was acquired.

(4) *Controlled participant relinquishes interests.* A controlled participant in a qualified cost sharing arrangement may be deemed to have acquired an interest in one or more covered intangibles if another controlled participant transfers, abandons, or otherwise relinquishes an interest under the arrangement, to the benefit of the first participant. If such a relinquishment occurs, the participant relinquishing the interest must receive an arm's length consideration, under the provisions of §§1.482-1 and 1.482-4 through 1.482-6, for its interest. If the controlled participant that has relinquished its interest subsequently uses that interest, then that participant must pay an arm's length consideration, under the provisions of §§1.482-1 and 1.482-4 through 1.482-6, to the controlled participant that acquired the interest.

(5) *Conduct inconsistent with the terms of a cost sharing arrangement.* If, after any cost allocations authorized by paragraph (a)(2) of this section, a controlled participant bears costs of intangible development that over a period of years are consistently and materially greater or lesser than its share of reasonably anticipated benefits, then the district director may conclude that the economic substance of the arrangement between the controlled participants is inconsistent with the terms of the cost sharing arrangement. In such a case, the district director may disregard such terms and impute an agreement consistent with the controlled participants' course of conduct, under which a controlled participant that bore a disproportionately greater share of costs received additional interests in covered intangibles. See §1.482-1(d)(3)(ii)(B) (Identifying contractual terms) and §1.482-4(f)(3)(ii) (Identification of owner). Accordingly, that participant must receive an arm's length payment from any controlled participant whose share of the intangible development costs is less than its share of reasonably anticipated benefits over time, under the provisions of §§1.482-1 and 1.482-4 through 1.482-6.

(6) *Failure to assign interests under a qualified cost sharing arrangement.*

If a qualified cost sharing arrangement fails to assign an interest in a covered intangible, then each controlled participant will be deemed to hold a share in such interest equal to its share of the costs of developing such intangible. For this purpose, if cost shares have varied materially over the period during which such intangible was developed, then the costs of developing the intangible must be measured by their present discounted value as of the date when the first such costs were incurred.

(7) *Form of consideration.* The consideration for an acquisition described in this paragraph (g) may take any of the following forms:

(i) *Lump sum payments.* For the treatment of lump sum payments, see §1.482-4(f)(5) (Lump sum payments);

(ii) *Installment payments.* Installment payments spread over the period of use of the intangible by the transferee, with interest calculated in accordance with §1.482-2(a) (Loans or advances); and

(iii) *Royalties.* Royalties or other payments contingent on the use of the intangible by the transferee.

(8) *Examples.* The following examples illustrate allocations described in this paragraph (g):

Example 1. In year one, four members of a controlled group enter into a cost sharing arrangement to develop a commercially feasible process for capturing energy from nuclear fusion. Based on a reliable projection of their future benefits, each cost sharing participant bears an equal share of the costs. The cost of developing intangibles for each participant with respect to the project is approximately \$1 million per year. In year ten, a fifth member of the controlled group joins the cost sharing group and agrees to bear one-fifth of the future costs in exchange for part of the fourth member's territory reasonably anticipated to yield benefits amounting to one-fifth of the total benefits. The fair market value of intangible property within the arrangement at the time the fifth company joins the arrangement is \$45 million. The new member must pay one-fifth of that amount (that is, \$9 million total) to the fourth member from whom it acquired its interest in covered intangibles.

Example 2. U.S. Subsidiary (USS), Foreign Subsidiary (FS) and Foreign Parent (FP) enter into a cost sharing arrangement to develop new products within the Group X product line. USS manufactures and sells Group X products in North America, FS manufactures and sells Group X products in South America, and FP manufactures and sells Group X products in the rest of the world. USS, FS and FP project that each will manufacture and sell a third of the Group X products under development, and they share costs on the basis of projected sales of manufactured products. When the new Group X products are developed, however, USS ceases to manufacture Group X products, and FP sells its Group X

products to USS for resale in the North American market. USS earns a return on its resale activity that is appropriate given its function as a distributor, but does not earn a return attributable to exploiting covered intangibles. The district director determines that USS' share of the costs (one-third) was greater than its share of reasonably anticipated benefits (zero) and that it has transferred an interest in the intangibles for which it should receive a payment from FP, whose share of the intangible development costs (one-third) was less than its share of reasonably anticipated benefits over time (two-thirds). An allocation is made under §§1.482-1 and 1.482-4 through 1.482-6 from FP to USS to recognize USS' one-third interest in the intangibles. No allocation is made from FS to USS because FS did not exploit USS' interest in covered intangibles.

Example 3. U.S. Parent (USP), Foreign Subsidiary 1 (FS1), and Foreign Subsidiary 2 (FS2) enter into a cost sharing arrangement to develop a cure for the common cold. Costs are shared USP-50%, FS1-40% and FS2-10% on the basis of projected units of cold medicine to be produced by each. After ten years of research and development, FS1 withdraws from the arrangement, transferring its interests in the intangibles under development to USP in exchange for a lump sum payment of \$10 million. The district director may review this lump sum payment, under the provisions of §1.482-4(f)(5), to ensure that the amount is commensurate with the income attributable to the intangibles.

Example 4. (i) Four members A, B, C, and D of a controlled group form a cost sharing arrangement to develop the next generation technology for their business. Based on a reliable projection of their future benefits, the participants agree to bear shares of the costs incurred during the term of the agreement in the following percentages: A 40%; B 15%; C 25%; and D 20%. The arm's length charges, under the rules of §§1.482-1 and 1.482-4 through 1.482-6, for the use of the existing intangible property they respectively make available to the cost sharing arrangement are in the following amounts for the taxable year: A 80X; B 40X; C 30X; and D 30X. The provisional (before offsets) and final buy-in payments/receipts among A, B, C, and D are shown in the table as follows:

	(All amounts stated in X's)			
	A	B	C	D
PAYMENTS	<40 >	<21 >	<37.5 >	<30 >
RECEIPTS	48	34	22.5	24
FINAL	8	13	<15 >	<6 >

(ii) The first row/first column shows A's provisional buy-in payment equal to the product of 100X (sum of 40X, 30X, and 30X) and A's share of anticipated benefits of 40%. The second row/first column shows A's provisional buy-in receipts equal to the sum of the products of 80X and B's, C's, and D's anticipated benefits shares (15%, 25%, and 20%, respectively). The other entries in the first two rows of the table are similarly computed. The last row shows the final buy-in receipts/payments after offsets. Thus, for the taxable year, A and B are treated as receiving the 8X and 13X, respectively, pro rata out of payments by C and D of 15X and 6X, respectively.

Example 5. A and B, two members of a controlled group form a cost sharing arrangement

with an unrelated third party C to develop a new technology useable in their respective businesses. Based on a reliable projection of their future benefits, A and B agree to bear shares of 60% and 40%, respectively, of the costs incurred during the term of the agreement. A also makes available its existing technology for purposes of the research to be undertaken. The arm's length charge, under the rules of §§1.482-1 and 1.482-4 through 1.482-6, for the use of the existing technology is 100X for the taxable year. Under its agreement with A and B, C must make a specified cost sharing payment as well as a payment of 50X for the taxable year on account of the pre-existing intangible property made available to the cost sharing arrangement. B's provisional buy-in payment (before offsets) to A for the taxable year is 40X (the product of 100X and B's anticipated benefits share of 40%). C's payment of 50X is shared provisionally between A and B in accordance with their shares of reasonably anticipated benefits, 30X (50X times 60%) to A and 20X (50X times 40%) to B. B's final buy-in payment (after offsets) is 20X (40X less 20X). A is treated as receiving the 70X total provisional payments (40X plus 30X) pro rata out of the final payments by B and C of 20X and 50X, respectively.

(h) *Character of payments made pursuant to a qualified cost sharing arrangement*—(1) *In general.* Payments made pursuant to a qualified cost sharing arrangement (other than payments described in paragraph (g) of this section) generally will be considered costs of developing intangibles of the payor and reimbursements of the same kind of costs of developing intangibles of the payee. For purposes of this paragraph (h), a controlled participant's payment required under a qualified cost sharing arrangement is deemed to be reduced to the extent of any payments owed to it under the arrangement from other controlled or uncontrolled participants. Each payment received by a payee will be treated as coming pro rata out of payments made by all payors. Such payments will be applied pro rata against deductions for the taxable year that the payee is allowed in connection with the qualified cost sharing arrangement. Payments received in excess of such deductions will be treated as in consideration for use of the tangible property made available to the qualified cost sharing arrangement by the payee. For purposes of the research credit determined under section 41, cost sharing payments among controlled participants will be treated as provided for intra-group transactions in §1.41-8(e). Any payment made or received by a taxpayer pursuant to an arrangement that the district director determines not to be a qualified cost sharing arrangement, or a payment made or received

pursuant to paragraph (g) of this section, will be subject to the provisions of §§1.482-1 and 1.482-4 through 1.482-6. Any payment that in substance constitutes a cost sharing payment will be treated as such for purposes of this section, regardless of its characterization under foreign law.

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

Example 1. U.S. Parent (USP) and its wholly owned Foreign Subsidiary (FS) form a cost sharing arrangement to develop a miniature widget, the Small R. Based on a reliable projection of their future benefits, USP agrees to bear 40% and FS to bear 60% of the costs incurred during the term of the agreement. The principal costs in the intangible development area are operating expenses incurred by FS in Country Z of 100X annually, and operating expenses incurred by USP in the United States also of 100X annually. Of the total costs of 200X, USP's share is 80X and FS's share is 120X, so that FS must make a payment to USP of 20X. This payment will be treated as a reimbursement of 20X of USP's operating expenses in the United States. Accordingly, USP's Form 1120 will reflect an 80X deduction on account of activities performed in the United States for purposes of allocation and apportionment of the deduction to source. The Form 5471 for FS will reflect a 100X deduction on account of activities performed in Country Z, and a 20X deduction on account of activities performed in the United States.

Example 2. The facts are the same as in *Example 1*, except that the 100X of costs borne by USP consist of 5X of operating expenses incurred by USP in the United States and 95X of fair market value rental cost for a facility in the United States. The depreciation deduction attributable to the U.S. facility is 7X. The 20X net payment by FS to USP will first be applied in reduction pro rata of the 5X deduction for operating expenses and the 7X depreciation deduction attributable to the U.S. facility. The 8X remainder will be treated as rent for the U.S. facility.

(i) *Accounting requirements.* The accounting requirements of this paragraph are that the controlled participants in a qualified cost sharing arrangement must use a consistent method of accounting to measure costs and benefits, and must translate foreign currencies on a consistent basis.

(j) *Administrative requirements*—(1) *In general.* The administrative requirements of this paragraph consist of the documentation requirements of paragraph (j)(2) of this section and the reporting requirements of paragraph (j)(3) of this section.

(2) *Documentation.* A controlled participant must maintain sufficient documentation to establish that the requirements of paragraphs (b)(4) and (c)(1) of this section have been met, as

well as the additional documentation specified in this paragraph (j)(2), and must provide any such documentation to the Internal Revenue Service within 30 days of a request (unless an extension is granted by the district director). Documents necessary to establish the following must also be maintained—

(i) The total amount of costs incurred pursuant to the arrangement;

(ii) The costs borne by each controlled participant;

(iii) A description of the method used to determine each controlled participant's share of the intangible development costs, including the projections used to estimate benefits, and an explanation of why that method was selected;

(iv) The accounting method used to determine the costs and benefits of the intangible development (including the method used to translate foreign currencies), and, to the extent that the method materially differs from U.S. generally accepted accounting principles, an explanation of such material differences; and

(v) Prior research, if any, undertaken in the intangible development area, any tangible or intangible property made available for use in the arrangement, by each controlled participant, and any information used to establish the value of pre-existing and covered intangibles.

(3) *Reporting requirements.* A controlled participant must attach to its U.S. income tax return a statement indicating that it is a participant in a qualified cost sharing arrangement, and listing the other controlled participants in the arrangement. A controlled participant that is not required to file a U.S. income tax return must ensure that such a statement is attached to Schedule M of any Form 5471 or to any Form 5472 filed with respect to that participant.

(k) *Effective date.* This section is effective for taxable years beginning on or after January 1, 1996.

(l) *Transition rule.* A cost sharing arrangement will be considered a qualified cost sharing arrangement, within the meaning of this section, if, prior to January 1, 1996, the arrangement was a bona fide cost sharing arrangement under the provisions of §1.482-7T (as contained in the 26 CFR part 1 edition revised as of April 1, 1995), but only if the arrangement is amended, if necessary, to conform with

the provisions of this section by December 31, 1996.

§1.482-7T [Removed]

Par. 4. Section 1.482-7T is removed.

PART 301—PROCEDURE AND ADMINISTRATION

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

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

Par. 6. Section 301.7701-3 is amended by adding paragraph (e) to read as follows:

§301.7701-3 Partnerships.

* * * * *

(e) *Qualified cost sharing arrangements.* A qualified cost sharing arrangement that is described in §1.482-7 of this chapter and any arrangement that is treated by the Service as a qualified cost sharing arrangement under §1.482-7 of this chapter is not classified as a partnership for purposes of the Internal Revenue Code. See §1.482-7 of this chapter for the proper treatment of qualified cost sharing arrangements.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 7. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 8. In §602.101, paragraph (c) is amended by adding an entry to the table in numerical order to read as follows:

“1.482-7 1545-1364”.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved November 30, 1995.

Leslie Samuels,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on December 19, 1995, 8:45 a.m., and published in the issue of the Federal Register for December 20, 1995, 60 F.R. 65553)

Section 671.—Trust Income, Deductions, and Credit Attributable to Grantors and Others as Substantial Owners

26 CFR 1.671-4: Method of reporting.

T.D. 8633

**DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1, 25, 301, and 602**

Grantor Trust Reporting Requirements

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the method of reporting for trusts that are treated as owned by grantors or other persons under the provisions of subpart E (section 671 and following), part I, subchapter J, chapter 1 of the Internal Revenue Code. These regulations are intended to reduce the current filing burden on trustees, to provide necessary information to grantors or other persons treated as the owners of trusts, to reduce any cases of duplicate filing, and to provide more meaningful information to the IRS. These regulations affect grantors and trustees of trusts that are treated as owned by grantors or other persons, as well as persons who are required to file information returns with respect to payments to these trusts.

DATES: These regulations are effective January 1, 1996.

For dates of applicability of these regulations, see §1.671-4(h).

FOR FURTHER INFORMATION CONTACT: Steven Schneider, (202) 622-3060 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1442. This infor-

mation is required by the IRS to insure the proper reporting of income and proceeds paid to a trust any portion of which is treated as owned by the grantor or another person.

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

The estimated annual burden per respondent is 30 minutes.

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

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

Background

On July 22, 1994, the IRS published in the Federal Register a notice of proposed rulemaking and notice of public hearing (59 FR 37450 [PS-79-93, 1994-2 C.B. 916]) proposing amendments to the Income Tax Regulations (26 CFR part 1) under section 671 of the Internal Revenue Code (Code) and to the Procedure and Administration Regulations (26 CFR part 301) under sections 6012 and 6109 of the Code.

Written comments responding to the notice were received. A public hearing was held on September 21, 1994, pursuant to the notice published in the Federal Register on July 22, 1994. After consideration of all written and oral comments regarding the proposed amendments, those amendments are adopted as revised by this Treasury decision.

Explanation of provisions and significant changes in the final regulations

Subject to certain new limitations under §1.671-4(b)(6) and (7), discussed

below, §1.671-4(b) of the final regulations retains the optional alternative methods of reporting contained in the proposed regulations published on July 22, 1994.

Several comments were submitted requesting confirmation that the alternative methods of reporting described in the proposed regulations are optional and not mandatory. Section 1.671-4(b) of the final regulations clarifies that the trustee of a trust all of which is treated as owned by one or more grantors or other persons may, but is not required to, report pursuant to one of the alternative methods.

Certain commentators were unsure of which persons are considered payors for purposes of the alternative filing methods. The final regulations define the term payor as including any person who is required by any provision of the Code and the regulations thereunder to make any type of information return with respect to the trust for the taxable year.

With respect to the alternative methods of reporting, several commentators were unsure of the items and the amounts of income that must be reported on any Forms 1099 required to be filed by the trustee. Section 1.671-4(b)(5) of the final regulations clarifies that the amounts that must be included on any Forms 1099 required to be filed by the trustee do not include any amounts that are reportable by the payor on an information return other than Form 1099.

For example, in the case of a trustee who furnishes the name, TIN, and address of the trust to all payors pursuant to §1.671-4(b)(2)(i)(B) of the final regulations, the trustee does not include items of income attributable to an interest in a partnership on any Forms 1099 filed by the trustee because those items are reportable by the partnership on Schedule K-1 of Form 1065 (reporting distributive shares to members of a partnership). While the statement furnished to the grantor or other person treated as the owner of the trust by the trustee will show all items of income, deduction, and credit attributable to the partnership interest, those items will not be reported to the IRS by the trustee on any type of form.

Several commentators were unsure of the dates by which a trustee must file any required Forms 1099 and must furnish any required statements to grantors or other persons treated as

owners of the trust. Section 1.671-4(c) of the final regulations provides that the due date for any Forms 1099 required to be filed with the IRS by a trustee is the due date otherwise in effect for filing Forms 1099. Currently, the due date is February 28 of the following year.

Section 1.671-4(d) of the final regulations provides that the due date for the statement required to be furnished by a trustee to the grantor or other person treated as an owner of the trust is the date specified by section 6034A(a). Currently, the due date is April 15 of the following year.

Comments were received requesting clarification of the trustee's obligation, under the first of the alternative reporting methods, to furnish the name and TIN of the grantor to all payors. The final regulations provide that: (1) a trustee may not report under the first alternative reporting method unless the grantor or other person treated as the owner of the trust provides to the trustee a complete Form W-9 or other acceptable substitute form; (2) a trustee reporting under the first alternative reporting method acts as the agent of the grantor or other person treated as the owner of the trust for purposes of furnishing backup withholding information to a payor; and (3) the payor may rely on the name and TIN provided to the payor by the trustee. If the Form W-9 indicates that the grantor or other person is subject to backup withholding, then the trustee must notify all payors of reportable interest and dividend payments of the requirement to backup withhold.

Comments were received requesting clarification of the annuity and unitrust payment dates under §25.2702-3 of the Gift Tax Regulations for trusts electing one of the alternative methods of reporting. The final regulations contain conforming amendments to §25.2702-3(b)(1)(i) and §25.2702-3(c)(1)(i).

One commentator noted the need for more guidance concerning the reporting requirements for widely held fixed investment trusts. Because that guidance is outside the scope of this regulation, the final regulations do not provide special rules for these trusts. However IRS and Treasury anticipate providing guidance for these trusts in a separate project and would welcome comments from interested taxpayers and practitioners regarding such guidance.

Several of the comments received with respect to the proposed regulations emphasized the necessity of making the trustee's choice to report under one of the alternative methods revocable. The final regulations provide that a trustee who has reported pursuant to one of the alternative methods may report pursuant to the general rule requiring the trustee to file a Form 1041 for any subsequent taxable years of the trust, provided that certain conditions are met.

The final regulations provide that the trustee of a trust all of which is treated as owned by one grantor or one other person that is an exempt recipient for information reporting purposes may not report under an alternative method. However, if the trust is treated as owned by two or more grantors or other persons, the trustee may report pursuant to the alternative method for multiple grantors if (1) at least one grantor or one other person who is treated as an owner of the trust is a person who is not an exempt recipient for information reporting purposes and (2) the trustee reports without regard to whether any of the grantors or other persons treated as owners of the trust are exempt recipients for information reporting purposes.

The final regulations also provide that the trustee of a trust all of which is treated as owned by one grantor or other person whose taxable year is a fiscal year may not report under an alternative method. However, the trustee of a trust that is treated as owned by two or more grantors or other persons may report pursuant to the alternative method for multiple grantors even though one or more of the grantors or other persons treated as an owner of the trust has a taxable year that is the fiscal year.

In addition, the final regulations provide that a trustee of a trust that is a qualified subchapter S trust as defined in section 1361(d)(3) may not report under an alternative method.

The final regulations also provide that the trustee of a trust may not report under an alternative method if any person who is treated as an owner of the trust is not a United States person.

Effective date and transition rule

The final regulations are effective for taxable years beginning on or after

January 1, 1996, subject to a requirement that certain trustees file a final Form 1041 before adopting one of the alternative methods of reporting. The final regulations retain the transition rule contained in the proposed regulations providing that, for taxable years beginning prior to January 1, 1996, the IRS will not challenge the manner of reporting by trustees of certain trusts.

Special Analyses

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

Drafting Information

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

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1, 25, 301, and 602 are amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.671-4 is revised to read as follows:

§1.671-4 Method of reporting.

(a) *Portion of trust treated as owned by the grantor or another person.* Except as otherwise provided in para-

graph (b) of this section, items of income, deduction, and credit attributable to any portion of a trust which, under the provisions of subpart E (section 671 and following), part I, subchapter J, chapter 1 of the Internal Revenue Code, is treated as owned by the grantor or another person are not reported by the trust on Form 1041, but are shown on a separate statement to be attached to that form.

(b) *A trust all of which is treated as owned by one or more grantors or other persons—*(1) *In general.* In the case of a trust all of which is treated as owned by one or more grantors or other persons, and which is not described in paragraph (b)(6) or (7) of this section, the trustee may, but is not required to, report by one of the methods described in this paragraph (b) rather than by the method described in paragraph (a) of this section. A trustee may not report, however, pursuant to paragraph (b)(2)(i)(A) of this section unless the grantor or other person treated as the owner of the trust provides to the trustee a complete Form W-9 or acceptable substitute Form W-9 signed under penalties of perjury. See section 3406 and the regulations thereunder for the information to include on, and the manner of executing, the Form W-9, depending upon the type of reportable payments made.

(2) *A trust all of which is treated as owned by one grantor or by one other person—*(i) *In general.* In the case of a trust all of which is treated as owned by one grantor or one other person, the trustee reporting under this paragraph (b) must either—

(A) Furnish the name and taxpayer identification number (TIN) of the grantor or other person treated as the owner of the trust, and the address of the trust, to all payors during the taxable year, and comply with the additional requirements described in paragraph (b)(2)(ii) of this section; or

(B) Furnish the name, TIN, and address of the trust to all payors during the taxable year, and comply with the additional requirements described in paragraph (b)(2)(iii) of this section.

(ii) *Additional obligations of the trustee when name and TIN of the grantor or other person treated as the owner of the trust and the address of the trust are furnished to payors.* (A) Unless the grantor or other person treated as the owner of the trust is the trustee or a co-trustee of the trust, the

trustee must furnish the grantor or other person treated as the owner of the trust with a statement that—

(1) Shows all items of income, deduction, and credit of the trust for the taxable year;

(2) Identifies the payor of each item of income;

(3) Provides the grantor or other person treated as the owner of the trust with the information necessary to take the items into account in computing the grantor's or other person's taxable income; and

(4) Informs the grantor or other person treated as the owner of the trust that the items of income, deduction and credit and other information shown on the statement must be included in computing the taxable income and credits of the grantor or other person on the income tax return of the grantor or other person.

(B) The trustee is not required to file any type of return with the Internal Revenue Service.

(iii) *Additional obligations of the trustee when name, TIN, and address of the trust are furnished to payors—*(A) *Obligation to file Forms 1099.* The trustee must file with the Internal Revenue Service the appropriate Forms 1099, reporting the income or gross proceeds paid to the trust during the taxable year, and showing the trust as the payor and the grantor or other person treated as the owner of the trust as the payee. The trustee has the same obligations for filing the appropriate Forms 1099 as would a payor making reportable payments, except that the trustee must report each type of income in the aggregate, and each item of gross proceeds separately. See paragraph (b)(5) of this section regarding the amounts required to be included on any Forms 1099 filed by the trustee.

(B) *Obligation to furnish statement.* (1) Unless the grantor or other person treated as the owner of the trust is the trustee or a co-trustee of the trust, the trustee must also furnish to the grantor or other person treated as the owner of the trust a statement that—

(i) Shows all items of income, deduction, and credit of the trust for the taxable year;

(ii) Provides the grantor or other person treated as the owner of the trust with the information necessary to take the items into account in computing the grantor's or other person's taxable income; and

(iii) Informs the grantor or other person treated as the owner of the trust that the items of income, deduction and credit and other information shown on the statement must be included in computing the taxable income and credits of the grantor or other person on the income tax return of the grantor or other person.

(2) By furnishing the statement, the trustee satisfies the obligation to furnish statements to recipients with respect to the Forms 1099 filed by the trustee.

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

Example 1. G, a United States citizen, creates an irrevocable trust which provides that the ordinary income is to be payable to him for life and that on his death the corpus shall be distributed to B, an unrelated person. Except for the right to receive income, G retains no right or power which would cause him to be treated as an owner under sections 671 through 679. Under the applicable local law, capital gains must be added to corpus. Since G has a right to receive income, he is treated as an owner of a portion of the trust under section 677. The tax consequences of any items of capital gain of the trust are governed by the provisions of subparts A, B, C, and D (section 641 and following), part I, subchapter J, chapter 1 of the Internal Revenue Code. Because not all of the trust is treated as owned by the grantor or another person, the trustee may not report by the methods described in paragraph (b)(2) of this section.

Example 2. (i)(A) On January 2, 1996, G, a United States citizen, creates a trust all of which is treated as owned by G. The trustee of the trust is T. During the 1996 taxable year the trust has the following items of income and gross proceeds:

Interest	\$2,500
Dividends	3,205
Proceeds from sale of B stock	2,000

(B) The trust has no items of deduction or credit.

(ii)(A) The payors of the interest paid to the trust are X (\$2,000), Y (\$300), and Z (\$200). The payors of the dividends paid to the trust are A (\$3,200), and D (\$5). The payor of the gross proceeds paid to the trust is D, a brokerage firm, which held the B stock as the nominee for the trust. The B stock was purchased by T for \$1,500 on January 3, 1996, and sold by T on November 29, 1996. T chooses to report pursuant to paragraph (b)(2)(i)(B) of this section, and therefore furnishes the name, TIN, and address of the trust to X, Y, Z, A, and D. X, Y, and Z each furnish T with a Form 1099-INT showing the trust as the payee. A furnishes T with a Form 1099-DIV showing the trust as the payee. D does not furnish T with a Form 1099-DIV because D paid a dividend of less than \$10 to T. D furnishes T with a Form 1099-B showing the trust as the payee.

(B) On or before February 28, 1997, T files a Form 1099-INT with the Internal Revenue Service on which T reports interest attributable

to G, as the owner of the trust, of \$2,500; a Form 1099-DIV on which T reports dividends attributable to G, as the owner of the trust, of \$3,205; and a Form 1099-B on which T reports gross proceeds from the sale of B stock attributable to G, as the owner of the trust, of \$2,000. On or before April 15, 1997, T furnishes a statement to G which lists the following items of income and information necessary for G to take the items into account in computing G's taxable income:

Interest	\$2,500
Dividends	3,205
Gain from sale of B stock	500
Information regarding sale of B stock:	
Proceeds	\$2,000
Basis	1,500
Date acquired	1/03/96
Date sold	11/29/96

(C) T informs G that any items of income, deduction and credit and other information shown on the statement must be included in computing the taxable income and credits of the grantor or other person on the income tax return of the grantor or other person.

(D) T has complied with T's obligations under this section.

(iii)(A) Same facts as paragraphs (i) and (ii) of this Example 2, except that G contributed the B stock to the trust on January 2, 1996. On or before April 15, 1997, T furnishes a statement to G which lists the following items of income and information necessary for G to take the items into account in computing G's taxable income:

Interest	\$2,500
Dividends	3,205
Information regarding sale of B stock:	
Proceeds	\$2,000
Date sold	11/29/96

(B) T informs G that any items of income, deduction and credit and other information shown on the statement must be included in computing the taxable income and credits of the grantor or other person on the income tax return of the grantor or other person.

(C) T has complied with T's obligations under this section.

Example 3. On January 2, 1996, G, a United States citizen, creates a trust all of which is treated as owned by G. The trustee of the trust is T. The only asset of the trust is an interest in C, a common trust fund under section 584(a). T chooses to report pursuant to paragraph (b)(2)(i)(B) of this section and therefore furnishes the name, TIN, and address of the trust to C. C files a Form 1065 and a Schedule K-1 (Partner's Share of Income, Credits, Deductions, etc.) showing the name, TIN, and address of the trust with the Internal Revenue Service and furnishes a copy to T. Because the trust did not receive any amounts described in paragraph (b)(5) of this section, T does not file any type of return with the Internal Revenue Service. On or before April 15, 1997, T furnishes G with a statement that shows all items of income, deduction, and credit of the trust for the 1996 taxable year. In addition, T informs G that any items of income, deduction and credit and other information shown on the statement must be included in computing the taxable income and

credits of the grantor or other person on the income tax return of the grantor or other person. T has complied with T's obligations under this section.

(3) *A trust all of which is treated as owned by two or more grantors or other persons—*(i) *In general.* In the case of a trust all of which is treated as owned by two or more grantors or other persons, the trustee must furnish the name, TIN, and address of the trust to all payors for the taxable year, and comply with the additional requirements described in paragraph (b)(3)(ii) of this section.

(ii) *Additional obligations of trustee—*(A) *Obligation to file Forms 1099.* The trustee must file with the Internal Revenue Service the appropriate Forms 1099, reporting the items of income paid to the trust by all payors during the taxable year attributable to the portion of the trust treated as owned by each grantor or other person, and showing the trust as the payor and each grantor or other person treated as an owner of the trust as the payee. The trustee has the same obligations for filing the appropriate Forms 1099 as would a payor making reportable payments, except that the trustee must report each type of income in the aggregate, and each item of gross proceeds separately. See paragraph (b)(5) of this section regarding the amounts required to be included on any Forms 1099 filed by the trustee.

(B) *Obligation to furnish statement.* (1) The trustee must also furnish to each grantor or other person treated as an owner of the trust a statement that—

(i) Shows all items of income, deduction, and credit of the trust for the taxable year attributable to the portion of the trust treated as owned by the grantor or other person;

(ii) Provides the grantor or other person treated as an owner of the trust with the information necessary to take the items into account in computing the grantor's or other person's taxable income; and

(iii) Informs the grantor or other person treated as the owner of the trust that the items of income, deduction and credit and other information shown on the statement must be included in computing the taxable income and credits of the grantor or other person on the income tax return of the grantor or other person.

(2) Except for the requirements pursuant to section 3406 and the regula-

tions thereunder, by furnishing the statement, the trustee satisfies the obligation to furnish statements to recipients with respect to the Forms 1099 filed by the trustee.

(4) *Persons treated as payors*—(i) *In general.* For purposes of this section, the term payor means any person who is required by any provision of the Internal Revenue Code and the regulations thereunder to make any type of information return (including Form 1099 or Schedule K-1) with respect to the trust for the taxable year, including persons who make payments to the trust or who collect (or otherwise act as middlemen with respect to) payments on behalf of the trust.

(ii) *Application to brokers and customers.* For purposes of this section, a broker, within the meaning of section 6045, is considered a payor. A customer, within the meaning of section 6045, is considered a payee.

(5) *Amounts required to be included on Forms 1099 filed by the trustee*—(i) *In general.* The amounts that must be included on any Forms 1099 required to be filed by the trustee pursuant to this section do not include any amounts that are reportable by the payor on an information return other than Form 1099. For example, in the case of a trust which owns an interest in a partnership, the trust's distributive share of the income and gain of the partnership is not includible on any Forms 1099 filed by the trustee pursuant to this section because the distributive share is reportable by the partnership on Schedule K-1.

(ii) *Example.* The following example illustrates the provisions of this paragraph (b)(5):

Example. (i)(A) On January 2, 1996, G, a United States citizen, creates a trust all of which is treated as owned by G. The trustee of the trust is T. The assets of the trust during the 1996 taxable year are shares of stock in X, an S corporation, a limited partnership interest in P, shares of stock in M, and shares of stock in N. T chooses to report pursuant to paragraph (b)(2)(i)(B) of this section and therefore furnishes the name, TIN, and address of the trust to X, P, M, and N. M furnishes T with a Form 1099-DIV showing the trust as the payee. N does not furnish T with a Form 1099-DIV because N paid a dividend of less than \$10 to T. X and P furnish T with Schedule K-1 (Shareholder's Share of Income, Credits, Deductions, etc.) and Schedule K-1 (Partner's Share of Income, Credits, Deductions, etc.), respectively, showing the trust's name, TIN, and address.

(B) For the 1996 taxable year the trust has the following items of income and deduction:

Dividends paid by M	\$12
Dividends paid by N	6
Administrative expense	\$20
Items reported by X on Schedule K-1 attributable to trust's shares of stock in X:	
Interest	\$20
Dividends	35

Items reported by P on Schedule K-1 attributable to trust's limited partnership interest in P:

Ordinary income	\$300
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(ii)(A) On or before February 28, 1997, T files with the Internal Revenue Service a Form 1099-DIV on which T reports dividends attributable to G as the owner of the trust in the amount of \$18. T does not file any other returns.

(B) T has complied with T's obligation under paragraph (b)(2)(iii)(A) of this section to file the appropriate Forms 1099.

(6) *Trusts that cannot report under this paragraph (b).* The following trusts cannot use the methods of reporting described in this paragraph (b)—

(i) A common trust fund as defined in section 584(a);

(ii) A trust that has its situs or any of its assets located outside the United States;

(iii) A trust that is a qualified subchapter S trust as defined in section 1361(d)(3);

(iv) A trust all of which is treated as owned by one grantor or one other person whose taxable year is a fiscal year;

(v) A trust all of which is treated as owned by one grantor or one other person who is not a United States person; or

(vi) A trust all of which is treated as owned by two or more grantors or other persons, one of whom is not a United States person.

(7) *Grantors or other persons who are treated as owners of the trust and are exempt recipients for information reporting purposes*—(i) *Trust treated as owned by one grantor or one other person.* The trustee of a trust all of which is treated as owned by one grantor or one other person may not report pursuant to this paragraph (b) if the grantor or other person is an exempt recipient for information reporting purposes.

(ii) *Trust treated as owned by two or more grantors or other persons.* The trustee of a trust, all of which is treated as owned by two or more grantors or other persons, may not report pursuant to this paragraph (b) if one or more

grantors or other persons treated as owners are exempt recipients for information reporting purposes unless—

(A) At least one grantor or one other person who is treated as an owner of the trust is a person who is not an exempt recipient for information reporting purposes; and

(B) The trustee reports without regard to whether any of the grantors or other persons treated as owners of the trust are exempt recipients for information reporting purposes.

(8) *Husband and wife who make a single return jointly.* A trust all of which is treated as owned by a husband and wife who make a single return jointly of income taxes for the taxable year under section 6013 is considered to be owned by one grantor for purposes of this paragraph (b).

(c) *Due date for Forms 1099 required to be filed by trustee.* The due date for any Forms 1099 required to be filed with the Internal Revenue Service by a trustee pursuant to this section is the due date otherwise in effect for filing Forms 1099.

(d) *Due date and other requirements with respect to statement required to be furnished by trustee.* The due date for the statement required to be furnished by a trustee to the grantor or other person treated as an owner of the trust pursuant to this section is the date specified by section 6034A(a). The trustee must maintain in its records a copy of the statement furnished to the grantor or other person treated as an owner of the trust for a period of three years from the due date for furnishing such statement specified in this paragraph (d).

(e) *Backup withholding requirements*—(1) *Trustee reporting under paragraph (b)(2)(i)(A) of this section.* In order for the trustee to be able to report pursuant to paragraph (b)(2)(i)(A) of this section and to furnish to all payors the name and TIN of the grantor or other person treated as the owner of the trust, the grantor or other person must provide a complete Form W-9 to the trustee in the manner provided in paragraph (b)(1) of this section, and the trustee must give the name and TIN shown on that Form W-9 to all payors. In addition, if the Form W-9 indicates that the grantor or other person is subject to backup withholding, the trustee must notify all payors of reportable interest and dividend payments of the requirement to backup

withhold. If the Form W-9 indicates that the grantor or other person is not subject to backup withholding, the trustee does not have to notify the payors that backup withholding is not required. The trustee should not give the Form W-9, or a copy thereof, to a payor because the Form W-9 contains the address of the grantor or other person and paragraph (b)(2)(i)(A) of this section requires the trustee to furnish the address of the trust to all payors and not the address of the grantor or other person. The trustee acts as the agent of the grantor or other person for purposes of furnishing to the payors the information required by this paragraph (e)(1). Thus, a payor may rely on the name and TIN provided to the payor by the trustee, and, if given, on the trustee's statement that the grantor is subject to backup withholding.

(2) *Other backup withholding requirements.* Whether a trustee is treated as a payor for purposes of backup withholding is determined pursuant to section 3406 and the regulations thereunder.

(f) *Penalties for failure to file a correct Form 1099 or furnish a correct statement.* A trustee who fails to file a correct Form 1099 or to furnish a correct statement to a grantor or other person treated as an owner of the trust as required by paragraph (b) of this section is subject to the penalties provided by sections 6721 and 6722 and the regulations thereunder.

(g) *Changing reporting methods—*
(1) *Changing from reporting by filing Form 1041 to a method described in paragraph (b) of this section.* If the trustee has filed a Form 1041 for any taxable year ending before January 1, 1996 (and has not filed a final Form 1041 pursuant to §1.671-4(b)(3) (as contained in the 26 CFR part 1 edition revised as of April 1, 1995)), or files a Form 1041 for any taxable year thereafter, the trustee must file a final Form 1041 for the taxable year which ends after January 1, 1995, and which immediately precedes the first taxable year for which the trustee reports pursuant to paragraph (b) of this section, on the front of which form the trustee must write: "Pursuant to §1.671-4(g), this is the final Form 1041 for this grantor trust."

(2) *Changing from reporting by a method described in paragraph (b) of this section to the filing of a Form*

1041. The trustee of a trust who reported pursuant to paragraph (b) of this section for a taxable year may report pursuant to paragraph (a) of this section for subsequent taxable years. If the trustee reported pursuant to paragraph (b)(2)(i)(A) of this section, and therefore furnished the name and TIN of the grantor to all payors, the trustee must furnish the name, TIN, and address of the trust to all payors for such subsequent taxable years. If the trustee reported pursuant to paragraph (b)(2)(i)(B) or (b)(3)(i) of this section, and therefore furnished the name and TIN of the trust to all payors, the trustee must indicate on each Form 1096 (Annual Summary and Transmittal of U.S. Information Returns) that it files (or appropriately on magnetic media) for the final taxable year for which the trustee so reports that it is the final return of the trust.

(3) *Changing between methods described in paragraph (b) of this section—*(i) *Changing from furnishing the TIN of the grantor to furnishing the TIN of the trust.* The trustee of a trust who reported pursuant to paragraph (b)(2)(i)(A) of this section for a taxable year, and therefore furnished the name and TIN of the grantor to all payors, may report pursuant to paragraph (b)(2)(i)(B) of this section, and furnish the name and TIN of the trust to all payors, for subsequent taxable years.

(ii) *Changing from furnishing the TIN of the trust to furnishing the TIN of the grantor.* The trustee of a trust who reported pursuant to paragraph (b)(2)(i)(B) of this section for a taxable year, and therefore furnished the name and TIN of the trust to all payors, may report pursuant to paragraph (b)(2)(i)(A) of this section, and furnish the name and TIN of the grantor to all payors, for subsequent taxable years. The trustee, however, must indicate on each Form 1096 (Annual Summary and Transmittal of U.S. Information Returns) that it files (or appropriately on magnetic media) for the final taxable year for which the trustee reports pursuant to paragraph (b)(2)(i)(B) of this section that it is the final return of the trust.

(4) *Example.* The following example illustrates the provisions of paragraph (g) of this section:

Example. (i) On January 3, 1994, G, a United States citizen, creates a trust all of which is treated as owned by G. The trustee of the trust is T. On or before April 17, 1995, T files with the

Internal Revenue Service a Form 1041 with an attached statement for the 1994 taxable year showing the items of income, deduction, and credit of the trust. On or before April 15, 1996, T files with the Internal Revenue Service a Form 1041 with an attached statement for the 1995 taxable year showing the items of income, deduction, and credit of the trust. On the Form 1041, T states that "pursuant to §1.671-4(g), this is the final Form 1041 for this grantor trust." T may report pursuant to paragraph (b) of this section for the 1996 taxable year.

(ii) T reports pursuant to paragraph (b)(2)(i)(B) of this section, and therefore furnishes the name, TIN, and address of the trust to all payors, for the 1996 and 1997 taxable years. T chooses to report pursuant to paragraph (a) of this section for the 1998 taxable year. On each Form 1096 (Annual Summary and Transmittal of U.S. Information Returns) which T files for the 1997 taxable year (or appropriately on magnetic media), T indicates that it is the trust's final return. On or before April 15, 1999, T files with the Internal Revenue Service a Form 1041 with an attached statement showing the items of income, deduction, and credit of the trust. On the Form 1041, T uses the same TIN which T used on the Forms 1041 and Forms 1099 it filed for previous taxable years. T has complied with T's obligations under paragraph (g)(2) of this section.

(h) *Effective date and transition rule—*(1) *Effective date.* The trustee of a trust any portion of which is treated as owned by one or more grantors or other persons must report pursuant to this section for taxable years beginning on or after January 1, 1996.

(2) *Transition rule.* For taxable years beginning prior to January 1, 1996, the Internal Revenue Service will not challenge the manner of reporting of—

(i) A trustee of a trust all of which is treated as owned by one or more grantors or other persons who did not report in accordance with §1.671-4(a) (as contained in the 26 CFR part 1 edition revised as of April 1, 1995) as in effect for taxable years beginning prior to January 1, 1996, but did report in a manner substantially similar to one of the reporting methods described in paragraph (b) of this section; or

(ii) A trustee of two or more trusts all of which are treated as owned by one or more grantors or other persons who filed a single Form 1041 for all of the trusts, rather than a separate Form 1041 for each trust, provided that the items of income, deduction, and credit of each trust were shown on a statement attached to the single Form 1041.

(i) *Cross-reference.* For rules relating to employer identification numbers, and to the obligation of a payor of income or proceeds to the trust to furnish to the payee a statement to recipient, see §301.6109-1(a)(2) of this chapter.

Par. 3. Section 1.6012-3 is amended by revising paragraph (a)(9) to read as follows:

§1.6012-3 Returns by fiduciaries.

(a) * * *

(9) A trust any portion of which is treated as owned by the grantor or another person pursuant to sections 671 through 678. In the case of a trust any portion of which is treated as owned by the grantor or another person under the provisions of subpart E (section 671 and following) part I, subchapter J, chapter 1 of the Internal Revenue Code see §1.671-4.

* * * * *

PART 25—GIFT TAX; GIFTS MADE AFTER DECEMBER 31, 1954

Par. 4. The authority citation for part 25 continues to read in part as follows:

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

Par. 5. Section 25.2702-3 is amended by adding a sentence to the end of paragraphs (b)(1)(i) and (c)(1)(i), respectively, to read as follows:

§25.2702-3 Qualified interests.

* * * * *

(b) * * *

(1) * * * (i) * * * If the trustee reports for the taxable year pursuant to §1.671-4(b) of this chapter, the annuity payment must be made no later than the date by which the trustee would have been required to file the Federal income tax return of the trust for the taxable year (without regard to extensions) had the trustee reported pursuant to §1.671-4(a) of this chapter.

* * * * *

(c) * * *

(1) * * * (i) * * * If the trustee reports for the taxable year pursuant to §1.671-4(b) of this chapter, the unitrust payment must be made no later than the date by which the trustee would have been required to file the Federal income tax return of the trust for the taxable year (without regard to extensions) had the trustee reported pursuant to §1.671-4(a) of this chapter.

* * * * *

PART 301—PROCEDURE AND ADMINISTRATION

Par. 6. The authority citation for part 301 continues to read in part as follows:

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

Par. 7. Section 301.6109-1 is amended by revising paragraph (a)(2) to read as follows:

§301.6109-1 Identifying numbers.

(a) * * *

(2) A trust all of which is treated as owned by the grantor or another person pursuant to sections 671 through 678—(i) Obtaining a taxpayer identification number. If a trust does not have a taxpayer identification number and the trustee furnishes the name and taxpayer identification number of the grantor or other person treated as the owner of the trust and the address of the trust to all payors pursuant to §1.671-4(b)(2)(i)(A) of this chapter, the trustee need not obtain a taxpayer identification number for the trust until either the first taxable year of the trust in which all of the trust is no longer owned by the grantor or another person, or until the first taxable year of the trust for which the trustee no longer reports pursuant to §1.671-4(b)(2)(i)(A) of this chapter. If the trustee has not already obtained a taxpayer identification number for the trust, the trustee must obtain a taxpayer identification number for the trust as provided in paragraph (d)(2) of this section in order to report pursuant to §1.671-4(a), (b)(2)(i)(B), or (b)(3)(i) of this chapter.

(ii) Obligations of persons who make payments to certain trusts. Any payor that is required to file an information return with respect to payments of income or proceeds to a trust must show the name and taxpayer identification number that the trustee has furnished to the payor on the return. Regardless of whether the trustee furnishes to the payor the name and taxpayer identification number of the grantor or other person treated as an owner of the trust, or the name and taxpayer identification number of the trust, the payor must furnish a statement to recipients to the trustee of the trust, rather than to the grantor or other person treated as the owner of the trust. Under these circumstances, the payor satisfies the obligation to show the name and taxpayer

identification number of the payee on the information return and to furnish a statement to recipients to the person whose taxpayer identification number is required to be shown on the form.

(iii) Persons treated as payors. For purposes of this paragraph (a)(2), the term payor means a person described in §1.671-4(b)(4) of this chapter.

* * * * *

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 8. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 9. In §602.101, paragraph (c) is amended in the table by revising the entry for 1.671-4 to read “1.671-4 1545-1442”.

Margaret Milner Richardson,
Commissioner of
Internal Revenue.

Approved December 5, 1995.

Leslie Samuels,
Assistant Secretary of
the Treasury.

(Filed by the Office of the Federal Register on December 20, 1995, 8:45 a.m., and published in the issue of the Federal Register for December 21, 1995, 60 F.R. 66085)

Section 703.—Partnership Computations

26 CFR 1.703-1: Partnership Computations

If a partnership makes a charitable contribution of property, are the partners' bases in their partnership interests decreased to reflect the contribution. See Rev. Rul. 96-11, page 28.

Section 705.—Determination of Basis in Partner's Interest

26 CFR 1.705-1: Determination of basis of partner's interest.
(Also §§ 267, 707; 1.267(d)-1, 1.707-1.)

Basis of partner's interest; sale between partnerships. Partners' bases in their partnership interests are decreased to reflect losses on the sale of partnership property to a related partnership that are disallowed under section 707(b)(1) of the Internal Revenue Code. Partners' bases in their part-

nership interests are increased to reflect gain from the sale of partnership property that is not recognized under sections 267(d) and 707(b)(1) of the Code.

Rev. Rul. 96-10

ISSUE

(1) If a loss on the sale of partnership property is disallowed under § 707(b)(1) of the Internal Revenue Code, are the partners' bases in their partnership interests decreased under § 705(a)(2) to reflect the disallowed loss?

(2) If gain from the sale of partnership property is not recognized due to §§ 707(b)(1) and 267(d), are the partners' bases in their partnership interests increased under § 705(a)(1) to reflect that gain?

FACTS

A and B contribute cash to form *PRS*, a general partnership. Under the partnership agreement, each item of income, gain, loss, and deduction of the partnership is allocated 75 percent to A and 25 percent to B. A is also a partner in *PRS2*, a general partnership. Under the partnership agreement, each item of income, gain, loss, and deduction of the partnership is allocated 60 percent to A and 40 percent to C. A, B, and C are unrelated to each other.

In year 1, *PRS* sells Property to *PRS2* at its fair market value of \$80x. The adjusted basis of Property at the time of the sale is \$100x.

In year 5, *PRS2* sells Property to an unrelated party for its fair market value of \$90x. The adjusted basis of Property at the time of the sale is \$80x.

LAW AND ANALYSIS

Section 1001(a) provides that the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis and the loss shall be the excess of the adjusted basis over the amount realized. Section 1001(c) requires that the entire amount of this gain or loss be recognized, except as otherwise provided in subtitle A of the Code.

Section 707(b)(1) provides that no deduction shall be allowed for losses

from sales or exchanges of property (other than an interest in the partnership) between a partnership and a person owning, directly or indirectly, more than 50 percent of the capital interest or the profits interest in the partnership or between two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profits interests.

Section 707(b)(1) also provides that, in the case of a subsequent sale or exchange by a transferee described in § 707(b)(1), § 267(d) applies as if the loss were disallowed under § 267(a)(1). Section 267(d) provides that, if a taxpayer acquires property by sale or exchange from a transferor who, on the transaction, sustained a loss not allowable as a deduction by reason of § 267(a)(1), then any gain realized by the taxpayer on a sale or other disposition of the property shall be recognized only to the extent that the gain exceeds so much of the loss as is properly allocable to the property sold or otherwise disposed of by the taxpayer.

Section 705(a)(1) provides that the adjusted basis of a partner's interest in a partnership shall be increased by the sum of the partner's distributive share for the taxable year and prior taxable years of: (1) taxable income of the partnership as determined under § 703(a), (2) income of the partnership exempt from income tax, and (3) the excess of the deductions for depletion over the basis of the property subject to depletion.

Section 705(a)(2) provides that the adjusted basis of a partner's interest in a partnership shall be decreased (but not below zero) by distributions by the partnership and by the sum of the partner's distributive share for the taxable year and prior taxable years of: (1) losses of the partnership, and (2) expenditures of the partnership not deductible in computing its taxable income and not properly chargeable to capital account.

The adjustments to the basis of a partner's interest in a partnership under § 705 are necessary to prevent inappropriate or unintended benefits or detriments to the partners. Generally, the basis of a partner's interest in a partnership is adjusted to reflect the tax allocations of the partnership to that partner. This ensures that the income and loss of the partnership are taken

into account by its partners only once. In addition, as provided in § 705(a)-(1)(B) and (a)(2)(B), adjustments must also be made to reflect certain nontaxable events in the partnership. For example, a partner's share of nontaxable income (such as exempt income) is added to the basis of the partner's interest because, without a basis adjustment, the partner could recognize gain with respect to the tax-exempt income, for example, on the sale or redemption of the partner's interest, and the benefit of the tax-exempt income would be lost to the partner. Similarly, a partner's share of nondeductible expenditures must be deducted from the partner's basis in order to prevent that amount from giving rise to a loss to the partner on a sale or a redemption of the partner's interest in the partnership. See H.R. Rep. No. 1337, 83d Cong., 2d Sess. A225 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 384 (1954).

In determining whether a transaction results in exempt income within the meaning of § 705(a)(1)(B) or a nondeductible, noncapital expenditure within the meaning of § 705(a)(2)(B), the proper inquiry is whether the transaction has a permanent effect on the partnership's basis in its assets, without a corresponding current or future effect on its taxable income. *PRS* realizes a \$20x loss on the sale of Property to *PRS2* (\$100x adjusted basis less \$80x amount realized). Pursuant to § 707(b)(1), this loss is not deductible in computing taxable income because A owns more than 50 percent of the profits interest in both *PRS* and *PRS2*. Consequently, the sale results in a permanent decrease in the aggregate basis for the assets of *PRS* that is not taken into account by *PRS* in determining its taxable income and will not be taken into account for federal income tax purposes in any other manner. Therefore, for purposes of § 705(a)-(2)(B), the loss on the sale of Property, and the resulting permanent decrease in partnership basis, is an expenditure of the partnership not deductible in computing its taxable income and not properly chargeable to capital account. Cf. § 1.704-1(b)(2)(iv)(i)(3) (losses disallowed under § 707(b) treated as § 705(a)(2)(B) expenditures for purposes of maintaining partners' capital accounts); § 1.701-2(f), *Example 2* (requiring adjustments under § 705(a)(2)(B) for reductions in the basis of stock held by a partnership following an extraordinary dividend under § 1059).

Reducing the partners' bases in their partnership interests by their respective shares of the partnership's \$20x loss preserves the intended detriment of not allowing losses from sales or exchanges between partnerships and related persons to be deducted. If the partners' bases in their partnership interests were not reduced by the amount of the partnership's disallowed loss, the partners could subsequently recognize this loss (or a reduced gain), for example, upon a disposition of their partnership interests.

Under the *PRS* agreement, A's distributive share of the partnership loss is \$15x and B's distributive share is \$5x. Accordingly, the basis of A's interest in *PRS* is decreased by \$15x and the basis of B's interest in *PRS* is decreased by \$5x.

PRS2 realizes a gain of \$10x on the subsequent sale of Property (\$90x amount realized less \$80x adjusted basis). Pursuant to §§ 707(b)(1) and 267(d), *PRS2* must recognize the gain only to the extent that it exceeds the amount of *PRS*'s disallowed loss. *PRS2*'s gain on the sale (\$10x) does not exceed *PRS*'s disallowed loss (\$20x) and, therefore, *PRS2* does not recognize any gain on the sale of Property. Consequently, the sale of Property results in a permanent increase in the aggregate basis of the assets of *PRS2* that is not taken into account by *PRS2* in determining its taxable income and will not be taken into account for federal income tax purposes in any other manner. Therefore, for purposes of § 705(a)(1)(B), the gain realized but not recognized by *PRS2* on the sale of Property, and the resulting permanent increase in basis, is income of the partnership exempt from tax.

Increasing the partner's bases in their partnership interests by their respective shares of the unrecognized gain on the sale of Property preserves the intended benefit of §§ 707(b)(1) and 267(d). If the partners' bases in their partnership interests were not increased by the amount of the partnership's unrecognized gain, the partners could subsequently recognize this gain (or a reduced loss), for example, upon a disposition of their partnership interests.

Under the *PRS2* agreement, A's distributive share of the partnership gain is \$6x and C's distributive share is \$4x. Accordingly, the basis of A's

interest in *PRS2* is increased by \$6x and the basis of C's interest in *PRS2* is increased by \$4x.

HOLDINGS

(1) If a loss on the sale of partnership property is disallowed under § 707(b)(1), the basis of each partner's interest in the partnership is decreased (but not below zero) under § 705(a)(2) by the partner's share of that loss.

(2) If gain from the sale of partnership property is not recognized under §§ 707(b)(1) and 267(d), the basis of each partner's interest in the partnership is increased under § 705(a)(1) by the partner's share of that gain.

DRAFTING INFORMATION

For further information regarding this revenue ruling contact Deborah Harrington at (202) 622-3050 (not a toll-free call).

26 CFR 1.7-5-1: Adjustments to basis of partner's interest in partnership. (Also §§ 170, 702, 703; 1.170A-1, 1.702-1, 1.703-1.)

Charitable contribution by partnership. A charitable contribution of property by a partnership reduces each partner's basis in the partnership by the amount of the partner's share of the partnership's basis in the property contributed.

Rev. Rul. 96-11

ISSUE

If a partnership makes a charitable contribution of property, are the partners' bases in their partnership interests decreased to reflect the contribution?

FACTS

A and B each contribute an equal amount of cash to form *PRS*, a general partnership. Under the *PRS* agreement, each item of income, gain, loss, and deduction of the partnership is allocated 50 percent to A and 50 percent to B. *PRS* has unencumbered property, X, with a basis of \$60x and a fair market value of \$100x. *PRS* contributes X in a transaction that qualifies as a charitable contribution under § 170(c) of the In-

ternal Revenue Code. The charitable contribution is not subject to the limitations of § 170(e)(1).

LAW AND ANALYSIS

Section 170(a) allows as a deduction any charitable contribution (as defined in § 170(c)) payment of which is made within the taxable year. The deduction provided by § 170(a) is subject to the limitations of § 170(b).

Section 1.170A-1(c)(1) of the Income Tax Regulations provides that, if a charitable contribution is made in property other than money, the amount of the contribution is the fair market value of the property at the time of the contribution reduced as provided by § 170(e)(1) and paragraph (a) of § 1.170A-4, or § 170(e)(3) and paragraph (c) of § 1.170A-4A.

Section 703(a)(2)(C) provides that the taxable income of a partnership is computed in the same manner as in the case of an individual except that the deduction for charitable contributions provided in § 170 is not allowed to the partnership. However, under § 702(a)-(4) each partner takes into account separately the partner's distributive share of the partnership's charitable contributions (as defined in § 170(c)).

Section 1.170A-1(h)(7) provides that a partner's distributive share of charitable contributions actually paid by a partnership during its taxable year may be allowed as a deduction in the partner's separate return for the partner's taxable year with or within which the taxable year of the partnership ends, to the extent that the aggregate of the partner's share of the partnership contributions and the partner's own contributions does not exceed the limitations in § 170(b).

Section 705(a)(1) provides that the adjusted basis of a partner's interest in a partnership shall be increased by the sum of the partner's distributive share for the taxable year and prior taxable years of: (1) taxable income of the partnership as determined under § 703(a); (2) income of the partnership exempt from income tax; and (3) the excess of the deductions for depletion over the basis of the property subject to depletion.

Section 705(a)(2) provides that the adjusted basis of a partner's interest in a partnership shall be decreased (but not below zero) by distributions by the partnership and by the sum of the

partner's distributive share for the taxable year and prior taxable years of: (1) losses of the partnership; and (2) expenditures of the partnership not deductible in computing its taxable income and not properly chargeable to capital account.

The adjustments to the basis of a partner's interest in a partnership under § 705 are necessary to prevent inappropriate or unintended benefits or detriments to the partners. Generally, the basis of a partner's interest in a partnership is adjusted to reflect the tax allocations of the partnership to that partner. This ensures that the income and loss of the partnership are taken into account by its partners only once. In addition, as provided in § 705(a)(1)(B) and (a)(2)(B), adjustments must also be made to reflect certain nontaxable events in the partnership. For example, a partner's share of nontaxable income (such as exempt income) is added to the basis of the partner's interest because, without a basis adjustment, the partner could recognize gain with respect to the tax-exempt income, for example, on a sale or redemption of the partner's interest, and the benefit of the tax-exempt income would be lost to the partner. Similarly, a partner's share of nondeductible expenditures must be deducted from the partner's basis in order to prevent that amount from giving rise to a loss to the partner on a sale or a redemption of the partner's interest in the partnership. *See* H.R. Rep. No. 1337, 83d Cong., 2d Sess. A225 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 384 (1954).

In determining whether a transaction results in exempt income within the meaning of § 705(a)(1)(B), or a nondeductible, noncapital expenditure within the meaning of § 705(a)(2)(B), the proper inquiry is whether the transaction has a permanent effect on the partnership's basis in its assets, without a corresponding current or future effect on its taxable income. Pursuant to § 703(a)(2)(C), the contribution of *X* by *PRS* is not taken into account by *PRS* in computing its taxable income. Consequently, the contribution results in a permanent decrease in the aggregate basis of the assets of *PRS* that is not taken into account by *PRS* in determining its taxable income and will not be taken into account for federal income tax purposes in any other manner. Therefore, for purposes of § 705(a)(2)(B), the contribution of *X*, and the resulting

permanent decrease in partnership basis, is an expenditure of the partnership not deductible in computing its taxable income and not properly chargeable to capital account. *Cf.* § 1.701-2(f), *Example 2* (requiring adjustments under § 705(a)(2)(B) for reductions in the basis of stock held by a partnership following an extraordinary dividend under § 1059).

Reducing the partners' bases in their partnership interests by their respective shares of the permanent decrease in the partnership's basis in its assets preserves the intended benefit of providing a deduction (in circumstances not under § 170(e)) for the fair market value of appreciated property without recognition of the appreciation. By contrast, reducing the partners' bases in their partnership interests by the fair market value of the contributed property would subsequently cause the partners to recognize gain (or a reduced loss), for example, upon a disposition of their partnership interests, attributable to the unrecognized appreciation in *X* at the time of this contribution.

Under the *PRS* agreement, partnership items are allocated equally between *A* and *B*. Accordingly, the basis of *A*'s and *B*'s interests in *PRS* is each decreased by \$30x.

HOLDING

If a partnership makes a charitable contribution of property, the basis of each partner's interest in the partnership is decreased (but not below zero) by the partner's share of the partnership's basis in the property contributed.

DRAFTING INFORMATION

The principal author of this revenue ruling is Terri A. Belanger of the Office of Assistant Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling contact Ms. Belanger at (202) 622-3080 (not a toll-free call).

Section 707.—Transactions between Partner and Partnership.

26 CFR 1.707-1: Transactions between partner and partnership.

If loss on the sale of partnership property is disallowed under § 707(b)(1) of the Internal Revenue Code, are the partners' bases in their

partnership interests decreased to reflect the disallowed loss? See Rev. Rul 96-10, page 00.

Section 3406.—Backup Withholding

26 CFR 31.3406-0: Outline of the backup withholding regulations.

T.D. 8637

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1, 31, 35a, 301, and 602

Backup Withholding, Statement Mailing Requirements, and Due Diligence

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document provides final rules on backup withholding under sections 3406(a)(1)(A), (C), and (D) of the Internal Revenue Code of 1986 (Code) when a payee fails to provide a taxpayer identification number in the required manner to a person required to make an information return, when a payee is subject to notified payee underreporting, or when a payee fails to certify, under penalties of perjury, that the payee is not subject to backup withholding due to notified payee underreporting.

This document also provides final rules on the manner for providing a statement to a payee under sections 6042(c), 6044(e), 6049(c), and 6050N(b) of the Code.

This document also contains temporary regulations on the effective date of §§35a.9999-1 through 35a.9999-5, Temporary Employment Tax Regulations under the Interest and Dividend Tax Compliance Act of 1983. The text of these temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in *** [IA-33-95, page 00, this Bulletin].

DATES: These regulations are effective December 21, 1995. These regulations are applicable to transactions occurring after December 31, 1996.

FOR FURTHER INFORMATION CONTACT: Renay France of the Of-

office of Assistant Chief Counsel (Income Tax and Accounting) with respect to domestic transactions, 202-622-4910 (not a toll-free number); and Teresa Burridge Hughes of the Office of Assistant Chief Counsel (International) with respect to international transactions, 202-622-3880 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this final regulation has been reviewed and approved by the Office of Management and Budget in accordance with the requirements of the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-0112. Responses to this collection of information are mandatory.

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

The estimated annual burden per respondent/recordkeeper is approximately 1 hour, depending on individual circumstances.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be directed to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, PC:FP, Washington, D.C. 20224, and to the Office of Management and Budget, Attention: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, D.C. 20503.

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

Background

On October 4, 1983, the Federal Register published Temporary Employment Tax Regulations under the Interest and Dividend Tax Compliance Act of 1983 (26 CFR part 35a) under sections 3406 and 6676(b) of the Internal Revenue Code of 1954 (26 CFR part 35a.9999-1; TD 7916 (48 FR

45362), as amended on November 25, 1983, by TD 7922 (48 FR 53111), on November 23, 1987, by TD 8163 (52 FR 44861), and on April 11, 1989, by TD 8248 (54 FR 14341). Additional temporary regulations were published in the Federal Register on November 25, 1983 (26 CFR part 35a.9999-2; TD 7922 (48 FR 53106), as amended on December 20, 1983, by TD 7929 (48 FR 56342), on March 13, 1984, by TD 7922 (49 FR 9417), on November 23, 1987, by TD 8163, and on April 11, 1989, by TD 8248 (54 FR 14341)), on December 20, 1983 (26 CFR part 35a.9999-3; TD 7929 (48 FR 56332), as amended on January 3, 1984, by TD 7933 (49 FR 63), on August 22, 1984, by TD 7966 (49 FR 33236), on November 23, 1987, by TD 8163 (52 FR 44861), and on April 11, 1989, by TD 8248 (54 FR 14341)), on February 28, 1984 (26 CFR part 35a.9999-3A; TD 7946 (49 FR 7227)), on August 22, 1984 (26 CFR part 35a.9999-4T, TD 7966 (49 FR 33237), as amended on August 29, 1984, by TD 7972 (49 FR 34340); and 26 CFR part 35a.9999-5, TD 7967 (49 FR 33240), as amended on September 19, 1984, by TD 7973 (49 FR 36645), on August 20, 1985, by TD 8046 (50 FR 33526), on April 3, 1986, by TD 8046 (51 FR 11447), on December 19, 1986, by TD 8110 (51 FR 45453), and on May 19, 1988, by TD 8202 (53 FR 17927)), on April 23, 1987 (26 CFR part 35a.3406-2; TD 8137 (52 FR 13430)), and on November 23, 1987 (26 CFR part 35a.3406-1; TD 8163 (52 FR 44861), as amended on April 11, 1989, by TD 8248 (54 FR 14341). Those regulations were published primarily to provide guidance under the Interest and Dividend Tax Compliance Act of 1983.

Proposed regulations on backup withholding, the statement mailing requirements, and due diligence were published in the Federal Register on September 27, 1990, 55 FR 39427. Those regulations were proposed under regulations file number IA-224-82 and RIN 1545-AE20, which numbers were closed in error. These final regulations are issued under regulations file number IA-31-95 and RIN 1545-AT76.

A public hearing on the proposed regulations was held on March 4, 1991. The public submitted written comments on the proposed regulations. After consideration of those comments, the proposed regulations are adopted as revised by this Treasury decision.

Explanation of Provisions

I. Overview.

The proposed regulations contain rules on the requirement to backup withhold, which section 3406 imposes in four situations. First, backup withholding under section 3406(a)(1)(A) applies if a payee fails to provide a taxpayer identification number (TIN) in the required manner (the A trigger or certification). Second, backup withholding under section 3406(a)(1)(B) applies if the Service or a broker notifies a payor that a payee provided an incorrect TIN (the B trigger). Third, backup withholding under section 3406(a)(1)(C) applies if the Service or a broker notifies a payor that a payee is subject to notified payee underreporting, *i.e.*, the payee has failed to report and pay tax on reportable interest and dividends (the C trigger). Fourth, backup withholding under section 3406(a)(1)(D) applies if a payee fails to certify, when required, that the payee is not subject to backup withholding under section 3406(a)(1)(C) (the D trigger).

Because the IRS published final regulations on the B trigger as a separate project (TD 8409) in 1992, the final regulations in this document address only the other three triggers, sections 3406(a)(1)(A), (C), and (D). The final regulations on these triggers considerably shorten as well as simplify the proposed regulations. In addition, the final regulations contain several modifications to the proposed regulations relating to grantor trusts, S corporations, reportable payments, and certain foreign provisions.

II. Changes regarding grantor trusts, S corporations, reportable payments, and certain foreign provisions.

A. Grantor trusts—proposed §31.3406(a)-2. The proposed regulations provide that a grantor trust with ten or fewer grantors is not a payor under section 3406 and, as a result, has no obligation to withhold under section 3406 on reportable payments flowing through the trust and includible in the gross income of its grantors. However, a grantor trust with eleven or more grantors is a payor and must withhold under section 3406 on reportable payments to its grantors who are subject to such withholding.

Recently, the IRS issued proposed regulations under section 671 on the methods of reporting by grantor trusts. These proposed regulations provide two regimes for reporting, one for a grantor trust that is owned (or treated as owned) by one grantor and another for a grantor trust that is owned by two or more grantors. To avoid confusion and thereby promote simplification, the final backup withholding regulations are conformed to these regimes. Accordingly, under these final regulations a grantor trust with two or more grantors is considered a payor and must withhold on payments to its grantors who are subject to backup withholding. For purposes of determining the number of grantors, a husband and wife filing a joint return are considered one grantor. See §31.3406(a)-2(b)(4).

B. S corporations—proposed §31.3406(a)-2(c)(3). Under an exception in the proposed regulations defining payors, a partnership making a payment of a distributive share to a partner is not considered a payor. The exception does not include S corporations. Because the tax treatment of both entities is similar, the final regulations provide that an S corporation making a similar distribution is not a payor under section 3406. See §31.3406(a)-2(c)(3).

C. Transferred short-term obligations—proposed §31.3406(b)(2)-2. The proposed regulations provide that a subsequent holder of a short-term obligation with original issue discount may establish the purchase price at which the subsequent holder purchased the obligation. That purchase price is then treated as the original issue price for purposes of computing the amount of original issue discount subject to backup withholding. To reduce the paperwork of issuers and payors of these obligations, the final regulations provide that a payor may disregard the subsequent holder's purchase price if the payor's computer or recordkeeping system is not able to accept that price without substantial manual intervention. See §31.3406(b)(2)-2(c)(1)(ii).

D. Foreign provisions. The proposed regulations contained several provisions on international transactions that are not included in the final regulations. For those international provisions relating to section 3406, the temporary regulations under §35a.9999 remain in effect.

III. *The C trigger (payee underreporting).*

A. Identifying the account subject to the C trigger—proposed §31.3406(c)-1(b)(3)(i) and (iv). The proposed regulations provide that a payor must withhold under section 3406(a)(1)(C) on reportable interest or dividend payments to all existing accounts of a payee that the payor can identify exercising reasonable care. Commentators suggested several modifications to or clarifications of the reasonable care standard. For example, some commentators suggested that the procedures for locating and identifying an account of a payee subject to the C trigger should more closely resemble the procedures for identifying an account subject to the B trigger. In response to this comment, the final regulations modify the procedures for identifying accounts subject to the C trigger, and thus require a payor to identify those accounts by identifying accounts with the same TIN as the one provided in the notice from the IRS to the payor that advises the payor to commence withholding on accounts of a payee.

Commentators also informed the IRS that some computer systems use a universal account number that retrieves all accounts of a payee with that payor. In light of this information, the final regulations require payors with such systems to identify all accounts that can be so retrieved.

Some commentators also addressed the requirement under the proposed regulations that a payor search for accounts of a payee on the computer or other recordkeeping system for the region, division, or branch that serves the geographic area in which the payee's mailing address is located. These commentators questioned whether payors must search every such computer or record system. The final regulations clarify that a payor need not search a computer or other recordkeeping system if it is highly unlikely that the system contains an account of the payee that should be identified as one subject to the C trigger. See §31.3406(c)-1(c)(3)(ii).

B. Newly opened accounts—proposed §31.3406(c)-1(b)(3)(ii). Under the proposed regulations, if a payee subject to the C trigger has one account with a payor and subsequently opens another account, the payor may not rely on the subsequent Form W-9 on which

the payee certifies that the payee is not subject to the C trigger, but only if the payor discovers while processing the Form W-9 or administering the account that the Form W-9 is false because the IRS previously notified the payor to withhold on the payee under the C trigger. Commentators argued that this discovery standard was unclear and potentially burdensome. As a result, the final regulations clarify when a payor may not rely on a Form W-9 provided by the payee.

Under the final regulations, a payor has knowledge that a payee opening a new account with the payor is subject to withholding under section 3406(a)(1)(C), and thus must commence backup withholding on reportable interest and dividend payments to the new account, only if (1) the employee or individual agent of the payor receiving the Form W-9 knows at the time the payee opens the account that the payee's statement under section 3406(a)(1)(D) is not true; (2) at the time the payor processes the Form W-9 or in administering the account to which it relates, the payor discovers that the payee is currently subject to withholding under section 3406(a)(1)(C) on a pre-existing account with the payor; (3) the payor uses a single Form W-9 for multiple accounts of the payee; or (4) the payor uses a universal identifier to associate all of the payee's accounts with the payor and other accounts under that universal identifier have been identified as subject to withholding under section 3406(a)(1)(C). See §31.3406(c)-1(c)(3)(iii).

C. Including certain dates in the notice that the payor must send to a payee—proposed §31.3406(c)-1(c)(2)-(ii) and (iii). A commentator objected to the proposed rule requiring a payor to include the following dates in the notice informing a payee that backup withholding for the C trigger has begun or will begin: (1) the last date before the payor must commence backup withholding, and (2) the date the payor received the notice from the IRS. The significant date for the payee is the date backup withholding begins on the payee's account. Therefore, to ease payors' administrative costs, the final regulations require the payor to include only the date the payor started (or plans to start) backup withholding in the notice to the payee. See §31.3406(c)-1(d)(2)(iii).

D. Monitoring accounts subject to withholding—proposed §31.3406(c)-1-

(e). Commentators asked the IRS to address how long a payor must monitor an account identified as one subject to the C trigger, if that account later becomes dormant. The final regulations provide that a payor is not required to backup withhold on dormant accounts. In this connection, backup withholding terminates no later than the close of the third calendar year ending after the later of (1) the date that the payor pays the last reportable payment to that account, or (2) the date that the payor received a notice from the IRS to impose the C trigger on that account. See §31.3406(c)-1(e)(3).

IV. *Special rules for acquiring accounts (including a readily tradable instrument) or selling a readily tradable instrument.*

A. *By electronic transmission—proposed §31.3406(d)-3.* A payee can acquire by electronic transmission an account or an instrument that earns reportable interest or dividends. Under the proposed regulations the payor, at its option, may permit a payee to furnish the certifications relating to the A and D triggers within 30 days after the establishment or acquisition of the account or the instrument (30-day period) by electronic transmission, provided that the payee furnishes the payee's TIN at the time of the establishment or the acquisition. However, if the payee makes any withdrawal within the 30-day period and before the payor receives the payee's certifications, the payor must withhold to the extent of any reportable interest or dividends paid to the payee during the 30-day period and at the time of withdrawal.

The proposed regulations provide comparable rules for the sale of a readily tradable instrument by electronic transmission. In this context, the payee is permitted to withdraw (or reinvest) up to 69 percent of the gross proceeds from the sale during the relevant 30-day period.

Commentators requested that backup withholding be applied in the same manner whether the electronic transmission involves the establishment or acquisition of an account or a readily tradable instrument or the sale of a readily tradable instrument. In response to this comment, the final regulations provide that backup withholding applies if the payee withdraws more than

69 percent of the reportable interest or dividends paid to the payee during the relevant 30-day period and at the time of withdrawal, but only if the payor has not received the payee's certifications relating to the A and D triggers at the time of the withdrawal. See §31.3406(d)-3(a).

B. *By mail—proposed §31.3406(d)-3(a)(1).* The proposed regulations provide that a payee may provide the certifications relating to the A and D triggers within 30 days after a payee establishes or acquires a readily tradable instrument by mail before January 1, 1985, provided the payee furnishes the payee's TIN upon the establishment or acquisition. The proposed regulations do not provide a similar rule for the sale of a readily tradable instrument by mail.

To simplify the procedures for entering into investments which do not occur in person, the final regulations provide a 30-day rule for the establishment or acquisition of an account or readily tradable instrument by mail and extend the 30-day rule to the sale of a readily tradable instrument by mail. Under the final regulations, if the payee furnishes the payee's TIN before the transaction, backup withholding applies during the 30-day period only if the payee withdraws more than 69 percent of the reportable payment and if the payor has not received the payee's certifications relating to the A or D triggers, whichever applies, at the time of the withdrawal. See §31.3406(d)-3(a).

V. *Section 3406 confidentiality issues—proposed §31.3406(f)-1(a).* Section 3406(f) provides that a payor may not use information obtained under section 3406 except for meeting a requirement of that section. Commentators requested clarification on what actions a payor or broker may take, consistent with section 3406(f), in response to a payee's failure to provide the payee's TIN under section 3406(a)-(1)(A). The final regulations provide that a payor who closes an account at or before the end of a calendar year in which the payee opens the account without providing the payee's TIN or documentation of foreign status, as required, during that year will not, in the absence of evidence to the contrary, be deemed in violation of section 3406(f).

Another commentator inquired whether prohibiting a payee from with-

drawing funds from the payee's account is a violation of section 3406(f). The final regulations clarify that refusing to allow a payee to withdraw funds from the payee's account solely because the payee has not furnished a TIN violates section 3406(f). See §31.3406(f)-1(b)(1).

VI. *Exemptions from backup withholding.*

A. *Interaction of information reporting and backup withholding exemptions—proposed §31.3406(g)-1(a).* Several commentators questioned the interaction between the rules exempting payees from information reporting and those exempting payees from backup withholding. The class of recipients exempt from information reporting is larger than the class exempt from backup withholding. The final regulations clarify that the list of the payees that are specifically exempt from backup withholding is not exclusive and that other payees that are exempt from information reporting also are exempt from backup withholding. See §31.3406(g)-1(a)(2).

B. *Interest on certain life-insurance contracts—proposed §31.3406(g)-1(a)-(4).* Commentators requested that the temporary exemption from backup withholding for interest payments made before January 1, 1992, on "advance premiums", "prepaid premiums", or "premium deposit funds", on certain insurance policies be made permanent. The final regulations provide an extension through December 31, 1996.

C. *Payments reportable under section 6047—proposed §31.3406(g)-2(c)-(1) and (2).* Commentators noted that, contrary to the position set forth in the proposed regulations, backup withholding does not apply to designated distributions paid after December 31, 1984. The final regulations clarify that backup withholding does not apply to those payments. See §31.3406(g)-2(d).

D. *Awaiting-TIN certificate—proposed §31.3406(g)-3.* Commentators requested simplification of the backup withholding rules applicable to accounts for which a payor has received an awaiting-TIN certification. One suggestion was that backup withholding should not apply during the period (up to 60 days) that the payee is waiting for the payee's TIN if no more than 69 percent of the reportable payment is withdrawn during the 60-day period.

The final regulations adopt this suggestion. Therefore, backup withholding is deferred during the 60-day period unless the payee makes a withdrawal (of more than \$500 in one transaction) during that time or has failed to provide the certification relating to the D trigger. If the payee makes a withdrawal of more than \$500 in one transaction during the 60-day period, backup withholding applies to the extent of any reportable interest or dividends made to the account during the 60-day period and at the time of withdrawal unless the payee reserves 31 percent of all reportable payments made to the account during that period. Payors may elect, however, to impose withholding during the 60-day period. See §31.3406(g)-3(a)(2) and (3).

Commentators requested clarification of the interaction of the awaiting-TIN rules for post-1983 accounts or instruments and the obligation of the payee to provide the certification relating to the D trigger that the payee is not subject to backup withholding due to the C trigger. The final regulations clarify that in spite of the awaiting-TIN certification, backup withholding applies under section 3406(a)(1)(D) during the 60-day period if the payee has not provided this certification to the payor. See §31.3406(g)-3(a)(1).

A commentator asked whether the 60-day period refers to calendar or business days. Accordingly, the final regulations clarify that the term “day” means a calendar day. See §§31.3406(g)-3 and 31.3406(h)-1(e).

VII. Other changes.

A. *Identifying the person listed on a joint account as the one subject to withholding—proposed §31.3406(h)-2(a).* Under the proposed regulations, a payor of a reportable payment to a joint account may treat the first person listed on the account (or on the instrument) as the payee subject to information reporting and backup withholding. The final regulations provide that the relevant payee is the one whose name and TIN combination the payor uses for information reporting purposes, whether or not that account or instrument registration lists that payee first. See §31.3406(h)-2(a)(1).

B. *Backup withholding on payments made in property—proposed §31.3406(h)-2(b).* Under the proposed regulations, a payor making a reportable

payment in property subject to backup withholding must withhold on an amount equal to the fair market value of the property. The obligation to withhold occurs at the time the property is paid to the payee. Consequently, the payor must find an alternative source, such as another account of the payee, from which the payor can satisfy its backup withholding liability. Otherwise, the payor must continue to look for accounts of the payee to satisfy the payor’s backup withholding liability. A commentator suggested that the final regulations add an ending date after which a payor no longer has to search for alternative sources from which to satisfy a backup withholding obligation arising from a payment in property. According to this commentator, the obligation should extinguish after a reasonable period of time. In response to this comment, the final regulations provide that a payor’s obligation to backup withhold on property terminates on the earlier of the date sufficient cash is deposited to the account to fully satisfy the obligation or the close of the fourth calendar year after the obligation arose. See §31.3406(h)-2(b)(2)(ii).

C. *Gross-up of payments by middlemen—proposed §31.3406(h)-2(d).* Under the proposed regulations, a middleman is required to remit the full amount due a payee unless one of the requirements for imposing backup withholding exists at the time of payment. Thus, the middleman is required to remit the full amount even though an upstream payor erroneously withheld on that payment to the middleman. In that event, the middleman may recover the difference between the amount received and the amount paid to the payee, i.e., 31 percent, by seeking a refund from the upstream payor or by taking an equivalent credit against the next required deposit of employment taxes. One commentator noted that the middleman payor incurs a loss in the time value of money measured from the time it pays the full amount due to the payee to the time the payor receives a refund or credit. Because of this, the commentator suggested that the regulations allow the middleman to remit only the net amount due its payee. This suggestion presents several problems. First, it requires a new reconciliation process to correlate the backup withholding reflected on the upstream payor’s Form 945 with the backup withholding

shown as withheld tax on the payee’s income tax return. Second, the suggestion produces an anomalous result, namely, withholding occurs even though none of the statutory conditions requiring withholding exist. For these reasons the final regulations do not adopt this suggestion.

D. *Refund of amount erroneously subject to backup withholding—proposed §31.6413(a)-3.* Under the proposed regulations, a payor must refund an amount previously withheld under the C trigger if the IRS instructs the payor to do so. This provision is also set forth in §35a.9999-3 Q/A-38 of the Temporary Employment Tax Regulations issued under the Interest and Dividend Tax Compliance Act of 1983, as amended by TD 8248 (54 FR 18713) on May 2, 1989. One commentator suggested eliminating this refund provision. This rule was needed initially to allow refunds in certain cases where payees had interest or dividend income subject to backup withholding under the C trigger but had no income tax liability on this income. The IRS has subsequently enhanced its C withholding program to eliminate C notices to payors in such cases. Thus, the final regulations adopt the suggestion and delete the proposed rule. See §31.6413(a)-3.

E. *Effective date.* The final regulations are effective for reportable payments made and transactions occurring after December 31, 1996, and, optionally, for reportable payments made and transactions occurring on or after December 21, 1995. See §31.3406(i)-1.

F. *Coordination with the temporary regulations—§§35a.9999-1 through 35a.9999-5.* The temporary regulations issued under 26 CFR Part 35a are not effective for noninternational transactions occurring on and after the effective date of the final regulations. The temporary regulations, however, remain effective for the due diligence safe harbor and for international transactions, including transactions involving a foreign payee, a foreign payor, or a payment from sources without the United States.

G. *Statement mailing requirement—proposed §§1.6042-5, 1.6044-6, 1.6049-6, and 1.6050N-1.* These final regulations set forth rules on the manner in which a payor who is required to file an information return for dividends and corporate earnings and profits, patronage dividends, interest,

and royalties under sections 6042(c), 6044(e), 6049(c), and 6050N(b), respectively, must provide a copy of that information return to the payee, *i.e.*, payee statement mailing.

The proposed regulations limit the permissible nontax enclosures includable in a statement mailing. Several commentators requested that the inclusion of additional nontax enclosures be permitted. This suggestion was not adopted because the relevant legislative history indicates that Congress wanted to substantially restrict the nontax enclosures in a statement mailing.

H. *Correct identifying number for estates—proposed §301.6109-1.* The final regulations clarify that the taxpayer identification number to be used to identify estates of decedents is the employer identification number (rather than a social security number).

Special Analyses

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

Drafting Information

The principal author of these regulations is Renay France of the Office of Assistant Chief Counsel (Income Tax and Accounting), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

The amendments to 26 CFR parts 1, 31, 35a, 301, and 602 read as follows:

PART 1—INCOME TAXES

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

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

Section 1.6049-6 also issued under 6049(a), (b), and (d). * * *

Par. 2. Section 1.6042-4 is revised as follows:

§1.6042-4 *Statements to recipients of dividend payments.*

(a) *Requirement.* A person required to make an information return under section 6042(a)(1) and §1.6042-2 must furnish a statement to each recipient whose identifying number is required to be shown on the related information return for dividend payments.

(b) *Form of the statement.* The statement required by paragraph (a) of this section must be either the official Form 1099 prescribed by the Internal Revenue Service for the respective calendar year or an acceptable substitute statement that contains provisions that are substantially similar to those of the official Form 1099 for the respective calendar year. For further guidance on how to prepare an acceptable substitute statement, see Rev. Proc. 95-30 (1995-27 I.R.B. 9) (or its successor), republished as “Rules and Specifications for Private Printing of Substitute Forms 1096, 1098, 1099 Series, 5498, and W-2G.” See §601.601(d)(2) of this chapter.

(c) *Aggregation of payments.* A payor may aggregate on one Form 1099 all payments made to a recipient with respect to each separate account during a calendar year.

(d) *Manner of providing statements to recipients—(1) In general.* The Form 1099, or acceptable substitute statement, must be provided to the recipient either in person or by first-class mail to the recipient’s last known address in a statement mailing.

(2) *Statement mailing requirement.* The mailing required under section 6042(c) of a Form 1099 to a payee-recipient must qualify as a statement mailing. A statement mailing must contain the required Form 1099 or acceptable substitute statement (written statement) and must comply with enclosure and envelope restrictions.

(i) *Enclosure restrictions.* To qualify as a statement mailing, the mailing cannot contain any enclosures except those

listed in this paragraph (d)(2)(i). Moreover, no promotional or advertising material is permitted in the mailing of the written statement. Even a *de minimis* amount of promotional or advertising material violates the statement mailing requirement. However, a logo on the envelope containing the written statement and on nontax enclosures described in paragraph (d)(2)(i)(A) through (D) of this section does not violate the written statement requirement. The written statement required under section 6042(c) and paragraph (a) of this section may be perforated to a check or to a statement of the recipient-payee’s specific account with the payor described in paragraph (d)(2)(i)(A) or (C) of this section. The enclosure to which the written statement is perforated must contain, in a bold and conspicuous type, the legend: “Important Tax Return Document Attached.” The enclosures permitted in a mailing are limited to—

(A) A check with respect to the account reported on the written statement;

(B) A letter explaining why a check with respect to such account is not enclosed with the written statement (for example, because a dividend has not been declared payable);

(C) A statement of the taxpayer-recipient’s specific account with the payor if payments on such account are reflected on the written statement;

(D) A letter limited to an explanation of the tax consequences of the information set forth on the enclosed written statement;

(E) Payee statements related to other Forms 1099, Form 1098, and Form 5498 (or the account balance on a Form 5498), Forms W-2 and W-2G; and

(F) Any document concerning the solicitation of the Form W-9 or Form W-8.

(ii) *Envelope and delivery restrictions—(A) Envelope restrictions.* The outside of the envelope in which the written statement is mailed and each nontax enclosure enclosed in the envelope must contain, in a bold and conspicuous type, the legend: “Important Tax Return Document Enclosed.” For purposes of this paragraph (d)(2)-(ii), a nontax enclosure is any item listed in paragraphs (d)(2)(i)(A) through (C) of this section. However, a payor is not required to include the legend on the outside of an envelope

containing only the enclosures in paragraph (d)(2)(i)(D) through (F) of this section.

(B) *Delivery restrictions.* The requirement to provide the written statement in person or by first-class mail may be satisfied by sending the written statement and any enclosures described in paragraph (d)(2)(i) of this section by intra-office mail, provided that intra-office mail is used by the payor in sending account activity, balance information, and other correspondence to the payee. If a payor does not personally deliver the written statement (*i.e.*, the Form 1099 or its acceptable substitute) to the recipient or mail it to the recipient in a statement mailing as described in this paragraph (d), the payor is considered to have failed to mail the statement required under section 6042(c) and will be subject to the penalty under section 6722.

(e) *Time for furnishing statements—*
(1) *In general.* Each statement required by section 6042(c) and this section to be furnished to any person for a calendar year must be furnished to such person after November 30 of the year and on or before January 31 (February 10 in the case of a nominee filing under §1.6042-2(a)(1)(iii)) of the following year, but no statement may be furnished before the final dividend for the calendar year has been paid. However, the statement may be furnished at any time after April 30 if it is furnished with the final dividend for the calendar year.

(2) *Extensions of time.* For good cause upon written application of the person required to furnish statements under this section, the Director, Martinsburg Computing Center, may grant an extension of time not exceeding 30 days in which to furnish such statements. The application must be addressed to the Director, Martinsburg Computing Center, and must contain a full recital of the reasons for requesting the extension to aid the Director in determining the period of the extension, if any, that will be granted. Such a request in the form of a letter to the Director, Martinsburg Computing Center, signed by the applicant will suffice as an application. The application must be filed on or before the date prescribed in paragraph (e)(1) of this section.

(3) *Last day for furnishing statement.* For provisions relating to the time for performance of an act when

the last day prescribed for performance falls on Saturday, Sunday, or a legal holiday, see section 7503 and §301.7503-1 of this chapter (Regulations on Procedure and Administration).

(f) *Penalty.* For provisions relating to the penalty for the failure to furnish a statement under this section, see section 6722.

(g) *Effective date.* This section is effective for payee statements due after December 31, 1995, without regard to extensions. For the substantially similar statement mailing requirements that apply with respect to forms required to be filed after October 22, 1986, and before January 1, 1996, see Rev. Proc. 84-70 (1984-2 C.B. 716) (or successor revenue procedures). See §601.601(d)-(2) of this chapter.

Par. 3. Section 1.6044-5 is revised as follows:

§1.6044-5 Statements to recipients of patronage dividends.

(a) *Requirement.* A person required to make an information return under section 6044(a)(1) and §1.6044-2 must furnish a statement to each recipient whose identifying number is required to be shown on the related information return for patronage dividends paid.

(b) *Form, manner, and time for providing statements to recipients.* The statement required by paragraph (a) of this section must be either the official Form 1099 prescribed by the Internal Revenue Service for the respective calendar year or an acceptable substitute statement. The rules under §1.6042-4 (relating to statements with respect to dividends) apply comparably in determining the form of an acceptable substitute statement permitted by this section. Those rules also apply for purposes of determining the manner of and time for providing the Form 1099 or its acceptable substitute to a recipient under this section. However, each Form 1099 or acceptable substitute statement required by this section must be furnished on or before January 31 of the following year, but no statement may be furnished before the final payment has been made for the calendar year.

(c) *Penalty.* For provisions relating to the penalty for the failure to furnish a statement under this section, see section 6722.

(d) *Effective date.* This section is effective for payee statements due after

December 31, 1995, without regard to extensions. For the substantially similar statement mailing requirements that apply with respect to forms required to be filed after October 22, 1986, and before January 1, 1996, see Rev. Proc. 84-70 (1984-2 C.B. 716) (or successor revenue procedures). See §601.601(d)(2) of this chapter.

Par. 4. Section 1.6049-6 is amended by:

1. Revising the section heading.
2. Removing the language “section 3451” and adding “section 3406” in each of the following locations:
 - a. Paragraph (a), second sentence.
 - b. Paragraph (a), third sentence.
 - c. Paragraph (a), fourth sentence.
3. Removing the language “section 3451” and adding “section 3406” in each of the following locations:
 - a. Paragraph (b)(1)(ii).
 - b. Paragraph (b)(2)(ii).
4. Adding paragraph (e).
5. Removing the authority citation at the end of the section.

The revision and additions read as follows:

§1.6049-6 Statements to recipients of interest payments and holders of obligations for attributed original issue discount.

* * * * *

(e) *Statements to recipients—*(1) *Requirement.* A person required to make an information return under section 6049(a) and §1.6049-4 must furnish a statement to each recipient whose identifying number is required to be shown on the related information return for interest or original issue discount paid or accrued.

(2) *Form, manner, and time for providing statements to recipients.* The statement required by paragraph (e)(1) of this section must be either the official Form 1099 prescribed by the Internal Revenue Service for the respective calendar year or an acceptable substitute statement. The rules under §1.6042-4 (relating to statements with respect to dividends) apply comparably in determining the form of an acceptable substitute statement permitted by this paragraph (e). Those rules also apply for purposes of determining the manner of and time for providing the Form 1099 or its acceptable substitute to a recipient under paragraph (e)(1) of

this section. However, with respect to original issue discount, the Form 1099 or acceptable substitute statement required by paragraph (e)(1) of this section must show the aggregate amount of original issue discount includible in the gross income by the recipient for the calendar year with respect to the obligation (determined by applying the rules of §1.6049-4(b)(2)), and the amount, serial number, or other identifying number of each obligation with respect to which a return is being made. With respect to interest or original issue discount, the Form 1099 or acceptable substitute statement required by paragraph (e)(1) of this section must be furnished to the recipient on or before January 31 of the year following the calendar year for which the return under section 6049(a)(1) was required to be made.

(3) *Penalty.* For provisions relating to the penalty for the failure to furnish a statement under this section, see section 6722.

(4) *Effective date.* This paragraph (e) is effective for payee statements due after December 31, 1995, without regard to extensions. For the substantially similar statement mailing requirements that apply with respect to forms required to be filed after October 22, 1986, and before January 1, 1996, see Rev. Proc. 84-70 (1984-2 C.B. 716) (or successor revenue procedures). See §601.601(d)(2) of this chapter.

Par. 5. Section 1.6050N-1 is added to read as follows:

§1.6050N-1 Statements to recipients of royalties.

(a) *Requirement.* A person required to make an information return under section 6050N(a) must furnish a statement to each recipient whose name is required to be shown on the related information return for royalties paid.

(b) *Form, manner, and time for providing statements to recipients.* The statement required by paragraph (a) of this section must be either the official Form 1099 prescribed by the Internal Revenue Service for the respective calendar year or an acceptable substitute statement. The rules under §1.6042-4 (relating to statements with respect to dividends) apply comparably in determining the form of the acceptable substitute statement permitted by this section. Those rules also apply for purposes of determining the manner of

and time for providing the Form 1099 or its acceptable substitute statement to a recipient under this section.

(c) *Penalty.* For provisions relating to the penalty for failure to furnish a statement under this section, see section 6722.

(d) *Effective date.* This section is effective for payee statements due after December 31, 1995, without regard to extensions. For the substantially similar statement mailing requirements that apply with respect to forms required to be filed after October 22, 1986, and before January 1, 1996, see Rev. Proc. 84-70 (1984-2 C.B. 716) (or successor revenue procedures). See §601.601(d)(2) of this chapter.

PART 31—EMPLOYMENT TAXES AND COLLECTION OF INCOME TAX AT SOURCE

Par. 6. The authority for Part 31 is amended by removing the entry for §31.3406(d)-5 and by adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805. * * * Sections 31.3406(a)-1 through 31.3406(i)-1 also issued under 26 U.S.C. 3406(i).

Par. 7. Section 31.3406-0 is revised to read as follows:

§31.3406-0 Outline of the backup withholding regulations.

This section lists paragraphs contained in §§31.3406(a)-1 through 31.3406(i)-1.

§31.3406(a)-1 Backup withholding requirement on reportable payments.

- (a) Overview.
- (b) Conditions that invoke the backup withholding requirement.
 - (1) Conditions applicable to all reportable payments.
 - (2) Conditions applicable only to reportable interest or dividend payments.
- (c) Exceptions.
- (d) Cross references.

§31.3406(a)-2 Definition of payors obligated to backup withhold.

- (a) In general.
- (b) Middlemen treated as payors.
- (c) Persons not treated as payors.

§31.3406(a)-3 Scope and extent of accounts subject to backup withholding.

§31.3406(a)-4 Time when payments are considered to be paid and subject to backup withholding.

- (a) Timing.
 - (1) In general.
 - (2) Special rules for dividends.
- (b) Amounts reportable under section 6045.
 - (1) In general.
 - (2) Special rule for interest accrued on bonds.
- (c) Middlemen.
 - (1) In general.
 - (2) Special rule for common trust funds.
 - (3) Special rule for certain grantor trusts.

§31.3406(b)(2)-1 Reportable interest payment.

- (a) Interest subject to backup withholding.
 - (1) In general.
 - (2) Special rule for tax-exempt interest.
- (b) Amount subject to backup withholding.
 - (1) In general.
 - (2) Special rule to adjust for premature withdrawal penalty.

§31.3406(b)(2)-2 Original issue discount.

- (a) Original issue discount subject to backup withholding.
- (b) Amount subject to backup withholding and time when backup withholding is imposed with respect to short-term obligations.
- (c) Transferred short-term obligations.
 - (1) Subsequent holder may establish purchase price.
 - (2) Subsequent holder unable (or not permitted) to establish purchase price.
 - (3) Transferred obligation.
- (d) Amount subject to backup withholding and time when backup withholding is imposed with respect to long-term obligations.
 - (1) No cash payments prior to maturity.
 - (2) Registered long-term obligations with cash payments prior to maturity.

- (3) Transferred registered long-term obligations with payments prior to maturity.
- (e) Bearer long-term obligations.
 - (1) Payments prior to maturity.
 - (2) Payments at maturity.

§31.3406(b)(2)–3 Window transactions.

- (a) Requirement to backup withhold.
- (b) Window transaction defined.
- (c) Manner of furnishing taxpayer identification number in the case of a window transaction.

§31.3406(b)(2)–4 Reportable dividend payment.

- (a) Dividends subject to backup withholding.
- (b) Dividends not subject to backup withholding.
- (c) Amount subject to backup withholding.
 - (1) In general.
 - (2) Reasonable estimate of amount of dividend subject to backup withholding.
 - (3) Reinvested dividends.

§31.3406(b)(2)–5 Reportable patronage dividend payment.

- (a) Patronage dividends subject to backup withholding.
- (b) Amount subject to backup withholding.
 - (1) Failure to provide taxpayer identification number or notification of incorrect taxpayer identification number.
 - (2) Notified payee underreporting or payee certification failure.

§31.3406(b)(3)–1 Reportable payments of rents, commissions, nonemployee compensation, etc.

- (a) Section 6041 and 6041A(a) payments subject to backup withholding.
- (b) Amount subject to backup withholding.
 - (1) In general.
 - (2) Net commissions.
 - (3) Payments aggregating \$600 or more for the calendar year.

§31.3406(b)(3)–2 Reportable barter exchanges and gross proceeds of sales of securities or commodities by brokers.

- (a) Transactions subject to backup withholding.
- (b) Amount subject to backup withholding.
 - (1) In general.
 - (2) Forward contracts, including foreign currency contracts, and regulated futures contracts.
 - (3) Security sales made through a margin account.
 - (4) Security short sales.
 - (5) Fractional shares.

§31.3406(b)(3)–3 Reportable payments by certain fishing boat operators.

- (a) Payments subject to backup withholding.
- (b) Amount subject to backup withholding.

§31.3406(b)(3)–4 Reportable payments of royalties.

- (a) Royalty payments subject to backup withholding.
- (b) Amount subject to backup withholding.

§31.3406(b)(4)–1 Exemption for certain minimal payments.

- (a) In general.
- (b) Manner of making the election.
- (c) How to annualize.
 - (1) In general.
 - (2) Special aggregation rule for reportable interest and dividends.
- (d) Exception for window transactions and original issue discount.

§31.3406(c)–1 Notified payee underreporting of reportable interest or dividend payments.

- (a) Overview.
- (b) Definitions.
 - (1) Notified payee underreporting.
 - (2) Payee underreporting.
- (c) Notice to payors regarding backup withholding due to notified payee underreporting.
 - (1) In general.
 - (2) Additional requirements for payors that are also brokers.

- (3) Payor identification of accounts of the payee subject to backup withholding due to notified payee underreporting.

- (d) Notice from payors of backup withholding due to notified payee underreporting.
 - (1) In general.
 - (2) Procedures.
- (e) Period during which backup withholding is required.
 - (1) In general.
 - (2) Stop withholding.
 - (3) Dormant accounts.
- (f) Notice to payees from the Internal Revenue Service.
 - (1) Notice period.
 - (2) Payee subject to backup withholding.
 - (3) Disclosure of names of payors and brokers.
 - (4) Backup withholding certification.
- (g) Determination by the Internal Revenue Service that backup withholding should not start or should be stopped.
 - (1) In general.
 - (2) Date notice to stop backup withholding will be provided.
 - (3) Grounds for determination.
 - (4) No underreporting.
 - (5) Correcting any payee underreporting.
 - (6) Undue hardship.
 - (7) Bona fide dispute.
- (h) Payees filing a joint return.
 - (1) In general.
 - (2) Exceptions.
- (i) [Reserved.]
- (j) Penalties.

§31.3406(d)–1 Manner required for furnishing a taxpayer identification number.

- (a) Requirement to backup withhold.
- (b) Reportable interest or dividend account.
 - (1) Manner required for furnishing a taxpayer identification number with respect to a pre-1984 account or instrument.
 - (2) Determination of pre-1984 account or instrument.
 - (3) Manner required for furnishing a taxpayer identification number with respect to an account or instrument that is not a pre-1984 account.

- (4) Special rule with respect to the acquisition of a readily tradable instrument in a transaction between certain parties acting without the assistance of a broker.
- (c) Brokerage account.
 - (1) Manner required for furnishing a taxpayer identification number with respect to a brokerage relationship that is not a post-1983 brokerage account.
 - (2) Manner required for furnishing a taxpayer identification number with respect to a post-1983 brokerage account.
- (d) Rents, commissions, non-employee compensation, and certain fishing boat operators, etc.—Manner required for furnishing a taxpayer identification number.

§31.3406(d)–2 Payee certification failure.

- (a) Requirement to backup withhold.
- (b) Exceptions.

§31.3406(d)–3 Special 30-day rules for certain reportable payments.

- (a) Accounts or readily tradable instruments acquired directly from the payor (including a broker who holds an instrument in street name) by electronic transmission or by mail.
- (b) Sale of an instrument for a customer by electronic transmission or by mail.
- (c) Application to foreign payees.

§31.3406(d)–4 Special rules for readily tradable instruments acquired through a broker.

- (a) Readily tradable instruments acquired through post-1983 brokerage accounts with a broker who is not a payor.
 - (1) In general.
 - (2) Additional requirements.
 - (3) Transactions entered into through a brokerage account that is not a post-1983 brokerage account.
 - (4) Payor must notify payee.
- (b) Notices.
 - (1) Form of notice by broker to payor.

- (2) Form of notice by payor to payee.
- (c) Payor’s reliance on information from broker.
 - (1) In general.
 - (2) Amount subject to backup withholding.

§31.3406(d)–5 Backup withholding when the Service or a broker notifies the payor to withhold because the payee’s taxpayer identification number is incorrect.

- (a) Overview.
- (b) Definitions and special rules.
 - (1) Definition of an incorrect name/TIN combination.
 - (2) Definition of account.
 - (3) Definition of business day.
 - (4) Certain exceptions.
- (c) Notice regarding an incorrect name/TIN combination.
 - (1) In general.
 - (2) Additional requirements for payors that are also brokers.
 - (3) Payor identification of the account or accounts of the payee that have the incorrect taxpayer identification number.
 - (4) Special rule for joint accounts.
 - (5) Date of receipt.
- (d) Notice from payors of backup withholding due to an incorrect name/TIN combination.
 - (1) In general.
 - (2) Procedures.
- (e) Period during which backup withholding is required due to notification of an incorrect name/TIN combination.
 - (1) In general.
 - (2) Grace periods.
 - (3) Dormant accounts.
- (f) Manner required for payee to furnish certified taxpayer identification number.
- (g) Receipt of two notices within a 3-year period.
 - (1) In general.
 - (2) Notice to payee who has provided two incorrect name/TIN combinations within 3 calendar years.
 - (3) Period during which backup withholding is required due to a second notice of an incorrect name/TIN combination within 3 calendar years.
 - (4) Receipt of two notices in one calendar year.

- (5) Notification from the Social Security Administration (or the Internal Revenue Service) validating a name/TIN combination.
- (h) Payors must use newly provided certified number.
- (i) Effective date.
- (j) Examples.

§31.3406(e)–1 Period during which backup withholding is required.

- (a) In general.
- (b) Failure to furnish a taxpayer identification number in the manner required.
 - (1) Start withholding.
 - (2) Stop withholding.
- (c) Notification of an incorrect taxpayer identification number.
- (d) Notified payee underreporting.
- (e) Payee certification failure.
 - (1) Start withholding.
 - (2) Stop withholding.
- (f) Rule for determining when the payor receives a taxpayer identification number or certificate from a payee.

§31.3406(f)–1 Confidentiality of information.

- (a) Confidentiality and liability for violation.
- (b) Permissible use of information.
 - (1) In general.
 - (2) Window transactions.
- (c) Specific restrictions on the use of information.

§31.3406(g)–1 Exception for payments to certain payees and certain other payments.

- (a) Exempt recipients.
 - (1) In general.
 - (2) Nonexclusive list.
- (b) Determination of whether a person is described in paragraph (a)(1) of this section.
- (c) Prepaid or advance premium life-insurance contracts.

§31.3406(g)–2 Exception for reportable payments for which backup withholding is otherwise required.

- (a) In general.
- (b) Payment of wages.
- (c) Distribution from a pension, annuity, or other plan of deferred compensation.
- (d) Gambling winnings.

- (1) In general.
- (2) Definition of a reportable gambling winning and determination of amount subject to backup withholding.
- (3) Special rules.
- (e) Certain real estate transactions.
- (f) Certain payments after an acquisition of accounts or instruments.
- (g) Certain gross proceeds.

§31.3406(g)-3 Exemption while payee is waiting for a taxpayer identification number.

- (a) In general.
 - (1) Backup withholding not required for 60 days.
 - (2) Reserve method.
 - (3) Alternative rule; 7-day grace period.
- (b) Special rule for readily tradable instruments.
- (c) Exceptions.
 - (1) In general.
 - (2) Special rule for amounts subject to reporting under section 6045 other than proceeds of redemptions of bearer obligations.
- (d) Awaiting-TIN certificate.
- (e) Form for awaiting-TIN certificate.

§31.3406(h)-1 Definitions.

- (a) In general.
- (b) Taxpayer identification number.
 - (1) In general.
 - (2) Obviously incorrect number.
- (c) Broker.
- (d) Readily tradable instrument.
- (e) Day.
- (f) Business day.

§31.3406(h)-2 Special rules.

- (a) Joint accounts.
 - (1) Relevant name and taxpayer identification number combination.
 - (2) Optional rule for accounts subject to backup withholding under section 3406(a)(1)(B) or (C) where the names are switched.
 - (3) Joint foreign payees.
- (b) Backup withholding from an alternative source.
 - (1) In general.
 - (2) Exceptions for payments made in property.
- (c) Trusts.

- (d) Adjustment of prior withholding by middleman.
- (e) Conversion of amounts paid in foreign currency into United States dollars.
 - (1) Convertible foreign currency.
 - (2) Nonconvertible foreign currency. [Reserved]
- (f) Coordination with other sections.
- (g) Tax liabilities and penalties.
- (h) To whom payor is liable for amount withheld.

§31.3406(h)-3 Certificates.

- (a) Prescribed form to furnish information under penalties of perjury.
 - (1) In general.
 - (2) Use of a single or multiple Forms W-9 for accounts of the same payee.
- (b) Prescribed form to furnish a noncertified taxpayer identification number.
- (c) Forms prepared by payors or brokers.
 - (1) Substitute forms; in general.
 - (2) Form for exempt recipient.
- (d) Special rule for brokers.
- (e) Reasonable reliance on certificate.
 - (1) In general.
 - (2) Circumstances establishing reasonable reliance.
- (f) Who may sign certificate.
 - (1) In general.
 - (2) Notified payee underreporting.
- (g) Retention of certificates.
 - (1) Accounts or instruments that are not pre-1984 accounts and brokerage relationships that are post-1983 brokerage accounts.
 - (2) Accounts or instruments that are pre-1984 accounts and brokerage relationships that are not post-1983 brokerage accounts.
- (h) Cross references.

§31.3406(i)-1 Effective date.

Par. 8. Sections 31.3406(a)-1 through 31.3406(a)-4, 31.3406(b)(2)-1 through 31.3406(b)(2)-5, 31.3406(b)(3)-1 through 31.3406(b)(3)-4, 31.3406(b)(4)-1, 31.3406(c)-1, 31.3406(d)-1 through 31.3406(d)-4, 31.3406(e)-1, 31.3406(f)-1, 31.3406(g)-1 through

31.3406(g)-3, 31.3406(h)-1 through 31.3406(h)-3, and 31.3406(i)-1 are added to read as follows:

§31.3406(a)-1 Backup withholding requirement on reportable payments.

(a) *Overview.* Under section 3406, a payor must deduct and withhold 31 percent of a reportable payment if a condition for withholding exists. *Reportable payments* mean interest and dividend payments (as defined in section 3406(b)(2)) and other reportable payments (as defined in section 3406(b)(3)). The conditions described in paragraph (b)(1) of this section apply to all reportable payments, including reportable interest and dividend payments. The conditions described in paragraph (b)(2) of this section apply only to reportable interest and dividend payments.

(b) *Conditions that invoke the backup withholding requirement—(1) Conditions applicable to all reportable payments.* A payor of a reportable payment must deduct and withhold under section 3406 if—

(i) The payee of the reportable payment does not furnish the payee's taxpayer identification number to the payor, as required in section 3406(a)(1)(A) and §31.3406(d)-1; or

(ii) The Internal Revenue Service or a broker notifies the payor that the taxpayer identification number furnished by its payee for a reportable payment is incorrect, as described in section 3406(a)(1)(B) and §31.3406(d)-5.

(2) *Conditions applicable only to reportable interest or dividend payments.* A payor of a reportable interest or dividend payment must deduct and withhold under section 3406 if—

(i) The Internal Revenue Service or a broker notifies the payor that its payee has underreported interest or dividend income, as described in section 3406(a)(1)(C) and §31.3406(c)-1; or

(ii) The payee fails to certify to the payor or broker that the payee is not subject to withholding due to notified payee underreporting, as described in section 3406(a)(1)(D) and §31.3406(d)-2.

(c) *Exceptions.* The requirement to withhold does not apply to certain minimal payments as described in §31.3406(b)(4)-1 or to payments exempt from withholding under §§31.3406(g)-1 through 31.3406(g)-3.

(d) *Cross references.* For the definition of *payor*, see §31.3406(a)-2. For the definition of *taxpayer identification number*, see §31.3406(h)-1(b).

§31.3406(a)-2 Definition of payors obligated to backup withhold.

(a) *In general.* *Payor* means any person who is required to make an information return with respect to any reportable payment (as described in section 3406(b)) under section 6041, 6041A(a), 6042, 6044, 6045, 6049, 6050A, or 6050N, including any middleman as described in paragraph (b) of this section.

(b) *Middlemen treated as payors.* A person who receives or collects a reportable payment on behalf of or for the account of a payee is a middleman and is treated as the payor of the payment. These persons include, but are not limited to—

(1) A custodian of a payee's account, such as a bank, financial institution, or brokerage firm acting as custodian of an account;

(2) A nominee, including the joint owner of an account or instrument, except if the joint owners are husband and wife or if the payment is actually owned by another person whose name is also shown on the information return filed with respect to the payment;

(3) A broker holding a security (including stock) for a customer in street name;

(4) A grantor trust established after December 31, 1995, all of which is owned by two or more grantors, and for this purpose spouses filing a joint return are considered to be one grantor;

(5) A common trust fund; and

(6) A partnership or an S corporation that makes a reportable payment.

(c) *Persons not treated as payors.* The following persons are not treated as payors for purposes of section 3406 if the person does not have a reporting obligation under the section on information reporting to which the payment relates:

(1) An agent of the payor who is acting on behalf of the payor in making the payment and who has not entered into an agreement with the payor (for further guidance see Rev. Proc. 84-33 (1984-1 C.B. 502), and §601.601(d)(2) of this chapter), such as a bank that acts as a paying agent in making a payment of dividends on behalf of a

corporation (although payments made by the agent are considered to be payments made by the payor, and thus are subject to withholding, reporting, and the depositing requirements pertaining to section 3406 as if they were made by the payor itself, and failure by the agent so to withhold, report, or deposit is considered to be failure by the payor);

(2) A trust (other than a grantor trust as described in paragraph (b)(4) of this section) that files a Form 1041 and furnishes each beneficiary a Form K-1 containing information required to be shown on an information return, including amounts withheld under section 3406; or

(3) A partnership making a payment of a distributive share or an S corporation making a similar distribution.

§31.3406(a)-3 Scope and extent of accounts subject to backup withholding. A payor who is required to withhold under §31.3406(a)-1 must withhold—

(a) On the accounts subject to withholding under §31.3406(a)-1(b)(1)(i) or (b)(2)(ii); and

(b) On the accounts subject to withholding under §31.3406(a)-1(b)(1)(ii) or (b)(2)(i), as described under §31.3406(d)-5 (relating to notification of incorrect TIN) or §31.3406(c)-1 (relating to notified payee underreporting), respectively.

§31.3406(a)-4 Time when payments are considered to be paid and subject to backup withholding.

(a) *Timing*—(1) *In general.* If backup withholding is required under section 3406 on a reportable payment (as defined in section 3406(b)), the payor must withhold at the time it makes the payment to the payee or to the payee's account that is subject to withholding. Amounts are considered paid when they are credited to the account of, or made available to, the payee. Amounts are not considered paid solely because they are posted (e.g., an informational notation on the payee's passbook) if they are not actually credited to the payee's account or made available to the payee. See paragraph (c) of this section for the timing of withholding by a middleman.

(2) *Special rules for dividends.* For purposes of section 3406 and this section—

(i) *Record date earlier than payment date.* In the case of stock for which the record date is earlier than the payment date, the dividends are considered paid on the payment date.

(ii) *Dividends paid in corporate reorganizations.* In the case of a corporate reorganization, if a payee is required to exchange stock held in the former corporation for stock in the new corporation before the dividends that have been paid with respect to the stock in the new corporation will be provided to the payee, the dividend is considered paid on the date the payee actually exchanges the stock and receives the dividend.

(b) *Amounts reportable under section 6045*—(1) *In general.* Notwithstanding paragraph (a) of this section, in the case of a transaction reportable under section 6045 (except in the case of forward contracts (including foreign currency contracts), regulated futures contracts, and security short sales), the obligation to withhold under section 3406 arises on the date the sale is entered on the books of the broker or the date the exchange occurs as provided in §1.6045-1(f)(3) of this chapter. A broker (in its capacity as payor) is not required, however, to satisfy its withholding liability until payment is made. See §31.3406(b)(3)-2(b)(2) for special rules applicable to forward contracts (including foreign currency contracts), regulated futures contracts, and security short sales.

(2) *Special rule for interest accrued on bonds.* For purposes of determining the time that interest is considered paid and subject to withholding under section 3406 when bonds are sold between interest payment dates, the portion of the sales price representing interest accrued to the date of sale is considered a portion of a reportable payment of gross proceeds under section 6045 (provided that the accrued interest is not tax-exempt as described in section 103(a), relating to certain governmental obligations), and is not considered to be a payment of interest for purposes of section 6049.

(c) *Middlemen*—(1) *In general.* Any middleman (as defined in §31.3406(a)-2(b)) must withhold under section 3406 at the time the reportable payment is received by or credited to the middleman. If the middleman makes or credits the reportable payment to the payee prior to the middleman's receipt of the corresponding payment, the middleman may withhold at the time the reportable

payment is made or credited to the payee.

(2) *Special rule for common trust funds.* A common trust fund (as defined in section 584) must withhold either—

(i) At the time the reportable payment is received by or credited to the common trust fund as provided in paragraph (c)(1) of this section;

(ii) On the date on which the assets of the common trust fund are valued; or

(iii) At the time the common trust fund pays or credits the reportable payment to a participant of the common trust fund.

(3) *Special rule for certain grantor trusts.* For grantor trusts described in §31.3406(a)–2(b)(4), reportable payments made to the trust are treated as paid by the trust to each grantor, in an amount equal to the distribution made by the trust to each grantor, on the date that the reportable payment is paid to the trust (except for gross proceeds reportable under section 6045). Paragraph (b)(2) of this section applies to a grantor trust making a payment of gross proceeds under section 6045 subject to withholding under section 3406. For purposes of this paragraph (c)(3) a husband and wife filing a joint return are considered to be one grantor.

§31.3406(b)(2)–1 Reportable interest payment.

(a) *Interest subject to backup withholding—(1) In general.* A payment of a kind, and to a payee, that is required to be reported under section 6049 (relating to returns regarding interest and original issue discount) is a reportable payment for purposes of section 3406, subject to the special rules of §31.3406(b)(2)–2 (relating to original issue discount) and §31.3406(b)(2)–3 (relating to window transactions). See §31.6051–4 for the requirement to furnish a statement to the payee if tax is withheld under section 3406.

(2) *Special rule for tax-exempt interest.* When an issuer is required to make an information return under §1.6049–4(d)(8) of this chapter because a payee provided a signed written statement on the envelope or shell incorrectly claiming that the interest was exempt from taxation under section 103(a) (as described in §1.6049–5(b)(1)(ii) of this chapter), the issuer is not required to impose withholding under section 3406.

(b) *Amount subject to backup withholding—(1) In general.* The amount of interest subject to withholding under section 3406 is the amount subject to reporting under section 6049.

(2) *Special rule to adjust for premature withdrawal penalty.* Solely for purposes of computing the amount subject to withholding under section 3406, the payor may elect not to withhold from the portion of any interest payment that is not received by the payee because a penalty is in fact imposed for premature withdrawal of funds deposited in a time savings account, certificate of deposit, or similar class of deposit.

§31.3406(b)(2)–2 Original issue discount.

(a) *Original issue discount subject to backup withholding.* The amount of original issue discount, treated as interest, subject to withholding under section 3406 is the amount subject to reporting under section 6049, but is limited to the amount of cash paid. In addition, if an original issue discount obligation, subject to reporting under section 6045, is sold prior to maturity and with respect to the seller a condition exists for imposing withholding under section 3406 on the gross proceeds, then withholding under §31.3406(b)(3)–2 applies to the gross proceeds of the sale reportable under section 6045, and not to the amount of any original issue discount includible in the gross income of the seller for the calendar year of the sale. See §31.6051–4 for the requirement to furnish a statement to the payee if tax is withheld under section 3406.

(b) *Amount subject to backup withholding and time when backup withholding is imposed with respect to short-term obligations.* In the case of an obligation with a fixed maturity date not exceeding one year from the date of issue (a short-term obligation), withholding under section 3406 applies to any payment of original issue discount on the obligation includible in the gross income of the holder to the extent of the cash amount of the payment. See §1.1273–1 of this chapter to determine the amount of original issue discount on a short-term obligation. See §1.446–2(e)(1) of this chapter to determine the amount of a payment treated as original issue discount.

(c) *Transferred short-term obligations—(1) Subsequent holder may*

establish purchase price—(i) In general. At maturity of a short-term obligation, a subsequent holder (*i.e.*, any person who purchased or otherwise obtained the obligation after the obligation was issued to the original holder) may establish the price of the obligation. The price established by the subsequent holder must then be treated as the original issue price for purposes of computing the amount of the original issue discount subject to withholding under section 3406. The price of a short-term obligation may be established by confirmation receipt or other record of a similar type or, if the obligation is redeemed by or through the person from whom the obligation was purchased or otherwise obtained, by the records of the person from whom or through whom the obligation was purchased or otherwise obtained. The subsequent holder is not required to certify under penalties of perjury that the price determined under this paragraph (c)(1)(i) is correct.

(ii) *Exception.* A payor may elect to disregard the price at which the subsequent holder purchased or otherwise obtained the obligation if the payor's computer or recordkeeping system on which the details of the obligation are stored is not able to accept that price without significant manual intervention.

(2) *Subsequent holder unable (or not permitted) to establish purchase price.* If a subsequent holder fails (or is unable, pursuant to paragraph (c)(1)(ii) of this section) to establish the purchase price of the obligation, then the person redeeming the obligation must determine the amount subject to withholding under section 3406 as though the obligation had been purchased by the holder on the date of issue. If the person redeeming the obligation is the issuer of the obligation, then the issuer must determine the amount subject to withholding from its records. If a person other than the issuer of the obligation redeems the obligation and the obligation is listed in Internal Revenue Service Publication 1212, List of Original Issue Discount Obligations, that person must determine the amount subject to withholding by using the issue price indicated in Publication 1212.

(3) *Transferred obligation.* If a short-term obligation is transferred, no part of the purchase price is considered a reportable interest payment under section 6049. Withholding under section 3406 applies, however, to the

gross proceeds of the sale of the obligation if the transfer is subject to reporting under section 6045 and a condition exists for imposing withholding. For the rules regarding withholding for amounts subject to reporting under section 6045, see §31.3406(b)(3)–2.

(d) *Amount subject to backup withholding and time when backup withholding is imposed with respect to long-term obligations*—(1) *No cash payments prior to maturity.* In the case of an obligation with a fixed maturity date that is more than one year from the date of issue (a long-term obligation) and with no cash payments prior to maturity, withholding under section 3406 applies at the maturity of the obligation to the amount of original issue discount includible in the gross income of the holder for the calendar year in which the obligation matures. The amount required to be withheld must not exceed the amount of the cash payment.

(2) *Registered long-term obligations with cash payments prior to maturity.* In the case of a long-term obligation in registered form that provides for cash payments prior to maturity, withholding under section 3406 applies at the time cash payments are made to the sum of the amounts of qualified stated interest and original issue discount includible in the gross income of the holder for the calendar year in which the cash payments are made. The amount required to be withheld at the time of any cash payment, however, must not exceed the amount of the cash payment. If more than one cash payment is made during a calendar year, the tax that is required to be withheld with respect to original issue discount must be allocated among all the expected cash payments in the ratio that each cash payment bears to the total of the expected cash payments.

(3) *Transferred registered long-term obligations with payments prior to maturity.* In the case of a long-term obligation that is transferred after its issuance from the original holder, the amount subject to withholding under section 3406 with respect to a subsequent holder is the amount of original issue discount includible in the gross income of all holders during the calendar year (without regard to any amount paid by a subsequent holder at the time of transfer). If the person redeeming the obligation at maturity is the issuer of the obligation, the issuer

must determine the amount subject to withholding through its records by treating the holder as if he were the original holder. If a person redeeming the obligation at maturity is a person other than the issuer of the obligation, and the obligation is listed in Internal Revenue Service Publication 1212, List of Original Issue Discount Obligations, the person must determine the amount subject to withholding by using the issue price indicated in Publication 1212.

(e) *Bearer long-term obligations.* In the case of a bearer long-term obligation with cash payments prior to maturity—

(1) *Payments prior to maturity.* Withholding under section 3406 applies prior to maturity only to the payment of qualified stated interest (and not to any amount of original issue discount) includible in the gross income of the holder for the calendar year.

(2) *Payments at maturity.* At maturity of the obligation, withholding applies to the sum of any qualified stated interest payment made at maturity and the total amount of original issue discount includible in the gross income of the holder during the calendar year of maturity. The amount required to be withheld at the time of the cash payment, however, must not exceed the amount of the cash payment.

§31.3406(b)(2)–3 *Window transactions.*

(a) *Requirement to backup withhold.* Withholding under section 3406 applies to a window transaction (as defined in paragraph (b) of this section) only if the payee does not furnish a taxpayer identification number to the payor in the manner required in paragraph (c) of this section or furnishes an obviously incorrect number as described in §31.3406(h)–1(b)(2). Withholding does not apply to a window transaction even though the Internal Revenue Service notifies the payor of the payee's incorrect taxpayer identification number under section 3406(a)(1)(B) or of notified payee underreporting under section 3406(a)(1)(C). The payee in a window transaction is not required to certify under penalties of perjury that the payee is not subject to withholding due to notified payee underreporting (as described in §31.3406(d)–2(b)(2)).

(b) *Window transaction defined.* *Window transaction* means a payment

of interest with respect to any of the following obligations:

(1) An interest coupon in bearer form that is subject to taxation (*i.e.*, other than exempt interest described in §1.6049–5(b)(1)(ii) of this chapter);

(2) A United States savings bond; or

(3) A discount obligation having a maturity at issue of one year or less, including commercial paper and bankers' acceptances that are in definitive form (*i.e.*, evidenced by a paper document other than a confirmation receipt) but not including short-term government obligations (as defined in section 1271(a)(3)(B)).

(c) *Manner of furnishing taxpayer identification number in the case of a window transaction.* A payee must furnish the payee's taxpayer identification number to the payor with respect to a window transaction either orally or in writing at the time that the window transaction occurs. See §31.3406(g)–3(c)(1)(i), which provides that a payee may not claim the payee is awaiting receipt of a taxpayer identification number with respect to a window transaction. The payee is not required to certify, under penalties of perjury, that the taxpayer identification number provided is correct.

§31.3406(b)(2)–4 *Reportable dividend payment.*

(a) *Dividends subject to backup withholding.* A payment of a kind, and to a payee, that is required to be reported under section 6042 (relating to returns regarding payments of dividends and corporate earnings and profits) is a reportable payment for purposes of section 3406. See paragraph (b) of this section for certain dividends not subject to withholding under section 3406. See §31.6051–4 for the requirement to furnish a statement to the payee if tax is withheld under section 3406.

(b) *Dividends not subject to backup withholding.* Except as provided in §31.3406(b)(3)–2 (relating to transactions reportable under section 6045), withholding under section 3406 does not apply to—

(1) Any amount treated as a taxable dividend by reason of section 302 (relating to redemptions of stock), section 304 (relating to redemptions through the use of related corporations), section 306 (relating to disposition of certain stock), section 356

(relating to receipt of additional consideration in connection with certain reorganizations), or section 1081(e)(2) (relating to certain distributions pursuant to an order of the Securities and Exchange Commission);

(2) Any exempt-interest dividend, as defined in section 852(b)(5)(A), paid by a regulated investment company; or

(3) Any amount paid or treated as paid during a year by a regulated investment company, provided that the payor reasonably estimates, as provided in paragraph (c)(2) of this section, that 95 percent or more of all dividends paid or treated as paid during the year are exempt-interest dividends.

(c) *Amount subject to backup withholding*—(1) *In general.* The amount of a dividend subject to withholding under section 3406 is the amount subject to reporting under section 6042, including any dividend that is reinvested pursuant to a plan under which a shareholder may elect to receive stock as a dividend instead of property. Except as otherwise provided in this paragraph (c), withholding applies to the entire amount of the distribution.

(2) *Reasonable estimate of amount of dividend subject to backup withholding.* Pursuant to section 6042(b)(3) and §1.6042-3(c) of this chapter, if the payor is unable to determine the portion of a distribution that is a dividend, the entire amount of the distribution must be treated as a dividend for information reporting under section 6042. Hence, withholding applies to the entire amount of the distribution. If a payor is able reasonably to estimate under section 6042 and §1.6042-3(c) of this chapter the portion of a distribution that is not a dividend, however, the payor must not withhold on that portion (which is not considered a dividend). A payor making a payment, all or a portion of which may not be a dividend, may use previous experience to estimate the portion of a distribution that is not a dividend. The payor's estimate is considered reasonable if—

(i) The estimate does not exceed the proportion of the distributions made by the payor during the most recent calendar year for which a Form 1099 was required to be filed that was not reported by the payor as a dividend; and

(ii) The payor has no reasonable basis to expect that the proportion of the distribution that is not a dividend

will be substantially different for the current year.

(3) *Reinvested dividends.* In the case of a dividend paid pursuant to a dividend reinvestment plan, withholding under section 3406 applies, pursuant to §31.3406(a)-4(a), at the time and to the amount made available to the shareholder or credited to the shareholder's account. At the discretion of the payor, withholding under section 3406 need not be applied to any excess of the fair market value of the shares of stock received by the shareholder or credited to the shareholder's account over the purchase price of the shares (including shares acquired by the shareholder at a discount in connection with the dividend distribution) or to any fee that is paid by the payor in the nature of a broker's fee for purchase of the stock or service charge for maintenance of the shareholder's account. The payor must, however, treat any excess amounts and fees on a consistent basis for each calendar year.

§31.3406(b)(2)-5 *Reportable patronage dividend payment.*

(a) *Patronage dividends subject to backup withholding.* A payment of a kind, and to a payee, that is required to be reported under section 6044 (relating to returns regarding patronage dividends) is a reportable payment for purposes of section 3406. See §31.6051-4 for the requirement to furnish a statement to the payee if tax is withheld under section 3406.

(b) *Amount subject to backup withholding*—(1) *Failure to provide taxpayer identification number or notification of incorrect taxpayer identification number.* For purposes of sections 3406(a)(1)(A) and (B), the amount of a payment described in paragraph (a) of this section that is subject to withholding under section 3406 is the amount subject to reporting under section 6044, but only to the extent the payment is made in money. For purposes of this paragraph (b), *money* includes cash or a qualified check (as defined in section 1388(c)(4)).

(2) *Notified payee underreporting or payee certification failure.* For purposes of sections 3406(a)(1)(C) and (D), the amount of a payment described in paragraph (a) of this section that is subject to withholding under section 3406 is the amount subject to withhold-

ing under paragraph (b)(1) of this section, but only if 50 percent or more of that reportable amount is paid in money. Thus, a payor is required to withhold according to this paragraph (b)(2) on a payment if—

(i) There has been a notified payee underreporting described in section 3406(a)(1)(C) and §31.3406(c)-1 or there has been a payee certification failure described in section 3406(a)(1)(D) and §31.3406(d)-2;

(ii) The payor makes a reportable payment subject to reporting under section 6044 to the payee; and

(iii) Fifty percent or more of the payment is in cash or by qualified check.

§31.3406(b)(3)-1 *Reportable payments of rents, commissions, nonemployee compensation, etc.*

(a) *Section 6041 and 6041A(a) payments subject to backup withholding.* A payment of a kind, and to a payee, that is required to be reported under section 6041 (relating to information reporting of rents, commissions, nonemployee compensation, etc.) or a payment that is required to be reported under section 6041A(a) (relating to information reporting of payments to nonemployees for services) is a reportable payment for purposes of section 3406. See paragraph (b) of this section for an exception concerning payments aggregating less than \$600. See §31.6051-4 for the requirement to furnish a statement to the payee if tax is withheld under section 3406.

(b) *Amount subject to backup withholding*—(1) *In general.* The amount of a payment described in paragraph (a) of this section subject to withholding under section 3406 is the amount subject to reporting under section 6041 or section 6041A(a).

(2) *Net commissions.* Withholding under section 3406 does not apply to net commissions paid to unincorporated special agents with respect to insurance policies that are subject to reporting under section 6041, provided that no cash is actually paid by the payor to the special agent.

(3) *Payments aggregating \$600 or more for the calendar year*—(i) *In general.* A payment is a reportable payment under paragraph (a) of this section only if the aggregate amount of the current payment and all previous payments to the payee during the

calendar year aggregate \$600 or more. The amount subject to withholding is the entire amount of the payment that causes the total amount paid to the payee to equal \$600 or more and the amount of any subsequent payments made to the payee during the calendar year. This paragraph (b)(3)(i) does not apply to gambling winnings (as provided in §1.3406(g)-2(e)(1)).

(ii) *Exceptions*—(A) *The \$600 aggregation rule*. The \$600 aggregation rule of paragraph (b)(3)(i) of this section does not apply if the payor was required to make an information return under section 6041 or 6041A(a) for the preceding calendar year with respect to payments to the payee, or the payor was required to withhold under section 3406 during the preceding calendar year with respect to payments to the payee that were reportable under section 6041 or 6041A(a).

(B) *Determination of whether payments aggregate \$600 or more*. In determining whether payments to a payee aggregate \$600 or more during a calendar year for purposes of withholding under section 3406, the payor must aggregate only payments of the same kind made to the same payee. For this purpose, payments are of the same kind if they are of the same type, regardless of whether they are reportable under the same section. However, a payor with different paying departments making reportable payments of the same kind is not required to aggregate payments made by all those departments unless it is the payor's customary method to aggregate those payments. A payor may, in its discretion, aggregate—

(1) Payments not of the same kind to the same payee, reportable under either section 6041 or 6041A(a); and

(2) Payments reportable under section 6041 with payments reportable under section 6041A(a).

§1.3406(b)(3)-2 Reportable barter exchanges and gross proceeds of sales of securities or commodities by brokers.

(a) *Transactions subject to backup withholding*. A payment of a kind, and to a payee, that any broker (as defined in section 6045(c) and §1.6045-1(a)(1) of this chapter) or any barter exchange (as defined in section 6045(c) and §1.6045-1(a)(4) of this chapter) is required to report under section 6045 is

a reportable payment for purposes of section 3406. See §1.6051-4 for the requirement to furnish a statement to the payee if tax is withheld under section 3406.

(b) *Amount subject to backup withholding*—(1) *In general*. The amount subject to withholding under section 3406 is the amount subject to reporting under section 6045. The amount subject to withholding with respect to broker reporting is the amount of gross proceeds (as determined under §1.6045-1(d)(5) of this chapter). The amount subject to withholding with respect to barter exchanges is the amount received by any member or client (as determined under §1.6045-1(f)(4) of this chapter).

(2) *Forward contracts, including foreign currency contracts, and regulated futures contracts*—(i) *In general*. If a customer is subject to withholding under section 3406 with respect to a forward contract (subject to information reporting under §1.6045-1(c)(5) of this chapter), including a foreign currency contract (as defined in section 1256(g)(2)), or a regulated futures contract (as defined in section 1256(g)(1)), or with respect to an account through which those contracts are disposed of or acquired, the broker must withhold on both of the following amounts:

(A) All cash or property withdrawn from the account by the customer during the relevant year; and

(B) The amount of cash in the account available for withdrawal by the customer at the relevant year-end (including both gross proceeds and variation margin).

(ii) *Rules concerning withdrawals*. A withdrawal includes the use of money (including both gross proceeds and variation margin) or property in the account to purchase any property other than property acquired in connection with the closing of a contract. For this purpose, the acceptance of a warehouse receipt or other taking of delivery to close a contract is in connection with the closing of a contract only if the property acquired is disposed of by the close of the seventh trading day following the trading day that the customer takes delivery under the contract. In addition, making delivery to close a contract is in connection with the closing of a contract only if the broker is able to determine that the property used to close the contract was acquired

no earlier than the seventh trading day prior to the trading day on which delivery is made. Withdrawals do not include repayments of debt incurred in connection with making or taking delivery that meets the requirements of this paragraph (b)(2). Withdrawals also do not include payments of commissions, fees, transfers of cash from the account to another futures account that is subject to this paragraph (b)(2) or cash withdrawals traceable to dispositions of property other than futures (not including profit on the contract separately reportable under §1.6045-1(c)(5)(i)(b) of this chapter).

(iii) *Special rule for forward contracts, including foreign currency contracts, and regulated futures contracts*. The determination of whether the customer is subject to withholding under section 3406 with respect to an account containing forward contracts, including foreign currency contracts, or regulated futures contracts must be made at the time of the cash or property withdrawals or the relevant year-end, whichever is applicable.

(3) *Security sales made through a margin account*. The amount described in paragraph (a) of this section that is subject to withholding under section 3406 in the case of a security sale made through a margin account (as defined in 12 CFR part 220 (Regulation T)) is the gross proceeds (as defined in §1.6045-1(d)(5) of this chapter) of the sale. The amount required to be withheld with respect to the sale, however, is limited to the amount of cash available for withdrawal by the customer immediately after the settlement of the sale. For this purpose, the amount available for withdrawal by the customer does not include amounts required to satisfy margin maintenance under Regulation T, rules and regulations of the National Association of Securities Dealers and national securities exchanges, and generally applicable self-imposed rules of the margin account carrier.

(4) *Security short sales*—(i) *Amount subject to backup withholding*. The amount subject to withholding under section 3406 with respect to a short sale of securities is the gross proceeds (as defined in §1.6045-1(d)(5) of this chapter) of the short sale. At the option of the broker, however, the amount subject to withholding may be the gain upon the closing of the short sale (if any); consequently, the obligation to withhold under section 3406 would be

deferred until the closing transaction. A broker may use this alternative method of determining the amount subject to withholding under section 3406 with respect to a short sale only if at the time the short sale is initiated, the broker expects that the amount of gain realized upon the closing of the short sale will be determinable from the broker's records. If, due to events unforeseen at the time the short sale was initiated, the broker is unable to determine the basis of the property used to close the short sale, the property must be assumed for this purpose to have a basis of zero.

(ii) *Time of backup withholding.* The determination of whether a short seller is subject to withholding under section 3406 must be made on the date of the initiation or closing, as the case may be, or on the date that the initiation or closing, as the case may be, is entered on the broker's books and records.

(5) *Fractional shares.* A broker is not required to withhold under section 3406 with respect to a sale of a fractional share of stock resulting in less than \$20 of gross proceeds (as described in §5f.6045-1(c)(3)(ix) of this chapter).

§31.3406(b)(3)-3 Reportable payments by certain fishing boat operators.

(a) *Payments subject to backup withholding.* A payment of a kind, and to a payee, that is required to be reported under section 6050A (relating to information reporting by certain fishing boat operators) is a reportable payment for purposes of section 3406. See §31.6051-4 for the requirement to furnish a statement to the payee if tax is withheld under section 3406.

(b) *Amount subject to backup withholding.* The amount described in paragraph (a) of this section subject to withholding under section 3406 is the amount subject to reporting under section 6050A, but only to the extent the amount is paid in money and represents a share of the proceeds of the catch.

§31.3406(b)(3)-4 Reportable payments of royalties.

(a) *Royalty payments subject to backup withholding.* A payment of a kind, and to a payee, that is required to be reported under section 6050N (relating to information reporting of pay-

ments of royalties) is a reportable payment for purposes of section 3406. See §31.6051-4 for the requirement to furnish a statement to the payee if tax is withheld under section 3406.

(b) *Amount subject to backup withholding.* In general, the amount described in paragraph (a) of this section that is subject to withholding under section 3406 is the amount subject to reporting under section 6050N. However, if the reportable payment is for an oil or gas interest, the amount subject to withholding is the net amount the payee receives (*i.e.*, the gross proceeds less production-related taxes such as state severance taxes).

§31.3406(b)(4)-1 Exemption for certain minimal payments.

(a) *In general.* A payor of reportable interest or dividends (as described in section 3406(b)(2)) or of royalties (as described in section 3406(b)(3)(E)) may elect not to withhold from a payment that does not exceed \$10 and that on an annualized basis does not exceed \$10 (see paragraph (c) of this section). A broker or barter exchange may elect not to withhold on gross proceeds of \$10 or less without regard to the annualization requirement. See §31.6051-4 for the requirement to furnish a statement to the payee if tax is withheld under section 3406.

(b) *Manner of making the election.* The election not to withhold from payments that do not exceed \$10 can be made only for payments described in paragraph (a) of this section. The election may be made on a payment-by-payment basis.

(c) *How to annualize—(1) In general.* To annualize a reportable interest payment, dividend payment, or royalty payment, a payor must calculate what the amount of the payment would be if it were paid for a 1-year period (instead of the period for which it actually is paid). The annualized amount is determined by dividing the amount of the payment by the number of days in the period for which it is being paid and then multiplying that result by the number of days in the year. If the annualized amount is \$10 or less, the payor may elect not to withhold on that payment regardless of whether more than \$10 may be or has been paid to the payee in other reportable payments during the calendar year. Conversely, if the annualized

amount is more than \$10, withholding applies even if \$10 or less is actually paid to the payee during the calendar year. For purposes of computing the annualized amount, the payor may assume that February always consists of 28 days and that the year always consists of 360 days. For amounts that are deposited with a payor in a new account or certificate between the dates on which the payor customarily pays or credits interest, the payor may assume that the period for which the interest is paid is the payor's customary period for paying or crediting interest.

(2) *Special aggregation rule for reportable interest and dividends.* If a payor maintains records that reflect multiple holdings of one payee and the payor makes an aggregate payment of reportable interest or dividends (as defined in section 3406(b)(2)) with respect to those multiple holdings (such as a dividend check that reflects payment on all stock owned by the payee), the payor must annualize the aggregate payment.

(d) *Exception for window transactions and original issue discount.* A payor is not required to annualize payments made in window transactions (as defined in §31.3406(b)(2)-3(b)) or payments of original issue discount. With respect to a window transaction, however, the payor is required to aggregate all payments made in the same transaction (*e.g.*, payments made with respect to coupons or obligations presented for payment at the same time as described in §1.6049-4(e)(4) of this chapter).

§31.3406(c)-1 Notified payee underreporting of reportable interest or dividend payments.

(a) *Overview.* Withholding under section 3406(a)(1)(C) applies to any reportable interest or dividend payment (as defined in section 3406(b)(2)) made with respect to an account of a payee if the Internal Revenue Service or a broker notifies a payor under paragraph (c)(1) or (2) of this section that the payee is subject to withholding due to notified payee underreporting (as defined in paragraph (b)(1) of this section), and the payor is required under paragraph (c)(3) of this section to identify that account. After receiving the notice and identifying accounts, the payor must notify the payee, in accordance with paragraph (d) of this section,

that withholding due to notified payee underreporting has started. Paragraph (e) of this section describes the period for which withholding due to notified payee underreporting is required. Paragraph (f) of this section provides rules concerning notices that the Internal Revenue Service will send to a payee before notifying a payor that the payee is subject to withholding due to notified payee underreporting. Paragraph (g) of this section provides rules that a payee can use to prevent withholding due to notified payee underreporting from starting or to stop it once it has started. Paragraph (h) of this section provides special rules for joint accounts of payees who have filed a joint return. See section 6682 for the penalties that may apply to a payee subject to withholding under section 3406(a)(1)(C).

(b) *Definitions*—(1) *Notified payee underreporting*. *Notified payee underreporting* means that the Internal Revenue Service has—

(i) Determined that there was a payee underreporting (as defined in paragraph (b)(2) of this section);

(ii) Mailed at least four notices under paragraph (f)(1) of this section to the payee (over a period of at least 120 days) with respect to the underreporting; and

(iii) Assessed any deficiency attributable to the underreporting in the case of any payee who has filed a return.

(2) *Payee underreporting*—(i) *In general*. *Payee underreporting* means that the Internal Revenue Service has determined, for a taxable year, that—

(A) A payee failed to include in the payee's return of tax under chapter 1 of the Internal Revenue Code for that year any portion of a reportable interest or dividend payment required to be shown on that tax return; or

(B) A payee may be required to file a return for that year and to include a reportable interest or dividend payment in the return, but failed to file the return.

(ii) *Payments included in making payee underreporting determination*. The determination of whether there is payee underreporting is made by treating as reportable interest or dividend payments, all payments of dividends reported under section 6042, all patronage dividends reported under section 6044, and all interest and original issue discount reported under section 6049, regardless of whether withholding due to notified payee underreporting applies to those payments.

(c) *Notice to payors regarding backup withholding due to notified payee underreporting*—(1) *In general*. If the Internal Revenue Service or a broker notifies a payor that a payee is subject to withholding due to notified payee underreporting, the payor must—

(i) Identify any accounts of the payee under the rules of paragraph (c)(3) of this section; and

(ii) Notify the payee and withhold under section 3406 on reportable interest or dividend payments made with respect to any identified account under the rules of paragraphs (d) and (e) of this section.

(2) *Additional requirements for payors that are also brokers*—(i) *In general*. A broker must notify the payor of a readily tradable instrument that the payee of the instrument is subject to withholding due to notified payee underreporting if—

(A) The broker (in its capacity as a payor) receives a notice from the Internal Revenue Service under paragraph (c)(1) of this section that a payee is subject to withholding due to notified payee underreporting and the broker is required to identify an account of the payee under paragraph (c)(3) of this section;

(B) The payee subsequently acquires the instrument from the broker through the same account; and

(C) The acquisition of the instrument occurs after the close of the 30th business day after the date that the broker receives the notice (or on any earlier date that the broker may begin applying this paragraph (c)(2) after receipt of the notice described in paragraph (c)(1) of this section).

(ii) *Transfer out of street name*. For purposes of this paragraph (c)(2), an acquisition includes a transfer of an instrument out of street name into the name of the registered owner (*i.e.*, the payee).

(iii) *Method of providing notice*. A broker must provide the notice required under this paragraph (c)(2) to the payor of the instrument with the transfer instructions for the acquisition. See §31.3406(d)-4(a)(2).

(iv) *Termination of obligation to provide information*. The obligation of a broker to provide notice to payors under this paragraph (c)(2) terminates simultaneously with the termination of the broker's obligation to withhold (in its capacity as payor) due to notified

payee underreporting on reportable interest or dividends made with respect to the account.

(3) *Payor identification of accounts of the payee subject to backup withholding due to notified payee underreporting*—(i) *In general*—(A) *Notice from the Internal Revenue Service*. If a payor receives a notice from the Internal Revenue Service under paragraph (c)(1) of this section, the payor must identify, exercising reasonable care, all accounts using the same taxpayer identification number for information reporting purposes as the one provided in the notice. The notice may provide, however, that the payor need only identify the account or accounts corresponding to any account number or designation and related taxpayer identification number used for information reporting purposes as that listed on the notice.

(B) *Notice from a broker*. If a payor receives a notice from a broker under paragraphs (c)(1) and (2) of this section, the payor is not required to identify any account other than the account identified in the notice.

(ii) *Exercise of reasonable care*. If an account identified pursuant to paragraph (c)(3)(i)(A) of this section contains a customer identifier that can be used to retrieve systemically any other accounts that use the same taxpayer identification number for information reporting purposes, the payor must identify all accounts that can be so retrieved. Otherwise, a payor is considered to exercise reasonable care in identifying accounts subject to withholding under section 3406(a)(1)(C) if the payor searches any computer or other recordkeeping system for the region, division, or branch that serves the geographic area in which the payee's mailing address is located and that was established (or is maintained) to reflect reportable interest or dividend payments.

(iii) *Newly opened accounts*. (A) In general, a new account is not subject to withholding under section 3406(a)(1)(C) if the payee provides to the payor a Form W-9 (or other acceptable substitute) on which the payor may reasonably rely (within the meaning of §31.3406(h)-3(e)(2) without regard to §31.3406(h)-3(e)(2)(v)), unless the payor has actual knowledge (within the meaning of paragraph (c)(3)(iii)(B) of this section) that the statements made on the form are not true.

(B) For purposes of paragraph (c)(3)(iii)(A) of this section, a payor is considered to have actual knowledge that a payee's statement that the payee is not subject to withholding under section 3406(a)(1)(C) is not true if—

(1) The employee or individual agent of the payor who receives the payee's certification knows that the statement is not true;

(2) In conducting the investigation, if any, required by paragraph (c)(3)-(iii)(C) of this section, the payor identifies any other accounts of the payee that are already subject to withholding under section 3406(a)(1)(C); or

(3) In the course of processing the certification or in administering an account to which a certification relates, the payor discovers that the payor was previously notified by the Internal Revenue Service that the payee is subject to withholding under section 3406(a)(1)(C) and no notice was received to stop withholding pursuant to section 3406(c)(3) prior to the time of the discovery.

(C) Except as provided in this paragraph (c)(3)(iii)(C), a payor is not required to investigate whether the statements made on the Form W-9 described in paragraph (c)(3)(iii)(A) of this section are true. If, however, in opening a new account, the payor relies on the same Form W-9 (or appropriate substitute) that it relied on previously in opening another account, the payor must investigate whether any such existing account is subject to withholding under section 3406(a)(1)(C). Similarly, if the payor utilizes a universal account system described in the first sentence of paragraph (c)(3)(ii) of this section, and in opening a new account the payor searches its records to determine whether the new account should be identified under an existing identifier (because the payee has existing accounts with the payor), the payor must investigate whether any existing accounts identified with the same identifier are subject to withholding under section 3406(a)(1)(C).

(d) *Notice from payors of backup withholding due to notified payee underreporting*—(1) *In general*. If a payor receives notice from the Internal Revenue Service or a broker under paragraph (c)(1) of this section and is required to identify an account under paragraph (c)(3) of this section as an account of the payee, the payor must

notify the payee in accordance with paragraph (d)(2) of this section that withholding due to notified payee underreporting has started.

(2) *Procedures*. The payor must send the notice required by paragraph (d)(1) of this section to the payee no later than 15 days after the date that the payor makes the first payment subject to withholding due to notified payee underreporting. The payor must send the notice by first-class mail to the payee at the payee's last known address. The notice to the payee required by paragraph (d)(1) of this section must state—

(i) That the Internal Revenue Service has given notice that the payee has underreported reportable interest or dividends;

(ii) That, as a result of the underreporting, the payor is required under section 3406(a)(1)(C) of the Internal Revenue Code to withhold 31 percent of reportable interest or dividend payments made to the payee;

(iii) The date that the payor started (or plans to start) withholding due to notified payee underreporting under section 3406(a)(1)(C);

(iv) The account number or numbers that are subject to withholding due to notified payee underreporting;

(v) That the payee must obtain a determination from the Internal Revenue Service in order to stop the withholding due to notified payee underreporting; and

(vi) That while the payee is subject to withholding due to notified payee underreporting, the payee may not certify to a payor making reportable interest or dividend payments (or to a broker acquiring a readily tradable instrument for the payee) that the payee is not subject to withholding due to notified underreporting.

(e) *Period during which backup withholding is required*—(1) *In general*. If a payor receives notice from the Internal Revenue Service or a broker under paragraph (c)(1) of this section, the payor must impose withholding under section 3406(a)(1)(C) on all reportable interest or dividend payments with respect to any account of the payee required to be identified under paragraph (c)(3) of this section made after the close of the 30th business day after the day on which the payor receives that notice and before the stop date (as described in paragraph (e)(2) of this section). A payor may

choose to start withholding under this paragraph (e)(1) at any time during the 30-business-day period described in the preceding sentence.

(2) *Stop withholding*—(i) *When no underreporting exists or undue hardship exists*—(A) *Stop date*. In the case of a determination under paragraph (g)(3)(i) or (iii) of this section that no underreporting exists or that an undue hardship exists, the stop date is the day that is 30 days after the earlier of—

(1) The date on which the payor receives written notification from the Internal Revenue Service under paragraph (g) of this section that withholding is to stop; or

(2) The date on which the payor receives a copy of the written certification provided to the payee by the Internal Revenue Service under paragraph (g) of this section that withholding is to stop.

(B) *Acceleration of stop date*. A payor may choose to stop withholding at any time during the 30-day period described in paragraph (e)(2)(i)(A) of this section.

(ii) *When underreporting is corrected or bona fide dispute exists*. In the case of a determination under paragraph (g)(3)(ii) or (iv) of this section that the underreporting has been corrected or that a bona fide dispute exists, the stop date occurs on the first day of January (immediately following a period of at least twelve months ending on October 15 of any calendar year in which the determination has been made) or if later, the stop date determined under paragraph (e)(2)(i) of this section.

(3) *Dormant accounts*. The requirement that a payor withhold under this paragraph (e) on reportable interest or dividend payments made with respect to an account terminates no later than the close of the third calendar year ending after the later of—

(i) The date that the most recent reportable interest or dividend payment was made with respect to that account; or

(ii) The date that the payor received notice under paragraph (c)(1) of this section.

(f) *Notice to payees from the Internal Revenue Service*—(1) *Notice period*. After the Internal Revenue Service determines under paragraph (b)(2) of this section that payee underreporting exists, the Internal Revenue

Service will mail to the payee at least four notices over a period of at least 120 days (the notice period) before payors will be notified under paragraph (c)(1) of this section that the payee is subject to withholding due to notified payee underreporting. The notices may be accompanied by, or incorporated in, other notices provided to the payee by the Internal Revenue Service.

(2) *Payee subject to backup withholding.* After the Internal Revenue Service provides the notices described in paragraph (f)(1) of this section, the Internal Revenue Service will send notices to payors under paragraph (c)(1) of this section unless—

(i) A payee obtains a determination under paragraph (g) of this section; or

(ii) In the case of a payee who has filed a tax return, the Internal Revenue Service has not assessed the deficiency attributable to the underreporting.

(3) *Disclosure of names of payors and brokers.* Pursuant to section 3406(c)(5) the Internal Revenue Service may require a payee subject to withholding due to notified payee underreporting to disclose the names of all the payee's payors of reportable interest or dividend payments and the names of all of the brokers with whom the payee has accounts which may involve reportable interest or dividend payments. To the extent required in the request from the Internal Revenue Service, the payee must also provide the payee's account numbers and other information necessary to identify the payee's accounts.

(4) *Backup withholding certification.* After a payee receives a final notice from the Internal Revenue Service under paragraph (f)(1) of this section, the payee is not permitted to certify to any payor or broker, under penalties of perjury, that the payee is not subject to withholding under section 3406(a)(1)(C), until the payee receives the certification from the Internal Revenue Service under paragraph (g) of this section advising the payee that the payee is no longer subject to withholding under section 3406(a)(1)(C). A final notice will contain the information described in this paragraph (f)(4). See sections 6682 and 7205(b) for civil and criminal penalties for making a false certification.

(g) *Determination by the Internal Revenue Service that backup withholding should not start or should be stopped—*(1) *In general.* A payee may

prevent withholding due to notified payee underreporting from starting, or stop the withholding once it has started, by requesting and receiving a determination from the Internal Revenue Service under one or more of the provisions of paragraph (g)(3) of this section. Following its review of a request for a determination under paragraph (g)(3) of this section, the Internal Revenue Service will either make the determination or provide the payee with a written report informing the payee that the request for determination is being denied and the reasons for the denial. If a determination is made during the notice period (as defined in paragraph (f)(1) of this section), the payee is not subject to withholding due to notified payee underreporting with respect to any taxable year for which a determination was made. If a determination is made after the notice period, the Internal Revenue Service will, at the time prescribed in paragraph (g)(2) of this section, provide written certification to a payee that withholding is to stop, and will notify payors who were contacted pursuant to paragraph (c)(1) of this section to stop withholding. A broker who (in its capacity as payor) under this paragraph (g)(1) receives a notice from the Internal Revenue Service or a copy of the certification provided to a payee by the Internal Revenue Service is not required to provide a corresponding notice to any payors whom the broker has previously notified under paragraph (c)(2) of this section.

(2) *Date notice to stop backup withholding will be provided—*(i) *Underreporting corrected or bona fide dispute.* If the Internal Revenue Service makes a determination under paragraph (g)(3)(ii) or (iv) of this section during the 12-month period ending on October 15 of any calendar year (as described in paragraph (e)(2)(ii) of this section), the Internal Revenue Service will provide the certification and the notices described in paragraph (g)(1) of this section no later than December 1 of that calendar year.

(ii) *No underreporting or undue hardship.* If the Internal Revenue Service makes a determination under paragraph (g)(3)(i) or (iii) of this section, the Internal Revenue Service will provide the notices described in paragraph (g)(1) of this section no later than the 45th day after the day on which the Internal Revenue Service makes its determination.

(3) *Grounds for determination.* The Internal Revenue Service will make a determination that withholding due to notified payee underreporting should not start or should stop once it has started if the payee—

(i) Shows that there was no payee underreporting (as provided in paragraph (g)(4) of this section) for each taxable year with respect to which the Internal Revenue Service determined under paragraph (b)(2) of this section that there was payee underreporting;

(ii) Corrects any payee underreporting (as provided in paragraph (g)(5) of this section) for each taxable year with respect to which the Internal Revenue Service determined under paragraph (b)(2) of this section that there was payee underreporting;

(iii) Shows that withholding will cause or is causing an undue hardship (as defined in paragraph (g)(6) of this section) and that it is unlikely that the payee will underreport interest or dividend payments again; or

(iv) Shows that a bona fide dispute exists regarding whether any underreporting has occurred (as provided in paragraph (g)(7) of this section) for each taxable year with respect to which the Internal Revenue Service determined under paragraph (b)(2) of this section that there was payee underreporting.

(4) *No underreporting.* A payee may show that no underreporting of reportable interest or dividends payments exists by presenting—

(i) Receipts or other satisfactory documentation to the Internal Revenue Service showing that all taxes relating to the payments were reported; or

(ii) Evidence showing that the payee did not have to file a return for the taxable year in question (e.g., because the payee did not make enough income) or that the underreporting determination was based upon a factual, clerical, or other error.

(5) *Correcting any payee underreporting—*(i) *Before issuance of a statutory notice of deficiency.* Before a statutory notice of deficiency is issued to a payee pursuant to section 6212, the payee may correct underreporting—

(A) By filing a return if one was not previously filed and including the unreported interest and dividends thereon;

(B) By filing an amended return in the event a return was filed and

including the unreported interest and dividends thereon; or

(C) By consenting to the additional assessment according to applicable notices and forms sent to the payee by the Internal Revenue Service with respect to the underreporting, and paying taxes, penalties, and interest due with respect to any underreported interest or dividend payments.

(ii) *After issuance of a statutory notice of deficiency.* After a statutory notice of deficiency is issued to a payee—

(A) The payee may correct underreporting at any time, by filing a return if one was not previously filed and paying the entire deficiency and any other taxes including penalties and interest attributable to any payee underreporting of interest or dividend payments; or

(B) The payee may correct underreporting after the mailing of the statutory notice of deficiency but before the expiration of the 90-day or 150-day period described in section 6213(a) or, if a petition is filed with the United States Tax Court, before the decision of the Tax Court is final, by making a remittance to the Internal Revenue Service of the amounts described in paragraph (g)(5)(ii)(A) of this section. The payee must specifically designate in writing that the remittance is a deposit in the nature of a cash bond.

(iii) *Special rules.* For purposes of paragraph (g)(5)(ii) of this section, the payee will not be deemed to have corrected the payee underreporting under paragraph (g)(5)(ii)(B) of this section after the remittance is returned to the payee in the manner described in any applicable administrative procedure. For further guidance on a deposit in the nature of a cash bond, see subparagraph 2 of section 4.01 of Rev. Proc. 84-58 (1984-2 C.B. 501). (See §601.601(d)(2) of this chapter.) Once the remittance is returned to the payee, the rules of this section will apply. If the Internal Revenue Service previously contacted payors of the payee to start withholding with respect to the notified payee underreporting, however, the Internal Revenue Service will recontact those payors to start withholding under paragraph (c)(1) of this section with respect to the payee underreporting without regard to paragraph (f) of this section.

(6) *Undue hardship*—(i) *In general.* A determination of undue hardship will

be based on the overall impact to the payee of having reportable interest or dividend payments withheld at a 31 percent rate under section 3406. In addition, a determination of undue hardship will be made only if the Internal Revenue Service concludes that it is unlikely that any payee underreporting will occur again.

(ii) *Factors.* Factors that will be considered in determining whether withholding causes undue hardship include, but are not limited to, the following—

(A) Whether estimated tax payments, and other credits for current tax liabilities, or amounts withheld on employee wages or pensions, in addition to withholding under section 3406, would cause significant overwithholding;

(B) The payee's health, including the payee's ability to pay foreseeable medical expenses;

(C) The extent of the payee's reliance on interest and dividend payments to meet necessary living expenses and the existence, if any, of other sources of income;

(D) Whether other income of the payee is limited or fixed (e.g., social security, pension, and unearned income);

(E) The payee's ability to sell or liquidate stocks, bonds, bank accounts, trust accounts, or other assets, and the consequences of doing so;

(F) Whether the payee reported and timely paid the most recent year's tax liability, including interest and dividend income; and

(G) Whether the payee has filed a bankruptcy petition with the United States Bankruptcy Court.

(7) *Bona fide dispute.* The Internal Revenue Service may make a determination under this paragraph (g)(7) if there is a dispute between the payee and the Internal Revenue Service on a question of fact or law that is material to a determination under paragraph (g)(3)(i) of this section and, based upon all the facts and circumstances, the Internal Revenue Service finds that the dispute is asserted in good faith by the payee and there is a reasonable basis for the payee's position.

(h) *Payees filing a joint return*—(1) *In general.* For purposes of this section, if payee underreporting is found to exist with respect to a joint return, then the provisions of this section

apply to both payees (i.e., the husband and wife). As a result, both payees are subject to withholding on accounts in their individual names as well as accounts in their joint names. Either or both payees may satisfy the criteria for a determination that no payee underreporting exists, that the underreporting has been corrected, or that a bona fide dispute exists (as provided in paragraph (g)(3)(i), (ii), or (iv) of this section). Both payees, however, must satisfy the criteria for a determination that withholding will cause or is causing undue hardship (as provided in paragraph (g)(3)(iii) of this section).

(2) *Exceptions*—(i) *Innocent spouse.* A spouse who files a joint return may obtain a determination that withholding should stop or not start with respect to payments made to his or her individual accounts, if the spouse shows that—

(A) He or she did not underreport income because he or she is a spouse described in section 6013(e), i.e., innocent spouse; or

(B) There is a bona fide dispute regarding whether he or she is an innocent spouse and hence did not underreport income.

(ii) *Divorced or legally separated payee.* A payee who, at the time of the request for a determination under paragraph (g) of this section, is divorced or separated under state law may obtain a determination that undue hardship exists (or would exist) under paragraph (g)(3)(iii) of this section with respect to reportable interest or dividend payments made to his or her individual accounts if the divorced or legally separated payee satisfies the criteria for a determination under paragraph (g)(6) of this section.

(i) *Reserved.*

(j) *Penalties.* For the application of penalties related to this section, see sections 6682 and 7205(b).

§31.3406(d)–1 Manner required for furnishing a taxpayer identification number.

(a) *Requirement to backup withhold.* Withholding under section 3406(a)(1)–(A) applies to a reportable payment (as defined in section 3406(b)) if the payee does not furnish the payee's taxpayer identification number to the payor in the manner required by this section. The period for which withholding is required is described in §31.3406(e)–

1(b). See §31.3406(d)–3(a) and (b) for special rules when an account is established directly with, or an instrument is acquired directly from, the payor by electronic transmission or by mail, or an instrument is sold through a broker by electronic transmission or by mail. See §31.3406(d)–4 for special rules applicable to readily tradable instruments acquired through a broker. See §31.3406(h)–3(e) for the rules on when a payor may rely on a Form W–9. See also §31.3406(g)–3 for rules regarding a payee awaiting receipt of a taxpayer identification number. See the applicable information reporting sections and section 6109 and the regulations thereunder to determine whose taxpayer identification number should be provided.

(b) *Reportable interest or dividend account*—(1) *Manner required for furnishing a taxpayer identification number with respect to a pre–1984 account or instrument.* A payee must furnish the payee’s taxpayer identification number to the payor with respect to any obligation, deposit, certificate, share, membership, contract, investment, account, or other relationship or instrument established or acquired on or before December 31, 1983 (a pre–1984 account) and with respect to which the payor makes a reportable interest or dividend payment (as defined in section 3406(b)(2)). The manner of determining whether an account or an instrument is a pre–1984 account is described in paragraph (b)(2) of this section. The payee of a pre–1984 account may furnish the payee’s taxpayer identification number to the payor orally or in writing. The payee is not required to certify under penalties of perjury that the taxpayer identification number is correct.

(2) *Determination of pre–1984 account or instrument*—(i) *In general.* An account that is in existence before January 1, 1984, will be considered a pre–1984 account, regardless of whether additional deposits are made to the account on or after January 1, 1984. An account established as an expansion of a credit union prime account in existence prior to January 1, 1984, constitutes a pre–1984 account. If funds taken from one account in existence prior to January 1, 1984, are used to create a new account on or after that date, however, the new account does not constitute a pre–1984 account except as provided in the preceding sentence. An instrument ac-

quired prior to January 1, 1984, is a pre–1984 account. Regardless of when an instrument was acquired, if it is negotiated in a window transaction as defined in §31.3406(b)(2)–3(b), it is treated as an instrument acquired after December 31, 1983. An obligation in bearer form and subject to reporting under section 6045, whenever acquired, is not a pre–1984 account. Any instrument, whenever acquired, that is held in a brokerage account is considered a pre–1984 account if the brokerage account is not a post–1983 brokerage account (as described in paragraph (c)(1)(ii) of this section). If shares of a corporation are held before January 1, 1984 (or considered held before that date by operation of this paragraph (b)(2)), and additional shares are acquired by the holder, irrespective of whether the shares are received by reason of a stock dividend, investing new cash, or otherwise, the new shares, in the discretion of the payor, may be considered a pre–1984 account. In the case of a qualified employee trust that distributes instruments in kind, any instrument distributed from the trust is considered a pre–1984 account with respect to employees who were participants in the trust before 1984. Similarly, when a payor offers participants in a plan the opportunity to purchase stock of the payor after a specified time, using the money that the payee invested during that period of time, the stock so purchased after December 31, 1983, is considered a pre–1984 account with respect to participants in the plan who either owned shares or invested money in the plan before January 1, 1984.

(ii) *Account or instrument automatically acquired on the maturity or termination of an account.* When an account is opened, or an instrument is acquired, automatically on the maturity or termination of an account that was in existence or an instrument that was held before January 1, 1984 (or considered to have been in existence or held before that date by operation of this paragraph (b)(2)(ii)), without the participation of the payee, the new account or instrument, in the discretion of the payor, may be considered a pre–1984 account. For purposes of the preceding sentence, a payee is not considered to have participated in the acquisition of the new account or instrument solely because the payee failed to exercise a right to withdraw funds at the maturity or termination of the old account or instrument.

(iii) *Insurance policies.* In the case of insurance policies in effect on December 31, 1983, the election of a dividend accumulation option pursuant to which interest is paid (as defined in §1.6049–5(a)(4) of this chapter), or the creation of an account in which proceeds of a policy are held for the policy beneficiary, may, in the payor’s discretion, be treated as a pre–1984 account.

(iv) *Acquisitions of accounts and instruments*—(A) *Pre–1984 or post–1983 status known.* If a payor acquires accounts or instruments of another payor (including through a tax-free reorganization under section 368), the acquiring payor must treat the persons specified in this paragraph (b)(2)(iv)(A) as having the same requirement to furnish a taxpayer identification number in the manner required under this paragraph (b) to the acquiring payor for information reporting, withholding, and related tax provisions as existed with respect to the payor whose accounts or instruments were acquired. Persons specified in this paragraph (b)(2)(iv)(A) are persons who held accounts or instruments in the other payor immediately before the acquisition and who receive an account or instrument in the acquiring payor immediately after the acquisition.

(B) *Pre–1984 or post–1983 status unknown.* If the acquiring payor, as described in paragraph (b)(2)(iv)(A) of this section, is unable to identify from the business records of the other payor whether any or all of the accounts or instruments of the persons specified in paragraph (b)(2)(iv)(A) of this section are pre–1984 (or post–1983) accounts or instruments, then the acquiring payor may treat these unidentified accounts or instruments as pre–1984 accounts or instruments.

(C) *Cross reference.* See §31.3406(g)–2(g) for the limited exception from withholding under section 3406(a)(1)(A) on accounts or instruments described in paragraphs (b)(2)(iv)(A) and (B) of this section for which the payor does not have a taxpayer identification number.

(3) *Manner required for furnishing a taxpayer identification number with respect to an account or instrument that is not a pre–1984 account.* A payee who receives reportable interest or dividend payments (as defined in section 3406(b)(2)) from a payor must certify under penalties of perjury that

the taxpayer identification number the payee furnishes to the payor is the payee's correct taxpayer identification number. The payee must make the certification only with respect to an account or instrument that is not a pre-1984 account (as described in paragraph (b)(2) of this section). See §31.3406(h)-3 for a description of the certificate on which the certification must be made. See §31.3406(d)-2 for the requirement that the payee must certify under penalties of perjury that the payee is not subject to withholding due to notified payee underreporting. See §31.3406(d)-3(a) with respect to an account established directly with, or an instrument acquired directly from, the payor by electronic transmission or by mail. See §31.3406(d)-4 for the rules applicable to readily tradable instruments acquired through a broker.

(4) *Special rule with respect to the acquisition of a readily tradable instrument in a transaction between certain parties acting without the assistance of a broker.* If a payee, at any time, acquires a readily tradable instrument without the assistance of a broker, and no party to the acquisition is a broker or an agent of the payor, the payee must furnish the payee's taxpayer identification number to the payor prior to the time reportable payments are made on the instrument. The payee is not required to certify under penalties of perjury that the number is correct. See §31.3406(d)-2 for the rule that a payee is not subject to withholding due to notified payee underreporting with respect to a readily tradable instrument acquired in the manner described in this paragraph (b)(4). A broker is considered to provide assistance in the acquisition of an instrument if the person effecting the acquisition would be required to make an information return under section 6045 if such person were to sell the instrument. See §31.3406(d)-4 for rules relating to an acquisition of a readily tradable instrument when a broker is involved.

(c) *Brokerage account—(1) Manner required for furnishing a taxpayer identification number with respect to a brokerage relationship that is not a post-1983 brokerage account—(i) In general.* With respect to any instrument, investment, or deposit made through a brokerage account that is not a post-1983 brokerage account, a payee must furnish the payee's taxpayer identification number to the broker either orally or in writing. The payee is

not required to certify under penalties of perjury that the taxpayer identification number is correct. See paragraph (b)(2)(i) of this section for the rule that any instrument, whenever acquired, that is held in a brokerage account that is not a post-1983 brokerage account, is considered held in an account that is not a post-1983 brokerage account. For example, in 1983 a payee established and acquired a readily tradable instrument from a brokerage account; no activity took place through that account until the payee purchased a readily tradable instrument in 1995. That readily tradable instrument is not held in a post-1983 brokerage account; therefore, the payee need not certify under penalties of perjury that the payee's taxpayer identification number is correct.

(ii) *Definition of a brokerage account that is not a post-1983 brokerage account.* A brokerage account that was established by a payee before January 1, 1984, through which during 1983 the broker either bought or sold securities for the payee or held securities on behalf of the payee as a nominee (*i.e.*, in street name), is an account that is not a post-1983 brokerage account.

(2) *Manner required for furnishing a taxpayer identification number with respect to a post-1983 brokerage account—(i) In general.* With respect to a post-1983 brokerage account, the payee must furnish the payee's taxpayer identification number to the broker and certify under penalties of perjury that the taxpayer identification number furnished is correct, except as provided in §31.3406(d)-3(b).

(ii) *Definition of a post-1983 brokerage account.* A brokerage account established after December 31, 1983 (or before January 1, 1984, through which during 1983 the broker neither bought nor sold securities nor held securities on behalf of the payee as a nominee (*i.e.*, in street name)), is a post-1983 brokerage account.

(d) *Rents, commissions, nonemployee compensation, and certain fishing boat operators, etc.—Manner required for furnishing a taxpayer identification number.* For accounts, contracts, or relationships subject to information reporting under section 6041 (relating to information reporting at source on rents, royalties, salaries, etc.), section 6041A(a) (relating to information reporting of payments for nonemployee

services), section 6050A (relating to information reporting by certain fishing boat operators), or section 6050N (relating to information reporting of payments of royalties), the payee must furnish the payee's taxpayer identification number to the payor either orally or in writing. Except as provided in §31.3406(d)-5, the payee is not required to certify under penalties of perjury that the taxpayer identification number is correct regardless of when the account, contract, or relationship is established.

§31.3406(d)-2 Payee certification failure.

(a) *Requirement to backup withhold.* Withholding under section 3406(a)-(1)(D) applies to a reportable interest or dividend payment (as defined in section 3406(b)(2)) if, and only if, the payee fails to certify to the payor, under penalties of perjury, that the payee is not subject to withholding due to notified payee underreporting under section 3406(a)(1)(C). The period for which withholding applies is described in §31.3406(e)-1(e). See §31.3406(d)-3(a) for special rules when an account is established directly with, or an instrument is acquired directly from, the payor by electronic transmission or by mail. See §31.3406(c)-1(c)(3)(iv) for rules with respect to a payor's reliance on a payee certification for a new account following notified payee underreporting. See §31.3406(d)-4 for special rules relating to the acquisition of a readily tradable instrument through a broker. The certificate on which the certification should be made is described in §31.3406(h)-3.

(b) *Exceptions.* Withholding under section 3406(a)(1)(D) and paragraph (a) of this section does not apply to reportable interest or dividend payments (as defined in section 3406(b)(2)) made—

(1) With respect to a pre-1984 account (as defined in §31.3406(d)-1(b)(1));

(2) In a window transaction (as defined in §31.3406(b)(2)-3(b));

(3) With respect to a readily tradable instrument described in §31.3406(d)-1(b)(2)(iv) or §31.3406(d)-4(a)(3); or

(4) During the period and with respect to an account or readily tradable instrument described in §31.3406(d)-3.

§31.3406(d)-3 Special 30-day rules for certain reportable payments.

(a) *Accounts or readily tradable instruments acquired directly from the payor (including a broker who holds an instrument in street name) by electronic transmission or by mail.* In the case of an account established directly with, or a readily tradable instrument acquired directly from, the payor by means of electronic transmission (*i.e.*, telephone or wire instruction) or by mail, the payor may permit the payee to furnish the certifications required in §31.3406(d)-1(b)(3) (relating to certification that the payee's taxpayer identification number is correct) and §31.3406(d)-2 (relating to certification of notified payee underreporting) within 30 days after the establishment or acquisition without subjecting the account to withholding during the 30 days. The preceding sentence applies only if the payee furnishes a taxpayer identification number to the payor at the time of the establishment or acquisition, and the payee does not withdraw more than 69 percent of a reportable interest or dividend payment before the certifications are received within the 30 days. If the payee does not provide the required certifications within 30 days of the establishment or acquisition, the payor must withhold 31 percent of any reportable interest or dividend payments made to the account after its acquisition. For purposes of this section, an account or instrument is considered acquired directly from the payor if the instrument was acquired by the payee without the assistance of a broker or the instrument was acquired directly from a broker who holds the instrument as nominee for the payee (*i.e.*, in street name) and who is considered a payor under §31.3406(a)-2.

(b) *Sale of an instrument for a customer by electronic transmission or by mail.* The special 30-day rules set forth in paragraph (a) of this section apply comparably with respect to certification of the taxpayer identification number for the sale of an instrument under section 6045 (as described in §31.3406(b)(3)-2) through a post-1983 brokerage account (as described in §31.3406(d)-1(c)(2)) for a customer by electronic transmission or by mail. However, these rules apply only if the payee furnishes the payee's taxpayer identification number before the sale occurs. For purposes of applying those 30-day rules under this paragraph (b), a

payee's reinvestment of the gross proceeds of the sale into other instruments constitutes a withdrawal.

(c) *Application to foreign payees.* The rules of paragraphs (a) and (b) of this section also apply to a payee from whom the payor is required to obtain a Form W-8 or a substitute of the form or is to obtain other evidence of foreign status (pursuant to the relevant regulations issued under sections 6049 and 6045), provided the payee represents orally or otherwise, before or at the time of the acquisition or sale of the instrument or the establishment of the account, that the payee is not a United States citizen or resident.

§31.3406(d)-4 Special rules for readily tradable instruments acquired through a broker.

(a) *Readily tradable instruments acquired through post-1983 brokerage accounts with a broker who is not a payor—(1) In general.* If a readily tradable instrument is acquired through a post-1983 brokerage account (as defined in §31.3406(d)-1(c)(2)) and the broker is not the payor of the instrument (as defined in §31.3406(a)-2(b)(3)), the broker must—

(i) Obtain once with respect to each account the certifications described in §31.3406(d)-2(a) and §31.3406(d)-1(b)(3) and (c)(2) from the payee (relating to certification regarding payee underreporting and taxpayer identification number, respectively);

(ii) Furnish the payee's taxpayer identification number to the payor; and

(iii) Notify the payor to impose withholding if the payee fails to make either of the required certifications to the broker or if the broker has been notified by the Internal Revenue Service before the acquisition of the instrument that the payee is subject to withholding due to notified payee underreporting under section 3406(a)(1)(C) or that the payee is subject to withholding because the payee's taxpayer identification number is incorrect under section 3406(a)(1)(B) (as described in §31.3406(d)-5).

(2) *Additional requirements.* The broker must give the information required by paragraphs (a)(1)(ii) and (iii) of this section to the payor with the transfer instructions for the acquisition (including account registration instructions transmitted by a broker in the case of acquisitions of shares in a

mutual fund). A notice including the information described in paragraph (b)(1) of this section fulfills the broker's requirement to give notice to the payor. Once the broker transmits the transfer instructions containing the information required by this section, the broker has no further responsibility to obtain a missing taxpayer identification number or missing certification or to provide additional notices to the payee or payor with respect to the acquisition of the instrument. Upon receiving the notice from a broker, the payor must impose withholding on the account pursuant to §31.3406(a)-1.

(3) *Transactions entered into through a brokerage account that is not a post-1983 brokerage account.* If a broker acquires readily tradable instruments for a payee through an account (with the broker) that is not a post-1983 brokerage account (as defined in §31.3406(d)-1(c)(1)), and the broker is not the payor of the instruments, the broker must furnish the payee's taxpayer identification number to the payor. In addition, if the broker has been notified by the Internal Revenue Service that the payee is subject to withholding under section 3406 either because of an incorrect taxpayer identification number or due to notified payee underreporting as described in sections 3406(a)(1)(B) or (C), respectively, the broker must notify the payor of the instrument to impose withholding with respect to that payee and transmit the information in the manner described in this paragraph (a). After a payor receives a notice from a broker pursuant to section 3406(d)(2)(B) and this paragraph (a), the payor must impose withholding on any accounts of the payee paying reportable interest or dividends as defined in section 3406(b)(2) in accordance with §31.3406(a)-1.

(4) *Payor must notify payee—(i) Failure to provide certifications.* If a payor is notified by a broker, as required in paragraph (a)(1) of this section, that a payee is subject to withholding because the payee failed to provide the certifications, as described in §31.3406(d)-2(a) and §31.3406(d)-1(b)(3) and (c)(2), and the payor has not received the certifications from the payee, then the payor must notify the payee that withholding has started (or will start) no later than 15 days after the payor makes the first payment to the payee that is subject to withholding under section 3406. A notice that

contains the information described in paragraph (b)(2) of this section satisfies the payor's requirement to give notice to the payee. If the broker notifies the payor that the payee failed to make a required certification and the payor has received the certification from the payee, the payor may disregard the notice from the broker.

(ii) *Notified payee underreporting and incorrect taxpayer identification number.* The payor must notify the payee under this section if the Internal Revenue Service or a broker notifies the payor to withhold either because of an incorrect taxpayer identification number under section 3406(a)(1)(B) (as described in §31.3406(d)-5) or due to notified payee underreporting under section 3406(a)(1)(C) (as described in §31.3406(c)-1). If a payor is notified by the Internal Revenue Service or a broker with respect to a readily tradable instrument, the payor may not ignore the notice even if the payee previously provided the payee's taxpayer identification number under penalties of perjury to the payor and even if the payee certified to the payor that the payee is not subject to backup withholding due to a notified payee underreporting. See §31.3406(d)-5(c)(1) and (2) and (f)(2) for notice requirements under section 3406(a)(1)(B) due to an incorrect taxpayer identification number. See §31.3406(c)-1(c)(2) for notice requirements under section 3406(a)(1)(C) due to notified payee underreporting.

(b) *Notices*—(1) *Form of notice by broker to payor.* A broker who is required under paragraphs (a)(1)(iii) and (2) of this section to notify the payor with respect to a readily tradable instrument may notify the payor in connection with the transfer instructions by means of magnetic media, machine readable document, or any other medium, provided that the notice includes the following information—

(i) The payee's name, address, and taxpayer identification number (if provided to the broker); and

(ii) A statement that the payee is subject to withholding under section 3406(a)(1)(A), (B), (C), or (D) of the Internal Revenue Code, whichever section applies; and

(iii) When applicable, a statement that the broker was notified by the Internal Revenue Service that the payee is subject to withholding under sections 3406(a)(1)(B) or (C).

(2) *Form of notice by payor to payee.* A payor who is required to notify a payee that the payee is subject to withholding must provide notice that is substantially similar to the following—

(i) For a notification concerning a failure to provide a taxpayer identification number in the required manner under section 3406(a)(1)(A) or a failure to make the following certification described in section 3406(a)(1)(D):

Recently, you purchased (identify security acquired). Because of the existence of one or more of the following conditions, payments of interest, dividends, and other reportable amounts that are made to you will be subject to withholding of tax at a 31 percent rate: (specify the condition or conditions, described below, that are applicable)

(1) You failed to provide a taxpayer identification number, or failed to provide this number under penalties of perjury, in connection with the purchase of the acquired security. (An individual's taxpayer identification number is his or her social security number.)

(2) You failed to certify, under penalties of perjury, that you are not subject to withholding due to notified payee underreporting as required under section 3406(a)(1)(D) of the Internal Revenue Code.

If condition (1) applies, you may stop withholding by providing your taxpayer identification number on the enclosed Form W-9, signing the form, and returning it to us. If you do not have a taxpayer identification number, but have applied (or will soon apply) for one, you may so indicate on the Form W-9. Withholding may apply during the 60-day period you are waiting for your taxpayer identification number. You must provide us with your taxpayer identification number promptly after you receive it in order to avoid withholding after the end of the 60-day period or to stop withholding if it has already begun. Certain persons, described on the enclosed Form W-9, are exempt from withholding. Follow the instructions on that form if applicable to you.

If condition (2) applies, you may stop withholding by certifying on the enclosed Form W-9 that you are not subject to withholding due to notified payee underreporting, signing the form, and returning it to us.

If more than one condition applies, you must remove all applicable conditions to stop withholding.

Please address any questions concerning this notice to: [Insert payor identifying information].

(Do not address questions to the broker who purchased the securities for you.)

(ii) For the form of the notice concerning imposition of withholding due to an incorrect taxpayer identification number, see §31.3406(d)-5(d)(2) and (g)(2).

(iii) For the form of the notice concerning the imposition of withhold-

ing due to notified payee underreporting, see §31.3406(c)-1(d)(2).

(c) *Payor's reliance on information from broker*—(1) *In general.* A payor of an instrument acquired by a payee through a broker may rely on the information that the payor receives from the broker pursuant to paragraphs (a) and (b) of this section.

(2) *Amount subject to backup withholding.* The payor is required to withhold under section 3406 depending on the payor's customary method of making payment on an instrument or instruments owned by a payee. If it is the practice of a payor to combine in one account all readily tradable instruments of the same issue owned by a payee and if only certain of those instruments are subject to withholding, the payor must withhold on the aggregate payment made with respect to all the instruments in the account. Otherwise, the payor must withhold on the payment made on the instrument or instruments with respect to which the payee is subject to withholding.

§31.3406(e)-1 Period during which backup withholding is required.

(a) *In general.* A payor must withhold under section 3406 at a rate of 31 percent on any reportable payment (as defined in section 3406(b)) made to a payee during the period described in this section (irrespective of the number of conditions for imposing withholding under section 3406 that exist with respect to the payee). A payor must continue to withhold under section 3406 until no condition for imposing backup withholding exists with respect to the payee.

(b) *Failure to furnish a taxpayer identification number in the manner required*—(1) *Start withholding.* A payor is required to withhold under section 3406(a)(1)(A) at a rate of 31 percent on any reportable payment (as defined in section 3406(b)) at the time the payor pays the reportable payment (as described in §31.3406(a)-4) to a payee if—

(i) The payor has not received the payee's taxpayer identification number in the manner required in §31.3406(d)-1; or

(ii) The payor has received notice from a broker (as required in §31.3406(d)-4(a)(1)(iii)) with respect to a readily tradable instrument that the payee did not furnish a taxpayer identification

number to the broker in the manner required in §31.3406(d)-1 and the payor has not received the taxpayer identification number from the payee in this manner.

(2) *Stop withholding.* The payor must stop withholding under section 3406(a)(1)(A) within 30 days after the payor receives—

(i) The payee's taxpayer identification number in the manner required under §31.3406(d)-1; or

(ii) A statement, in such form and containing such information as is required under applicable regulations, that the payee is not a United States person.

(c) *Notification of an incorrect taxpayer identification number.* See §31.3406(d)-5(e) and (g)(3) for the period for which withholding is required in the case of notification of an incorrect taxpayer identification number.

(d) *Notified payee underreporting.* See §31.3406(c)-1(e) for the period for which withholding is required in the case of notified payee underreporting.

(e) *Payee certification failure—(1) Start withholding.* A payor is required to withhold under section 3406(a)-(1)(D) at a rate of 31 percent on any reportable interest or dividend payment (as defined in section 3406(b)(2)) at the time the payor pays such reportable interest or dividend payment (as described in §31.3406(a)-4) to a payee if—

(i) The payor has not received from the payee the certification required in §31.3406(d)-2; or

(ii) The payor has received notice from a broker (as required in §31.3406(d)-4(a)(1)(iii)) with respect to a readily tradable instrument that the payee did not make the required certification and the payor has not received the required certification from the payee.

(2) *Stop withholding.* The payor must stop withholding under section 3406(a)(1)(D) on any reportable interest or dividend payment within 30 days after the payor receives the certification from the payee in the manner required by §31.3406(d)-2.

(f) *Rule for determining when the payor receives a taxpayer identification number or certificate from a payee.* In determining whether a payee has failed to provide a taxpayer identification number or any certification to a payor (including a Form W-8 or substitute

form), a payor is required to process the taxpayer identification number or certification within 30 days after the payor receives the taxpayer identification number or certification from the payee or in certain cases, from a broker. Thus, the payor may take up to 30 days to treat the taxpayer identification number or a certificate as having been received.

§31.3406(f)-1 Confidentiality of information.

(a) *Confidentiality and liability for violation.* Pursuant to section 3406(f) no person may use any information obtained under section 3406 for any purpose except for the purpose of complying with the requirements of section 3406 or for purposes permitted under section 6103 (subject to the safeguards of section 6103). See section 7431 for civil damages for violating the confidential use of the information (subject to an exception for good faith).

(b) *Permissible use of information—*

(1) *In general.* A payor or broker may transmit information on a Form W-9, Form W-8, or other acceptable form relating to withholding to the department, institution, or firm (or to any employee therein) responsible for withholding or processing of taxpayer identification numbers, certifications described in §31.3406(h)-3, or other substitute forms. In addition, a broker may notify the payor with respect to a readily tradable instrument of the requirement to withhold and the condition or conditions for imposing withholding (as described in §31.3406(d)-4) that exist with respect to the payee. A payor or broker may, without violating the Internal Revenue Code, close an account of, refuse to open an account for, issue an instrument to, or redeem an instrument for, a person solely because the person fails to furnish the person's taxpayer identification number or documentation of foreign status in the manner required in §31.3406(d)-1 and §31.3406(g)-1, respectively. A payor who closes an account of a payee in the calendar year in which the account was opened and during which no taxpayer identification number or evidence of foreign status was provided for that account will be presumed in the absence of evidence to the contrary to have closed the account without violating section 3406(f) even though the payee is subject to backup

withholding under section 3406(a)-(1)(A). A payor, except as provided in §§31.3406(d)-3 and 31.3406(g)-3, may not prohibit a payee who fails to furnish the payee's taxpayer identification number in the manner required in §31.3406(d)-1 from withdrawing any funds in the account.

(2) *Window transactions.* In the case of a window transaction (as defined in §31.3406(b)(2)-3(b)), a payor may, without violating the Internal Revenue Code, refuse to redeem or may refuse to make payment if the payee fails to provide a taxpayer identification number regardless of when the obligation was issued or acquired.

(c) *Specific restrictions on the use of information.* Except as provided in paragraph (b) of this section, a payor or broker is not permitted to—

(1) Close an account (or instrument) of a payee solely because that payee (or the account of a payee) is subject to withholding under section 3406(a)(1)-(A), (B), (C), or (D);

(2) Refuse to open an account or to issue an instrument if the person fails to certify, under penalties of perjury, that the person is not subject to withholding under section 3406(a)-(1)(C) (relating to notified payee underreporting);

(3) Use information obtained under section 3406 (including a payee's failure or inability to certify that the payee is not subject to withholding due to notified payee underreporting or the fact that the account is subject to withholding), surcharge an account (*i.e.*, charge an account more than the fee charged a similar account that was not subject to withholding under section 3406), or use that information to determine whether to open or close an account, whether to issue or redeem an instrument, or whether to extend credit to the payee.

§31.3406(g)-1 Exception for payments to certain payees and certain other payments.

(a) *Exempt recipients—(1) In general.* A payor of any reportable payment (as defined in section 3406(b)) must not withhold under section 3406 if the payee is—

(i) An organization exempt from taxation under section 501(a) or an individual retirement account;

(ii) The United States or any wholly owned agency or instrumentality thereof;

(iii) A state, the District of Columbia, a possession of the United States, any political subdivision of any of the foregoing, or any wholly owned agency or instrumentality of any one or more of the foregoing;

(iv) A foreign government, a political subdivision of a foreign government, or any wholly owned agency or instrumentality of any one or more of the foregoing (as defined in regulations under section 892); or

(v) An international organization or any wholly owned agency or instrumentality thereof (as defined in section 7701(a)(18)).

(2) *Nonexclusive list.* Paragraph (a)(1) of this section does not prescribe an exclusive list of payees that are exempt from information reporting and also are exempt from withholding under section 3406.

(b) *Determination of whether a person is described in paragraph (a)(1) of this section.* The determination of whether a person is a payee described in paragraph (a)(1) of this section must be made as provided in the applicable provisions of section 6049 and the regulations issued thereunder. A payor, even if permitted to treat a person as an exempt recipient without requiring a certificate under the provisions of section 6049, may require a payee, otherwise not required to file a certificate regarding its exempt status, to file a certificate and may treat a payee who fails to file the certificate as a person who is not an exempt recipient. See §31.3406(h)-3 for a description of the Form W-9 or a substitute form prescribed under section 3406 for claiming exempt status.

(c) *Prepaid or advance premium life-insurance contracts.* A payor of a reportable payment (as defined in section 3406(b)(1)) may, but is not required to, withhold under section 3406 on reportable payments made from January 1, 1984, to December 31, 1996, on prepaid or advance premium life-insurance contracts to a payee who is the owner for tax purposes of the prepaid or advance premium life-insurance contract. For purposes of this exception from backup withholding, a prepaid or advance premium life-insurance contract is one entered into on or before June 30, 1984, by the payee and under which the increment in value of the prepaid or advance premium is used for the payment of premiums during the period in which

the exception from backup withholding applies.

§31.3406(g)-2 Exception for reportable payments for which withholding is otherwise required.

(a) *In general.* A payor of a reportable payment (as defined in section 3406(b)) must not withhold under section 3406 if the payment is subject to withholding under any other provision of the Internal Revenue Code.

(b) *Payment of wages.* A payor who is required to make an information return under section 6041 with respect to a payment of wages (as defined in section 3401) because, e.g., the employee makes a certification under section 3402(n) (relating to employees incurring no income tax liability), must not withhold under section 3406 on those wages.

(c) *Distribution from a pension, annuity, or other plan of deferred compensation.* An amount reportable under section 6047, such as a designated distribution under section 3405, is not a reportable payment subject to withholding under section 3406. See section 3406(b). Designated distributions not subject to withholding under section 3406 include—

(1) Distributions from a pension, annuity, profit-sharing, stock bonus plan, or other plan deferring the receipt of compensation;

(2) Distributions from an individual retirement account or annuity;

(3) Distributions from an owner-employee plan; and

(4) Certain surrenders of life insurance contracts.

(d) *Gambling winnings—(1) In general.* A payor of a reportable gambling winning must not withhold under section 3406 if tax is required to be withheld from the gambling winning under section 3402(q) (relating to the extension of withholding to certain gambling winnings). If the reportable gambling winning is not required to be withheld upon under section 3402(q), withholding under section 3406 applies to the gambling winning if, and only if, the payee does not furnish a taxpayer identification number to the payor. Section 31.3406(b)(3)-1(b)(3) does not apply to a reportable gambling winning. The payor of a reportable gambling winning is not required to aggregate all such winnings made to a payee

during a calendar year, nor is the payor required to determine whether an information return was required to be made with respect to the payee for the preceding year.

(2) *Definition of a reportable gambling winning and determination of amount subject to backup withholding.* For purposes of withholding under section 3406, a reportable gambling winning is any gambling winning subject to information reporting under section 6041. The amount of a reportable gambling winning is—

(i) The amount paid with respect to the amount of the wager reduced, at the option of the payor; by

(ii) The amount of the wager.

(3) *Special rules.* Amounts paid with respect to identical wagers are treated as paid with respect to a single wager. The determination of whether wagers are identical is made under §31.3402-(q)-1(c)(1)(ii). In addition, a gambling winning (other than a winning from bingo, keno, or slot machines) is a reportable gambling winning only if the amount paid with respect to the wager is \$600 or more and if the proceeds are at least 300 times as large as the amount wagered. See §7.6041-1 of this chapter to determine whether a winning from bingo, keno, or slot machines is a reportable gambling winning and thus subject to withholding under section 3406.

(e) *Certain real estate transactions.* A real estate reporting person (the so-called broker) as defined in section 6045(e)(2) must not withhold under section 3406 on a payment made with respect to a real estate transaction that is subject to reporting under sections 6045(a) and (e) and §1.6045-4 of this chapter.

(f) *Certain payments after an acquisition of accounts or instruments.* A payor who acquires pre-1984 accounts or instruments described in §31.3406-(d)-1(b)(2)(iv) for which the payor does not have a taxpayer identification number or has an obviously incorrect taxpayer identification number as defined in §31.3406(h)-1(b)(2) must start withholding under section 3406(a)(1)-(A) and §31.3406(d)-1 on those accounts or instruments no later than sixty days following the date of the payor's acquisition of those accounts or instruments.

(g) *Certain gross proceeds.* No withholding under section 3406 is required with respect to any portion of the

original issue discount on an instrument or security that is subject to withholding under section 3406 as reportable gross proceeds of such instrument or security under section 6045.

§31.3406(g)-3 Exemption while payee is waiting for a taxpayer identification number.

(a) *In general*—(1) *Backup withholding not required for 60 days.* If a payor has received an awaiting-TIN certificate from a payee with respect to an account or instrument receiving reportable interest or dividends as described in section 3406(b)(2), the payor must exempt the payee from withholding under section 3406(a)-(1)(A) during the 60-day exemption period to the extent and in the manner described in either paragraph (a)(2) or (3) of this section. The 60-day exemption period means the 60-consecutive-day period beginning with the day the payor receives the awaiting-TIN certificate. The payor must withhold under section 3406 beginning after the 60-day exemption period if the payor has not received a taxpayer identification number from the payee in the manner required in §31.3406(d)-1. Regardless of whether the payee provides an awaiting-TIN certificate to a payor, the payor is required to withhold under section 3406(a)(1)(D) and §31.3406(d)-2 on reportable interest or dividend payments as described in §31.3406(d)-2 if the payee fails to certify, under penalties of perjury, that the payee is not subject to withholding due to notified payee underreporting as required in section 3406(a)(1)(D) and §31.3406(d)-2.

(2) *Reserve method.* A payor must not withhold under section 3406 during the 60-day exemption period unless the payee (or a joint payee in the case of a joint account) desires to make a withdrawal of more than \$500 of either principal or interest from the account in any single transaction during the period. If a payee (or a joint payee) desires to make a withdrawal of more than \$500 during the 60-day exemption period, the payor is required under section 3406 to withhold 31 percent of all reportable payments made during the period and at the time of withdrawal unless the payee reserves 31 percent of all reportable payments made to the account during the period.

(3) *Alternative rule; 7-day grace period*—(i) *In general.* A payor who

receives an awaiting-TIN certificate may elect, on a payee-by-payee basis or in general, to exempt reportable interest or dividend payments to a payee from withholding under section 3406 applying the rules in paragraph (a)(3)(ii) or (iii) of this section.

(ii) *Withholding on withdrawals.* Under this paragraph (a)(3)(ii), a payor must obtain a certified taxpayer identification number from the payee within 60 days after the date that the payor receives the awaiting-TIN certification. In addition, the payor must withhold under section 3406 on any withdrawals made after the close of 7 business days after the date the awaiting-TIN certification is received and before the earlier of the date that the payor receives a certified taxpayer identification number from the payee, the date the account is closed (in which case the payor must withhold on any reportable payment made at the time the account or relationship is closed), or the date withholding under section 3406 starts on all reportable payments made to the account, instrument, or relationship. All cash withdrawals in an amount up to the reportable payments made from the day after the date of receipt of the awaiting-TIN certification to the date of withdrawal are treated as reportable payments.

(iii) *Withholding regardless of withdrawals.* Under this paragraph (a)(3)-(iii), a payor must start withholding under section 3406 on the account not later than 7 business days after the date the payor receives the awaiting-TIN certification on reportable payments thereafter made to the account (whether or not the payee makes a cash withdrawal). The payor must withhold under section 3406 until the earlier of the date the payor receives a certified taxpayer identification number from the payee, the date the account is closed, or the date withholding under section 3406 starts on all reportable payments made to the account, instrument, or relationship. The payor must obtain a certified taxpayer identification number from the payee within 60 days after the date that the payor receives the awaiting-TIN certificate or undertake a mailing each year soliciting the certified taxpayer identification number from the payee until the earlier of the calendar year that the certified taxpayer identification number is received, or the calendar year in which the account is closed. However, if the account is closed in December of a calendar year,

the mailing must be made after the account is closed and before January 31 of the subsequent calendar year.

(b) *Special rule for readily tradable instruments.* The 60-day awaiting-TIN exemption described in paragraph (a)(1) of this section applies to payments made with respect to readily tradable instruments only if the payee provides an awaiting-TIN certificate directly to the payor. If a broker acquires a readily tradable instrument through a post-1983 brokerage account (as described in §31.3406(d)-1(c)(2)) for a payee who has no taxpayer identification number, the broker must advise the payor as required in §31.3406(d)-4(a)(1) that the payee failed to provide a taxpayer identification number under penalties of perjury, regardless of whether the payee provides an awaiting-TIN certificate to the broker. Once a payor is notified by a broker that a payee failed to provide a taxpayer identification number in the required manner, or that the payee is subject to withholding under section 3406(a)(1)(B) or (C), the payor must impose withholding under section 3406 for the appropriate period described in §31.3406(e)-1.

(c) *Exceptions*—(1) *In general.* The 60-day awaiting-TIN exemption described in paragraph (a) of this section does not apply to—

(i) Window transactions (as defined in §31.3406(b)(2)-3(b));

(ii) Redemptions of bearer obligations that are subject to reporting under section 6045; or

(iii) Other amounts that are subject to reporting under section 6045 (except as described in paragraph (c)(2) of this section).

(2) *Special rule for amounts subject to reporting under section 6045 other than proceeds of redemptions of bearer obligations.* If a broker's customer does not provide a taxpayer identification number to the broker, and the broker effects a sale that is subject to reporting under section 6045 (other than a redemption of a bearer obligation), §31.3406(d)-3(b) applies, whether or not the sale is pursuant to an instruction by electronic transmission, provided the customer furnishes an awaiting-TIN certificate to the broker before the sale. For purposes of this paragraph (c)(2), the 30-day period provided in §31.3406(d)-3(b) is a 60-day period.

(d) *Awaiting-TIN certificate.* A payee qualifies for the 60-day awaiting-

TIN exemption provided in paragraph (a) of this section if the payee furnishes a written statement to the payor, signed under penalties of perjury, that the payee has not been issued a taxpayer identification number, that the payee has applied for a taxpayer identification number or intends to apply for a number in the near future, and that the payee understands that if the payee does not provide a number to the payor within 60 days, the payor is required under section 3406 to withhold 31 percent of any reportable payment thereafter made to the payee until the payor receives a number, and 31 percent of a withdrawal to the extent of reportable payments made to the payee during the 60-day period, as described in paragraph (a) of this section. Language that is substantially similar to the awaiting-TIN certification on Form W-9 will satisfy the requirements of this paragraph (d).

(e) *Form for awaiting-TIN certificate.* A payor may use Form W-9 for the awaiting-TIN certificate, or a payor may include language that is substantially similar to the awaiting-TIN certification on Form W-9 in any other document of the payor. See §31.3406(h)-3, which provides that Form W-9 is the prescribed form but permits use of substitute forms, and specifies the length of time the payor is required to retain the form. If Form W-9 is used, the payee should write “Applied For” in the space reserved for the taxpayer identification number.

§31.3406(h)-1 Definitions.

(a) *In general.* For purposes of section 3406 and the regulations thereunder, the definitions of this section apply.

(b) *Taxpayer identification number*—(1) *In general.* *Taxpayer identification number* means the identifying number assigned to a person under section 6109 (relating to identifying numbers, generally a nine-digit social security number for an individual and a nine-digit employer identification number for a nonindividual, e.g., a corporation, partnership, trust, or estate). An obviously incorrect number is not considered a taxpayer identification number. See §31.6011(b)-2 and §301.6109-1 of this chapter for provisions relating to obtaining a taxpayer identification number.

(2) *Obviously incorrect number.* *Obviously incorrect number* means a

number that does not contain nine digits or a number that includes an alpha character as one of the nine digits.

(c) *Broker.* *Broker* is defined in section 6045(c)(1) and §1.6045-1(a)(1) of this chapter. If there could be more than one broker with respect to any acquisition, only the broker having the closest contact (as determined under §5f.6045-1(c)(3)(ii) and (iii) of this chapter) with the payee is treated as a broker. In the case of any instrument, the term *broker* does not include any person who is the payor with respect to the instrument as described in §31.3406(a)-2.

(d) *Readily tradable instrument.* *Readily tradable instrument* means—

(1) Any instrument that is part of an issue any portion of which is traded on an established securities market (within the meaning of section 453(f)(5)); or

(2) Any instrument that is regularly quoted by brokers or dealers making a market.

(e) *Day.* *Day* means a calendar day unless specified otherwise under any section of the regulations under section 3406. For example, see §§31.3406(d)-5(a) and 31.3406(g)-3(a)(2).

(f) *Business day.* *Business day* means any day other than a Saturday, Sunday, or legal holiday (within the meaning of section 7503).

§31.3406(h)-2 Special rules.

(a) *Joint accounts*—(1) *Relevant name and taxpayer identification number combination.* For purposes of identifying the account subject to withholding under sections 3406(a)(1)(B) and (C), the relevant name and taxpayer identification number combination is that which is used for information reporting purposes.

(2) *Optional rule for accounts subject to backup withholding under section 3406(a)(1)(B) or (C) where the names are switched.* See §31.3406(d)-5(c)(4)(iii) under which a payor may withhold under section 3406(a)(1)(B) as required even though the names or taxpayer identification numbers on the account have been switched. The rules under §31.3406(d)-5(c)(4)(iii) may be applied comparably by a payor who is required to withhold under section 3406(a)(1)(C).

(3) *Joint foreign payees*—(i) *In general.* If the first payee listed on an

account or instrument provides the penalties of perjury statement regarding its foreign status, withholding under section 3406 applies unless—

(A) Every joint payee provides the statement regarding foreign status (pursuant to the relevant regulations issued under sections 6045 and 6049); or

(B) Any one of the joint payees who has not established foreign status provides a taxpayer identification number to the payor in the manner required in §31.3406(d)-1.

(ii) *Information reporting on an account including foreign payees.* If any one of the joint payees who has not established foreign status provides a taxpayer identification number under paragraph (a)(3)(i)(B) of this section, that number is the taxpayer identification number that is required to be furnished for purposes of information reporting and withholding under section 3406.

(b) *Backup withholding from an alternative source*—(1) *In general.* A payor may not withhold under section 3406 from a source maintained by the payor other than the source with respect to which there exists a liability to withhold under section 3406 with respect to the payee. See section 3403 and §31.3403-1, which provide that the payor is liable for the amount required to be withheld regardless of whether the payor withholds.

(2) *Exceptions for payments made in property*—(i) *Backup withholding from alternative source.* In the case of a payment that is made in property (other than money), the payor must withhold under section 3406 31 percent of the fair market value of the property determined immediately before or on the date of payment. The payor may withhold under section 3406 from the principal amount being deposited with the payor or from another source maintained by the payee with the payor. The source from which the tax is withheld under section 3406 must be payable to at least one of the persons listed on the account subject to withholding. If the account or source is not payable exclusively to the same person or persons listed on the account subject to withholding under section 3406, then the payor must obtain a written statement from all other persons to whom the account or source is payable authorizing the payor to withhold under section 3406 from the alternative account or source. A payor that elects to

withhold under section 3406 from an alternative source may determine the account or source from which the tax is to be withheld, or may allow the payee to designate the alternative source. A payee may not, however, require a payor to withhold under section 3406 from a specific alternative source. See §31.3402(q)-1(d), *Example 5*, for methods of withholding on prizes, awards, and gambling winnings paid in property other than cash.

(ii) *Deferral of withholding.* If the payor cannot locate, using reasonable care (following procedures substantially similar to those set forth in §31.3406(d)-5(c)(3)(ii)(A) and (B)), an alternative source of cash from which the payor may satisfy its withholding obligation pursuant to paragraph (b)(2)(i) of this section, the payor may defer its obligation to withhold under section 3406, except for reportable payments of property made in connection with prizes, awards, or gambling winnings, until the earlier of—

(A) The date the payor makes a cash payment to the account subject to withholding under section 3406 or cash is otherwise deposited in the account in a sufficient amount to satisfy the obligation in full; or

(B) The close of the fourth calendar year after the obligation arose.

(iii) *Barter exchanges.* In the case of a barter exchange that issues scrip to, or credits the account of, a member or client of the exchange in payment for property or services, the barter exchange may withhold under section 3406 from—

(A) The scrip or credit, if converted to cash in order to satisfy the deposit requirements of section 6302 and §31.6302-4; or

(B) Any other source maintained by the exchange for the member or client in the manner described in paragraph (b)(2) of this section.

(c) *Trusts.* Withholding under section 3406 applies to reportable payments made to a trust if any of the conditions for imposing withholding under section 3406 apply to the trust. Generally, a trust is not a payor and will not be required to withhold under section 3406 on reportable payments that it makes to its beneficiary who is subject to withholding under section 3406. The preceding sentence does not apply, however, to a grantor trust with two or more grantors described in §31.3406(a)-2(b)(4), which is treated

as a middleman payor. The trustee of a trust described in this paragraph (c) may certify that the trust's taxpayer identification number is correct and that the trust is not subject to withholding due to notified payee underreporting, without regard to the status of the beneficiaries of the trust.

(d) *Adjustment of prior withholding by middlemen.* A middleman payor (as defined in §31.3406(a)-2(b)) who receives a payment from which tax has been erroneously withheld under section 3406 may seek a refund of the tax withheld by the payor from whom the middleman payor received the payment (referred to as the "upstream payor"). Alternatively, the middleman payor may obtain a refund of the tax by claiming a credit for the amount of tax withheld by the upstream payor against the deposit of any tax imposed by this chapter which the middleman payor is required to withhold and deposit (as described in section 6413 and §31.6413(a)-2). In either case, the middleman payor must pay or credit the gross amount of the payment (including the tax withheld) to its payee as though it had received the gross amount of the payment from the upstream payor and must withhold under section 3406 only if one of the conditions for imposing backup withholding exists with respect to its payee. If its payee is not subject to withholding under section 3406, the middleman payor must pay or credit the full amount of the payment to the payee. See §31.6413(a)-3 regarding repayment by a payor of tax erroneously collected from a payee.

(e) *Conversion of amounts paid in foreign currency into United States dollars—*(1) *Convertible foreign currency.* If a payment is made in a currency other than the United States dollar, the amount subject to withholding under section 3406 is determined by applying the statutory rate of backup withholding to the foreign currency payment and converting the amount withheld into United States dollars on the date of payment at the spot rate (as defined in §1.988-1(d)(1) of this chapter) or pursuant to a reasonable spot rate convention. For example, a withholding agent may use a month-end spot rate or a monthly average spot rate. A spot rate convention must be used consistently with respect to all non-dollar amounts withheld and from year to year. Such convention cannot be changed without the consent of the Commissioner.

(2) *Nonconvertible foreign currency.*
[Reserved]

(f) *Coordination with other sections.* For purposes of section 31, chapter 24 (other than section 3402(n)) of subtitle C of the Internal Revenue Code (relating to employment taxes and collection of income tax at source) and so much of subtitle F (other than section 7205) of the Internal Revenue Code (relating to procedure and administration) as relates to this chapter, and the regulations thereunder—

(1) An amount required to be withheld under section 3406 must be treated as a tax required to be withheld under section 3402;

(2) An amount withheld under section 3406 must be treated as an amount withheld under section 3402;

(3) An amount withheld under section 3406 must be deposited as required under §31.6302-4;

(4) *Wages* includes the gross amount of any reportable payment (as defined in section 3406(b)) except for purposes of section 6014 (relating to an election by the taxpayer not to compute the tax on his annual return);

(5) *Employee* includes a payee of any reportable payment; and

(6) *Employer* includes a payor who is required to withhold the tax under section 3406 (as defined in §31.3406(a)-2(a)) with respect to any reportable payment (as defined in section 3406(b)).

(g) *Tax liabilities and penalties.* A payor is subject to the same civil and criminal penalties for failing to impose withholding under section 3406 as an employer who fails to withhold on a payment of wages. In addition, a broker may be subject to the penalty under section 6705 (failure of a broker to provide notice to a payor).

(h) *To whom payor is liable for amount withheld.* A payor is not liable to any person for any amount withheld under section 3406. A payor is liable only to the United States for an amount that is required to be withheld as provided in §31.3403-1.

§31.3406(h)-3 *Certificates.*

(a) *Prescribed form to furnish information under penalties of perjury—*(1) *In general.* Except as provided in paragraph (c) of this section, the Form W-9 is the form prescribed under section 3406 on which the payee

certifies, under penalties of perjury, that—

(i) The taxpayer identification number furnished to the payor is correct (as required in §31.3406(d)-1 and §31.3406(d)-5);

(ii) The payee is not subject to withholding due to notified payee underreporting (as required in §31.3406(d)-2);

(iii) The payee is an exempt recipient (as described in §31.3406(g)-1); or

(iv) The payee is awaiting receipt of a taxpayer identification number (as described in §31.3406(g)-3).

(2) *Use of a single or multiple Forms W-9 for accounts of the same payee.* A valid Form W-9 must include the name and taxpayer identification number of the payee. Except as provided in paragraph (b) of this section, the payee must sign under penalties of perjury and date the Form W-9 in order to satisfy the requirements of this section. A payor or broker may require a payee to furnish a separate Form W-9 for each obligation, deposit, certificate, share, membership, contract, or other instrument, or one Form W-9 for all the payee's obligations or relationships with the payor or broker. In addition, a payee of a mutual fund that has a common investment advisor or common principal underwriter with other mutual funds (within the same family of funds) may be permitted, in the discretion of the mutual fund, to provide one Form W-9 with respect to shares acquired or owned in any of the funds.

(b) *Prescribed form to furnish a noncertified taxpayer identification number.* With respect to accounts or other relationships where the payee is not required to certify, under penalties of perjury, that the taxpayer identification number being furnished is correct, the payor or broker may obtain the taxpayer identification number orally or may use Form W-9, a substitute form, or any other document, but the payee is not required to sign the form.

(c) *Forms prepared by payors or brokers—(1) Substitute forms; in general.* A payor or broker may prepare and use a form that contains provisions that are substantially similar to those of the official Form W-9. A payor or broker may use any document relating to the transaction, such as the signature card for an account, so long as the certifications are clearly set forth. A payor or broker who uses a substitute

form may furnish orally or in writing the instructions for the Form W-9 that relate to the account. A payor or broker may refuse to accept certifications (including the official Form W-9) that are not made on the form or forms provided by the payor or broker. A payor or broker may refuse to accept a certification provided by a payee only if the payor or broker furnishes the payee with an acceptable form immediately upon receipt of an unacceptable form or within 5 business days of receipt of an unacceptable form. An acceptable form for this purpose must contain a notice that the payor or broker has refused to accept the form submitted by the payee and that the payee must submit the acceptable form provided by the payor in order for the payee not to be subject to withholding under section 3406. If the payor or broker requires the payee to furnish a form for each account of the payee, the payor or broker is not required to furnish an acceptable form until the payee furnishes the payor or broker with the payee's account numbers. A payor or broker may use separate substitute forms to have a payee certify under penalties of perjury that—

(i) The payee's taxpayer identification number is correct; and

(ii) The payee is not subject to withholding under section 3406 due to notified payee underreporting.

(2) *Form for exempt recipient.* A payor or broker may use a substitute form for the payee to certify, under penalties of perjury, that the payee is an exempt recipient (described in §31.3406(g)-1 or described in the respective reporting section), provided the form contains provisions that are substantially similar to those of the official Form W-9 relating to exempt recipients. A certificate must be prepared in accordance with the instructions applicable to exempt recipients on Form W-9, and must set forth fully and clearly the data called for therein. If a payor will treat the payee as an exempt recipient only if the payee files a certificate as to its exempt status, the certificate is valid only if it contains the payee's taxpayer identification number. Thus, a payee must include the payee's taxpayer identification number on a certificate that a payor requires to be made in order to treat the payee as an exempt recipient.

(d) *Special rule for brokers.* A broker may act as the payee's agent for

purposes of furnishing a taxpayer identification number or certification to a payor with respect to any readily tradable instrument (as defined in §31.3406(h)-1(d)) provided the payee provides a taxpayer identification number on Form W-9 or other acceptable substitute form to the broker. The payor may rely on a taxpayer identification number provided by the broker unless certification is required (as described in §31.3406(d)-4) and the broker notifies the payor that the number was not certified.

(e) *Reasonable reliance on certificate—(1) In general.* A payor is not liable for the tax imposed under section 3406 if the payor's failure to deduct and withhold the tax is due to reasonable reliance, as defined in paragraph (e)(2) of this section, on a Form W-9 (or other acceptable substitute) required by this section.

(2) *Circumstances establishing reasonable reliance.* For purposes of paragraph (e)(1) of this section, a payor can reasonably rely on a Form W-9 (or other acceptable substitute) unless—

(i) The form does not contain the name and taxpayer identification number of the payee (or does not state, in lieu of a taxpayer identification number, that the payee is awaiting receipt of a taxpayer identification number (i.e., an awaiting-TIN certificate));

(ii) The form is not signed and dated by the payee;

(iii) The form does not contain the statement, when required, that the payee is not subject to withholding due to notified payee underreporting;

(iv) The payee has deleted the jurat or other similar provisions by which the payee certifies or affirms the correctness of the statements contained on the form; or

(v) For purposes of section 3406(a)(1)(C), the payor is required to substitute the account to which the form relates to withholding under section 3406(a)(1)(C) under the circumstances described in §31.3406(c)-1(c)(3)(iii).

(f) *Who may sign certificate—(1) In general.* A Form W-9 or other acceptable substitute form may be signed by any person who is authorized to sign a declaration under penalties of perjury on behalf of the payee as provided in section 6061 and the regulations thereunder (relating to who may sign generally for an individual, which includes certain agents who may sign returns and other documents), section

6062 and the regulations thereunder (relating to who may sign corporate returns), and section 6063 and the regulations thereunder (relating to who may sign partnership returns).

(2) *Notified payee underreporting.* A payee who has not been notified that he is subject to withholding under section 3406(a)(1)(C) as a result of notified payee underreporting may make the certification related to notified payee underreporting. In addition, a payee who was subject to withholding under section 3406(a)(1)(C) due to notified payee underreporting may certify that he is not subject to withholding under section 3406(a)(1)(C) due to notified payee underreporting if the Internal Revenue Service has provided the payee with written certification that withholding under section 3406(a)(1)(C) due to notified payee underreporting has terminated.

(g) *Retention of certificates—(1) Accounts or instruments that are not pre-1984 accounts and brokerage relationships that are post-1983 brokerage accounts.* With respect to an account or instrument that is not a pre-1984 account (as described in §31.3406(d)-1(b)(3)), or with respect to a brokerage relationship that is a post-1983 brokerage account (as described in §31.3406(d)-1(c)(2)), a payor or broker who receives a Form W-9 or other acceptable substitute form related to withholding under section 3406 must retain the form in its records for 3 years from the date the account is opened or the instrument is purchased. The form may be retained on microfilm or microfiche.

(2) *Accounts or instruments that are pre-1984 accounts and brokerage relationships that are not post-1983 brokerage accounts.* With respect to a pre-1984 account (as described in §31.3406(d)-1(b)(1)) or with respect to a brokerage relationship that is not a post-1983 brokerage account (as described in §31.3406(d)-1(c)(1)), a payor or broker is not required to retain any Form W-9 or other acceptable substitute form. If, however, the payor or broker requires the payee to file only one Form W-9 or substitute form for all accounts or instruments of the payee, the payor or broker must retain the single form in the manner and for the period of time described in paragraph (g)(1) of this section if that form relates to any account or instrument that is not a pre-1984 account or relates to a post-1983 brokerage ac-

count. If a payee has certified that the payee is an exempt recipient described in §31.3406(g)-1, the payor or broker must retain the form unless the payor or broker can establish the existence of procedures that are reasonably calculated to ensure that a payee who has so certified is accurately identified in the payor's or broker's records.

(h) *Cross references.* For the requirement to file an information return (and furnish the related statement) with respect to a reportable payment, particularly if that payment has been subject to withholding under section 3406, see subtitle F, chapter 61, subparts B and C of the Internal Revenue Code. See §31.6302-4 for the requirement to deposit amounts withheld under section 3406 on either a monthly or semi-weekly basis. See §31.6011(a)-4(b) for the requirement to file Form 945, Annual Return of Withheld Federal Income Tax, to reflect amounts withheld under section 3406. See §31.6071(a)-1 for the time for filing the Form 945.

§31.3406(i)-1 Effective date.

Sections 31.3406-0 through 31.3406(i)-1 (except §§31.3406(d)-5 and 31.3406(g)-1(c) and except for international transactions) are effective after December 31, 1996, and, optionally, for reportable payments made and transactions occurring on or after December 21, 1995. For the effective date of §31.3406(d)-5, see §31.3406(d)-5(i). Section 31.3406(g)-1(c) is effective before January 1, 1997. See §§35a.9999-0T through 35a.9999-5 of this chapter for rules that apply to international transactions after December 31, 1996.

Par. 9. Section 31.6011(a)-5(a) is amended by:

1. Removing the word "or" immediately after the language "941PR," in the first and third sentences of paragraph (a)(1).

2. Adding the language " , or Form 945" immediately after the language "Form 941VI" in the first and third sentences of paragraph (a)(1).

3. Adding the language "(or other person)" immediately after the word "employer" in the second, third, fourth, and sixth sentences of paragraph (a)(1).

4. Removing the authority citation at the end of the section.

Par. 10. Section 31.6011(a)-6 is amended by revising the heading and

the first and third sentences of paragraph (a)(1) to read as follows:

§31.6011(a)-6 Final returns.

(a) *In general—(1) Federal Insurance Contributions Act; income tax withheld from wages and nonpayroll payments.* An employer (or other person) who is required to make a return on a particular form pursuant to §31.6011(a)-1, §31.6011(a)-4, or §31.6011(a)-5, and who in any return period ceases to pay wages or nonpayroll payments in respect of which he is required to make a return on that form, must make the return for the period as a final return. * * * Every such person filing a final return (other than a final return on Form 942 or Form 943) must furnish information showing the date of the last payment of wages (as defined in section 3121(a) or section 3401(a)), and, if appropriate, the date of the last payment of nonpayroll payments defined in §31.6011(a)-4(b). * * *

* * * * *

Par. 11. Sections 31.6051-4 and 31.6413(a)-3 are added to read as follows:

§31.6051-4 Statement required in case of backup withholding.

(a) *Statements required from payor.* Every payor of any reportable payment (as defined in section 3406(b)(1)) who is required to deduct and withhold tax under section 3406 must furnish to the payee a written statement containing the information required by paragraph (c) of this section.

(b) *Prescribed form.* The prescribed form for the statement required by this section is Form 1099. In the case of any reportable interest or dividend payment as defined in section 3406(b)(2), the prescribed form is the Form 1099 required in §1.6042-4 of this chapter (relating to payments of dividends), §1.6044-5 of this chapter (relating to payments of patronage dividends), or §1.6049-6(e) of this chapter (relating to payments of interest or original issue discount). Statements required to be furnished by this section will be treated as statements required by the respective sections with respect to any reportable payment, except that the statement required under this section must include the amount of tax

withheld under section 3406. In no event will a statement be required under this section if a statement with the same information is required to be furnished to the recipient under another section.

(c) *Information required.* Each statement on Form 1099 must show the following:

(1) The name, address, and taxpayer identification number of the person receiving any reportable payment;

(2) The amount subject to reporting under section 6041, 6041A(a), 6042, 6044, 6045, 6049, 6050A, or 6050N whether or not the amount of the reportable payment is less than the amount for which an information return is required. If tax is withheld under section 3406, the statement must show the amount of the payment withheld upon;

(3) The amount of tax deducted and withheld under section 3406;

(4) The name and address of the person filing the form;

(5) A legend stating that such amount is being reported to the Internal Revenue Service; and

(6) Such other information as is required by the form.

(d) *Time for furnishing statements.* The statement must be furnished to the payee no later than January 31 of the year following the calendar year in which the payment was made.

(e) *Aggregation.* The payor or broker may combine the information required to be shown under this section with information required to be shown under another section even if they do not relate to the same type of reportable payment.

§31.6413(a)-3 Repayment by payor of tax erroneously collected from payee.

(a) *In general—(1) Erroneous withholding under section 3406 of the Internal Revenue Code.* If a payor or broker withholds under section 3406 from a payee in error or withholds more than the proper amount of the tax under section 3406, the payor or broker may refund the amount erroneously withheld as provided in section 6413 and this section. A payor or broker will be considered to have withheld erroneously under section 3406 only if the amount is withheld because of an error by the payor or broker (e.g., an error in flagging or identifying an

account that is subject to withholding under section 3406). The payor or broker may, in its discretion, treat the amount withheld as an amount erroneously withheld and refund it to the payee if—

(i) The payor or broker requires a payee described in §31.3406(g)-1(a) or described in a provision of the Internal Revenue Code requiring the reporting of a payment subject to withholding under section 3406 to certify that it is an exempt recipient, the payee fails to make the required certification, and the payor or broker subsequently withholds under section 3406 from a payment to the payee;

(ii) The payor or broker does not require the payee to certify concerning its exempt status and the payor or broker withholds under section 3406; or

(iii) The payor or broker withholds under section 3406 from a payee after the payee provides a taxpayer identification number or required certification (including the certification relating to foreign status described in §1.6049-5(b)(2)(iv) of this chapter or §1.6045-1(g)(1) of this chapter) to the payor, but before the payor or broker treats the number or required certification as having been received under §31.3406(e)-1(b).

(2) *Limitation.* For purposes of paragraph (a)(1) of this section, if a payor or broker withholds because the payor or broker has not received a taxpayer identification number or required certification and the payee subsequently provides a taxpayer identification number or a required certification to the payor, the payor or broker may not refund the amount to the payee.

(b) *Refunding amounts erroneously withheld—(1) Time and manner.* If a payor or broker withholds under section 3406 from a payee in error (including withholding more than the correct amount, as described in paragraph (a) of this section), the payor or broker may refund the amount erroneously withheld to the payee if the refund is made prior to the end of the calendar year and prior to the time the payor or broker furnishes a Form 1099 to the payee with respect to the payment for which the erroneous withholding occurred. If the amount of the erroneous withholding is refunded to the payee, the payor or broker must—

(i) Keep as part of its records a receipt showing the date and amount of

refund and must provide a copy of the receipt to the payee (a canceled check or an entry in a statement is sufficient, provided that the check or statement contains a specific notation that it is a refund of tax erroneously withheld);

(ii) Not report on a Form 1099 as tax withheld any amount which the payor or broker has refunded to a payee; and

(iii) Not deposit the amount erroneously withheld if the payor or broker has not deposited the amount of the tax prior to the time that the refund is made to the payee.

(2) *Adjustment after the deposit of the tax.* For purposes of paragraph (b)(1) of this section, if the amount erroneously withheld has been deposited prior to the time that the refund is made to the payee, the payor or broker may adjust any subsequent deposit of the tax collected under chapter 24 of the Internal Revenue Code that the payor or broker is required to make in the amount of the tax that has been refunded to the payee.

PART 35a—TEMPORARY EMPLOYMENT TAX REGULATIONS UNDER THE INTEREST AND DIVIDEND TAX COMPLIANCE ACT OF 1983

Par. 12. The authority citation for part 35a is amended by removing the entry for 35a.3406-2 to read, in part, as follows:

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

§35a.3406-2 [Removed]

Par. 13. Section 35a.3406-2 is removed.

Par. 14. Section 35a.9999-0T is added to read as follows:

§35a.9999-0T Effective date (temporary).

In general, the provisions of §§35a.9999-1, 35a.9999-2, 35a.9999-3, 35a.9999-3A, 35a.9999-4T, and 35a.9999-5 are effective before January 1, 1997. The provisions of those sections remain effective after December 31, 1996, however, for purposes of §301.6724-1(g) of this chapter, relating to due diligence safe harbor, and for international transactions, including transactions involving a foreign payee, a foreign payor, a foreign office of a

U.S. bank or broker, or a payment from sources without the United States. See §§31.3406-0 through 31.3406(i)-1 of this chapter for rules that apply to other transactions after December 31, 1996.

PART 301—PROCEDURE AND ADMINISTRATION

Par. 15. The authority for part 301 continues to read in part as follows:

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

Par. 16. Section 301.6109-1 is amended by:

1. Revising the third sentence in paragraph (a)(1).

2. Revising the first sentence in paragraph (h).

The revised sentences read as follows:

§301.6109-1 Identifying numbers.

(a) *In general*—(1) *Social security numbers and employer identification numbers.* * * * Social security numbers identify individual persons, while employer identification numbers identify corporations, partnerships, non-profit associations, trusts, estates of decedents, and similar nonindividual persons. * * *

* * * * *

(h) *Effective date.* The provisions of this section are effective for information that must be furnished after April 15, 1974, except that the requirement that an estate obtain an Employer Identification Number applies on and after January 1, 1984. * * *

602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par 17. The authority for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 18. In §602.101, paragraph (c) is amended by adding an entry to the table in numerical order to read as follows:

“§31.3406(a)-1—§31.3406(i)-1 . . . 1545-0112”.

Dated November 28, 1995.

Margaret Milner Richardson,
*Commissioner of
Internal Revenue.*

Cynthia G. Beerbower,
*Deputy Assistant Secretary
of the Treasury.*

(Filed by the Office of the Federal Register on December 20, 1995, 8:45 a.m., and published in the issue of the Federal Register for December 21, 1995, 60 F.R. 66105)

Section 3504.—Acts to be Performed by Agents

26 CFR 31.3504-1: Acts to be performed by agents.

Description of acts that may be performed by reporting agents is provided. See Rev. Proc. 96-17, page 69.

26 CFR 31.3504-1: Acts to be performed by agents.

Requirements for the magnetic tape filing of Forms 940, 941, and 945 by reporting agents are described. See Rev. Proc. 96-18, page 73.

26 CFR 31.3504-1: Acts to be performed by agents.

Requirements for the electronic filing of Form 941 by reporting agents are described. See Rev. Proc. 96-19, page 80.

Section 4980B.—Continuation Coverage Requirements of Group Health Plans

Two COBRA premium issues. Guidance is given on two premium issues that arise under the continuation coverage requirements for group health plans in section 4980B of the Code.

Rev. Rul. 96-8

ISSUES

(1) Under the facts of situation 1 below, may the plan require that two qualified beneficiaries receiving COBRA continuation coverage with respect to the same qualifying event jointly pay 102 percent of the family rate?

(2)(a) Under the facts of situation 2(a) below, may the plan require that a sole qualified beneficiary receiving COBRA continuation coverage pay 102 percent of the family rate?

(b) Under the facts of situation 2(b) below, may the plan require that a sole qualified beneficiary receiving COBRA continuation coverage pay 102 percent of the individual rate?

FACTS

Situation 1. Plan *P* is a group health plan subject to the COBRA continuation coverage requirements of § 4980B of the Internal Revenue Code. *P* covers eligible employees and their eligible spouses and dependent children. The benefits under *P* are provided solely through a contract with insurance company *I*.

I charges *P* one of two premium rates for each eligible employee covered under *P*: a rate of \$150 per month where only the employee is covered (the “individual rate”), and a rate of \$400 per month where a spouse or one or more dependent children are covered together with the employee (the “family rate”). There are no experience rebates or dividends under *P*'s contract with *I*.

Employee *E* has a spouse *S*. A qualifying event occurs that results in a loss of coverage under *P* for *E* and *S*. Neither *E* nor *S* is disabled at the time of the qualifying event. COBRA continuation coverage is elected for *E* and *S*. *I* charges *P* the family rate for covering *E* and *S*, and *P* requires that *E* and *S* jointly pay 102 percent of the family rate.

Situation 2. (a) The facts are the same as in situation 1, except that, instead of COBRA continuation coverage being elected for both *E* and *S*, it is elected only for *S*. *I* charges *P* the family rate for *S*'s coverage, and *P* requires that *S* pay 102 percent of the family rate.

(b) The facts are the same as in paragraph (a) of this situation 2 except that *P* requires that *S* pay 102 percent of the individual rate.

LAW

Title X of the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA), P.L. 99-272, established continuation coverage requirements for certain group health plans (the “COBRA continuation coverage requirements”). These requirements, as amended by subsequent legislation, are now codified in § 4980B of the Code. Section 4980B imposes an excise tax if a plan subject to the COBRA continuation coverage requirements fails to comply with those requirements.

Under § 4980B(f)(1) of the Code, “qualified beneficiaries” (generally defined in § 4980B(g)(1) as employees,

their spouses, and their dependent children) are entitled to elect COBRA continuation coverage upon the occurrence of “qualifying events.” A qualifying event is an event such as a termination of employment, death, divorce, or other event described in § 4980B(f)(3), if the event results in a loss of coverage under the plan.

Section 4980B(f)(2)(C) permits a plan to require the payment of a premium for any period of COBRA continuation coverage, but limits that premium to 102 percent of the applicable premium for that period. (This limit is increased to 150 percent of the applicable premium in cases where a qualified beneficiary has obtained an extension of the maximum required period of COBRA continuation coverage under § 4980B(f)(2)(B) because of disability at the time of the qualifying event.)

The applicable premium is defined in § 4980B(f)(4)(A) of the Code, with respect to any period of continuation coverage of qualified beneficiaries, as the cost to the plan for that period of the coverage for similarly situated beneficiaries with respect to whom a qualifying event has not occurred (without regard to whether the cost is paid by the employer or the employee). Under § 4980B(f)(4)(C), the applicable premium is required to be determined for a period of 12 months, and the determination must be made before the beginning of that period.

Under § 4980B(f)(5)(B) of the Code, if there is a choice among types of coverage under the plan, each qualified beneficiary is entitled to make a separate election among the types of coverage. H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-859 (1986) clarifies that each qualified beneficiary is entitled to a separate election of continuation coverage, and that a spouse or dependent child can elect continuation coverage even when the employee does not.

In accordance with H.R. Conf. Rep. No. 453, 99th Cong., 1st Sess. 563 (1985), until final regulations are published, the excise tax imposed by § 4980B will not apply if employers and group health plans operate in good faith compliance with a reasonable interpretation of the statutory requirements.

ANALYSIS

(1) *P* is charged two rates for plan beneficiaries with respect to whom a

qualifying event has not occurred, an individual rate for coverage of the employee only, and a family rate for coverage of the employee and a spouse or one or more dependents. In situation 1, both *E* and *S* are receiving COBRA continuation coverage. If there had not been a qualifying event, *E* and *S* would have belonged to the category of beneficiaries consisting of an employee and one or more family members (a spouse or one or more dependent children), all of whom are covered as a family. Because *I* charges *P* the family rate for an employee in this category, it is a reasonable interpretation of the statutory requirements for *P* to determine that the family rate is the applicable premium for *E* and *S*. Consequently, if *P* operates in good faith compliance with this interpretation, *P* will not fail to meet the COBRA continuation coverage requirements by requiring that *E* and *S* jointly pay 102 percent of the family rate.

The conclusion in situation 1 is the same for any two or more qualified beneficiaries with respect to the same qualifying event. Thus, if *E* and *S* had a dependent child *C* who also lost coverage under *P* as a result of the qualifying event, it would be a reasonable interpretation of the statutory requirements for *P* to require the joint payment of up to 102 percent of the family rate if COBRA continuation coverage were elected for *E* and *C*. The conclusion in situation 1 would also be the same if COBRA continuation coverage were elected for *S* and *C* because these two qualified beneficiaries are members of the same family, and they are similarly situated to the category of two or more beneficiaries from the same family.

(2)(a) In situation 2(a), only spouse *S* has COBRA continuation coverage. As an individual, the sole qualified beneficiary *S* is not similarly situated to the family category of beneficiaries, which includes only groups of two or more individuals. Consequently, it is not a reasonable interpretation of the statutory requirements for *P* to determine that the applicable premium for *S* is the family rate, and *P* fails to meet the COBRA continuation coverage requirements in situation 2(a) by requiring that *S* pay 102 percent of the family rate.

The conclusion in situation 2(a) is the same in any case where COBRA continuation coverage is elected only for one qualified beneficiary in a family. Thus, if *E* and *S* had a

dependent child *C* who also lost coverage under *P* as a result of the qualifying event, *P* would also fail to meet the COBRA continuation coverage requirements by requiring the payment of 102 percent of the family rate if COBRA continuation coverage were elected only for *C* (or only for *E*).

(2)(b) In situation 2(b), *P* requires that *S* pay 102 percent of the individual rate. As noted above, under the facts of situation 2(b), the sole qualified beneficiary *S* is not similarly situated to the family category of beneficiaries, which includes only groups of two or more individuals. However, it is a reasonable interpretation of the statutory requirements for *P* to determine that *S*, a sole qualified beneficiary receiving COBRA continuation coverage, is similarly situated to the employee-only category of beneficiaries, for whom *P* is charged the individual rate, and that the applicable premium for *S* is the individual rate. Consequently, if *P* operates in good faith compliance with this interpretation, *P* will not fail to meet the COBRA continuation coverage requirements by requiring that *S* pay 102 percent of the individual rate.

The conclusion in situation 2(b) is the same in any case where COBRA continuation coverage is elected only for one qualified beneficiary in a family. Thus, if *E* and *S* had a dependent child *C* who also lost coverage under *P* as a result of the qualifying event, it would be a reasonable interpretation of the statutory requirements for *P* to require the payment of up to 102 percent of the individual rate if COBRA continuation coverage were elected only for *C* (or only for *E*).

HOLDINGS

(1) Under the facts of situation 1, the plan will not fail to meet the COBRA continuation coverage requirements merely because it, in good faith, requires that two qualified beneficiaries receiving COBRA continuation coverage with respect to the same qualifying event jointly pay up to 102 percent of the family rate.

(2)(a) Under the facts of situation 2(a), the plan will fail to meet the COBRA continuation coverage requirements by requiring that a sole qualified beneficiary receiving COBRA continuation coverage pay 102 percent of the family rate.

(b) Under the facts of situation 2(b), the plan will not fail to meet the COBRA continuation coverage requirements merely because it, in good faith, requires that a sole qualified beneficiary receiving COBRA continuation coverage pay up to 102 percent of the individual rate.

DRAFTING INFORMATION

The principal author of this revenue ruling is Russ Weinheimer of the Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations). For further information regarding this revenue ruling, contact Mr. Weinheimer at (202) 622-4695 (not a toll-free number).

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

26 CFR 31.6011(a)–7: Execution of Returns.

Procedures for execution of tax returns by an agent is provided. See Rev. Proc. 96–17, page 69.

26 CFR 31.6011(a)–7: Execution of Returns.

Procedures for execution of an electronically filed Form 941 by an agent is provided. See Rev. Proc. 96–19, page 80.

26 CFR 31.6011(a)–8: Composite return in lieu of specified form.

Procedures for using a composite return instead in lieu of paper Forms 940, 941, or 945 is provided. See Rev. Proc. 96–18, page 73.

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

26 CFR 31.6011(a)–8: Composite return in lieu of specified form.

Procedures for using a composite return instead in lieu of a paper Form 941. See Rev. Proc. 96–19, page 80.

Section 6012.—Persons Required to Make Returns of Income

26 CFR 1.6012–5: Composite return in lieu of specified form.

What are the requirements for participation in the 1996 On-Line Filing Program for the Form 1040 series? See Rev. Proc. 96–20, page 88.

Section 6051.—Receipts for Employees

26 CFR 31.6051–1: Statements for employees.

T.D. 8636

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 31 and 301

Time for Furnishing Wage Statements on Termination of Employer's Operations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations concerning the time for furnishing wage statements to employees and for filing wage statements with the Social Security Administration upon the termination of an employer's operations. These regulations will affect employers and their employees in the year the employer ceases to pay wages. These regulations are intended to improve the wage reconciliation process between the Social Security Administration and the IRS.

EFFECTIVE DATE: These regulations are effective January 1, 1997.

ADDRESSES: Send submissions to: CC:DOM:CORP:T:R (EE–83–89), Room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:T:R (EE–83–89), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Jean M. Casey, (202) 622-6040 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On December 22, 1994, the Federal Register (59 FR 65982 [EE–83–89, 1995–1 C.B. 845]) published a notice of proposed rulemaking which required an employer to furnish Forms W–2 to

employees and to file Forms W–2 and W–3 with the Social Security Administration (SSA) at the same time that the employer is required to file the final Form 941 with the IRS.

Written comments responding to the notice of proposed rulemaking were received. A public hearing was held on May 8, 1995, pursuant to a notice published in the Federal Register on March 24, 1995 (60 FR 15526). After consideration of the comments that were received in response to the notice of proposed rulemaking and at the hearing, the IRS and Treasury adopt the proposed regulations, as amended and revised by this Treasury decision.

Explanation of Revisions and Summary of Comments

Availability of Forms W–2

The regulations, as proposed, would have required an employer who ceases paying wages to furnish Form W–2 to employees and file Forms W–2 and W–3 with SSA on or before the date on which the final Form 941 is required to be filed with the IRS. Form 941 is generally due quarterly, on or before the last day of the first calendar month following the period for which it is made (*i.e.*, April 30, July 31, October 31, and January 31). Consequently, if an employer ceased paying wages in the first quarter of the calendar year, the Forms 941, W–2 and W–3 would be due by April 30. Some commentators expressed concern that Forms W–2 and W–3 are not available in the first quarter of the calendar year. Commentators questioned whether using prior year Forms W–2 was an acceptable alternative if current year forms were unavailable.

Under the Internal Revenue Code and the existing regulations, an employee may request the Form W–2 at any time during the year if the employee is terminated and there is no reasonable expectation on the part of the employer or the employee of further employment during the calendar year. Therefore, Forms W–2 are available from the IRS, either through the mail or at the district offices, in January of each year. Specifications for the private printing of substitute Forms W–2, however, are not always available during the first quarter of the calendar year. Thus, during this period, employers may be limited to using the Forms W–2 printed by the IRS. Neither prior year Forms W–2 nor

the prior year specifications for the private printing of substitute Forms W-2 should be used for filing Forms W-2 on an expedited basis for the current year because such procedures could result in significant processing errors.

Availability of Magnetic Media Specifications

Commentators questioned whether magnetic media specifications would be available in the first quarter of the calendar year for employers who are required to file on an expedited basis under the proposed regulations. Regulation section 301.6011-2 and Notice 90-15, 1990-1 C.B. 326, generally require an employer to file Forms W-2 with SSA on magnetic media if the employer is required to file 250 or more Forms W-2 in a calendar year. Employers who do not meet the 250 return threshold may also file their Forms W-2 with SSA on magnetic media.

It is not certain that magnetic media specifications, which are issued by SSA, will be available in the first quarter of the calendar year for employers who are required to file on an expedited basis. The Commissioner has the authority to provide for reasonable extensions of time, upon written application, for an employer to furnish Forms W-2 to employees and file Forms W-2 and W-3 with SSA. To assure that filers need not shift from magnetic media to paper filings in order to comply with the expedited filing requirements, the final regulations affirm that the Commissioner may adopt automatic extension procedures where appropriate.

It is anticipated that the Commissioner will establish automatic extension procedures to the extent necessary to permit employers that terminate operations a reasonable period of time, after the issuance of specifications, to make their filings on magnetic media.

It is further anticipated that these procedures will include appropriate automatic extensions of time to file expedited Forms W-2 both for employers required to file on magnetic media and for employers who have filed on magnetic media in the past whether or not required to do so. Even though Forms W-2 are furnished to employees on paper, the automatic extension procedures are anticipated to apply to the employee copy of the Form W-2 as well as the SSA copy in order to avoid the complexities and potential errors

that could arise from processing these forms at significantly different times.

It is also anticipated that the published procedure will provide for an automatic extension to a specified date which permits employers a reasonable period of time after the issuance of specifications to make their filings on magnetic media. This date will be communicated to filers sufficiently early in the year to permit adequate systems planning. In providing for these procedures, it is necessary to balance the practical issues of compliance with the concern for timely submission of information to SSA. Thus, if prior to a future year, it is anticipated that specifications will be issued sufficiently early in the year to permit a reasonable period of time for filing, while still complying with the due dates otherwise required in this regulation, the Commissioner may suspend the automatic extension procedures for that year. Discretionary extensions would continue to be considered on a case-by-case basis.

Comments are requested on the automatic extension procedures and their implementation.

Regulation section 301.6011-2(c)(4) provides that the Commissioner may, upon application, waive the requirement to file on magnetic media in the case of hardship. The final regulations clarify that the unavailability of the specifications for magnetic media filing of Form W-2 will be treated as creating a hardship. Therefore, an employer has the option of applying for a waiver from the requirement to file Forms W-2 on magnetic media and may instead file the Forms W-2 on paper. The employer must apply for a waiver within 45 days of the due date of the return.

Employers may also contact their local SSA Magnetic Media Coordinator for guidance on how to report on magnetic media. The Coordinators are listed in the annual Technical Instructions Bulletin (TIB-4) published by SSA.

Extension Procedures

Regulation section 31.6051-1(d)(2) provides procedures for an employer to request an extension of time to furnish Forms W-2 to employees. Regulation section 31.6081(a)-1 provides similar procedures for employers to request an extension of time to file Forms W-2 and W-3 with SSA. These procedures apply to employers who are required to furnish Forms W-2 to employees or file

Forms W-2 and W-3 with SSA on an expedited basis. Thus, an employer who, under the final regulations, is required to furnish and file the Forms W-2 on an expedited basis may request an extension of time if necessary.

Additional month to provide Forms W-2 and W-3 to SSA

Under existing regulations Forms W-2 and W-3 are due to SSA one month after they are due to the employees. This provides employers an opportunity to correct any errors found by employees before filing the Forms W-2 with SSA. Some commentators noted that providing the Forms W-2 to SSA at the same time the forms are provided to the employees eliminates the opportunity for corrections currently provided by the regulations. To minimize the need for employers to file corrected Forms W-2 (Form W-2c, Statement of Corrected Income and Tax Amounts), the final regulations include a suggested one month additional period for providing the Forms W-2 to SSA. Thus, Forms W-2 would be due to employees at the same time as the final Form 941 (generally one month after the end of the quarter). Forms W-2 and W-3 would be due to SSA two months after the final Form 941 is due.

Modification of Revenue Procedure 84-77

In Revenue Procedure 84-77, 1984-2 C.B. 753, the IRS provided procedures for preparing and filing certain forms, including Form 941, Form W-2 and Form W-3, when a successor employer acquires substantially all of the property (1) used in a trade or business of a predecessor employer, or (2) used in a separate unit of a trade or business of a predecessor, and in connection with, or immediately after the acquisition (but during the same calendar year) the successor employs individuals who were employed in the trade or business of the predecessor immediately prior to the acquisition. Under the standard procedure described in Rev. Proc. 84-77, both the predecessor and successor employer report the wages they paid employees on Form W-2. Under the alternate procedure, the predecessor is relieved from furnishing Form W-2 to any employee who is employed by the successor employer and from filing such Forms W-2 with SSA. Instead, the suc-

cessor employer assumes the predecessor's reporting obligation for those employees. The preamble to the proposed regulation stated that, other than modifying the time frame for the standard procedure, the proposed regulation would not affect the validity of Rev. Proc. 84-77.

One commentator questioned whether the proposed regulation expedited the filing requirements for the predecessor employer with regard to individuals who are not employed by the successor employer. If the predecessor employer ceases to pay wages, (i.e., is required to file a final Form 941), the predecessor employer is required under these regulations to furnish Forms W-2 on an expedited basis to those individuals who are not employed by the successor employer. The predecessor employer must also file Forms W-2 and W-3 with SSA on an expedited basis for those individuals who are not employed by the successor employer. Revenue Procedure 84-77 is being modified to reflect this change.

Some commentators asked how the proposed regulations apply in the context of mergers. If a final Form 941 is not filed because a merger does not involve the cessation of business operations but only a change in corporate or business form, the expedited filing requirements are inapplicable.

Use of an agent

One commentator suggested the final regulations provide an exception from expedited filing for an employer that appoints an agent to assume the employer's reporting obligation. A similar exception was suggested in the case of a controlled group of corporations in which one member of the group acts as the payroll agent for the group. Because there is no practically effective enforceable manner for shifting liability for reporting from an employer to an agent and for assuring that the agent will satisfy the reporting obligations, these suggestions were not adopted.

Application to Returns filed by Employers for Employees in Guam, U.S. Virgin Islands, American Samoa, Commonwealth of the Northern Mariana Islands and Puerto Rico.

One commentator questioned whether the proposed regulations applied to wage statements furnished to employees

and filed with SSA by employers for employees in Guam, U.S. Virgin Islands, American Samoa, Commonwealth of the Northern Mariana Islands and Puerto Rico. While these employers file variations of the Forms 941, W-2 and W-3, they are subject to the filing requirements for Forms 941, W-2 and W-3. In addition, employees of these employers receive social security credit on the same basis as employers who file the Forms 941, W-2 and W-3. Thus, these employers are subject to the regulations.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 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) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Jean M. Casey, Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 31 and part 301 are amended as follows:

PART 31—EMPLOYMENT TAXES AND COLLECTION OF INCOME TAX AT SOURCE

Paragraph 1. The authority citation for part 31 is amended by adding the following entries in numerical order to read as follows:

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

Section 31.6051-1(d) also issued under 26 U.S.C. 6051.

Section 31.6051-2 also issued under 26 U.S.C. 6051 * * *

Section 31.6071-1 also issued under 26 U.S.C. 6071 * * *

Section 31.6081-1 also issued under 26 U.S.C. 6081 * * *

Par. 2. Section 31.6051-1, paragraph (d) is amended as follows:

- 1. Paragraph (d)(1) is redesignated as (d)(1)(i).
- 2. Paragraph (d)(1)(ii) is added.
- 3. Paragraph (d)(2) is revised.

The addition and revision read as follows:

§31.6051-1 Statements for employees.

* * * * *

(d) * * * (1)(i) * * *

(ii) *Expedited furnishing*—(A) *General rule.* If an employer is required to make a final return under §31.6011(a)-6(a)(1) (relating to the final return for Federal Insurance Contributions Act taxes and income tax withholding from wages) on Form 941, or a variation thereof, the employer must furnish the statement required by this section on or before the date required for filing the final return. See §31.6071(a)-1(a)(1). However, if the final return under §31.6011(a)-6(a)(1) is a monthly return, as described in §31.6011(a)-5, the employer must furnish the statement required by this section on or before the last day of the month in which the final return is required to be filed. See §31.6071(a)-1(a)(2). Except as provided in paragraph (d)(2)(i) of this section, in no event may an employer furnish the statement required by this section later than January 31 of the year succeeding the calendar year to which it relates. The requirements set forth in this paragraph (d)(1)(ii) do not apply to employers with respect to employees whose wages are for domestic service in the private home of the employer. See §31.6011(a)-1(a)(3).

(B) *Requests by employees.* An employer is not permitted to furnish a statement pursuant to the provisions of the third sentence of paragraph (d)(1)(i) of this section (relating to written requests by terminated employees for Form W-2) at a time later than that required by the provisions of paragraph (d)(1)(ii)(A) of this section.

(C) *Effective date.* This paragraph (d)(1)(ii) is effective January 1, 1997.

(2) *Extensions of time*—(i) *In general*
(a) The Director, Martinsburg Computing Center, may grant an extension of time in which to furnish to employees the statements required by this section. A request may be made by a letter to the Director, Martinsburg Computing Center. The request must contain:

(1) *The employer's name and address;*

(2) *The employer's taxpayer identification number;*

(3) *The type of return (i.e., Form W-2); and*

(4) *A concise statement of the reasons for requesting the extension.*

(b) The application must be mailed or delivered on or before the applicable due date prescribed in paragraph (d)(1) of this section for furnishing the statements required by this section.

(c) In any case in which an employer is unable, by reason of illness, absence, or other good cause, to sign a request for an extension, any person standing in close personal or business relationship to the employer may sign the request on his behalf, and shall be considered as a duly authorized agent for this purpose, provided the request sets forth a reason for a signature other than the employer's and the relationship existing between the employer and the signer. For provisions relating to extensions of time for filing the Social Security Administration copies of the statement, see §31.6081(a)-1(a)(3).

(ii) *Automatic Extension of Time.* The Commissioner may, in appropriate cases, publish procedures for automatic extensions of time to furnish Forms W-2 where the employer is required to furnish the Form W-2 on an expedited basis.

* * * * *

Par. 3. Section 31.6051-2, paragraph (c), first sentence is revised to read as follows:

§31.6051-2 Information returns on Form W-3 and Internal Revenue Service copies of Form W-2.

* * * * *

(c) *Cross references.* For provisions relating to the time for filing the information returns required by this section and to extensions of the time for filing, see §§ 31.6071(a)-1(a)(3) and 31.6081(a)-1(a)(3), respectively. * * *

Par. 4. Section 31.6071(a)-1(a)(3) is amended as follows:

1. Paragraph (a)(3)(i) is removed.

2. Paragraph (a)(3)(ii) is redesignated as paragraph (a)(3)(i) and the heading is revised.

3. A new paragraph (a)(3)(ii) is added.

The addition and revision read as follows:

§31.6071(a)-1 Time for filing returns and other documents.

(a) * * *

(3) * * * (i) *General rule.* * * *

(ii) *Expedited filing*—(A) *General rule.* If an employer who is required to make a return pursuant to §31.6011(a)-1 or §31.6011(a)-4 is required to make a final return on Form 941, or a variation thereof, under §31.6011(a)-6(a)(1) (relating to the final return for Federal Insurance Contributions Act taxes and income tax withholding from wages), the return which is required to be made under §31.6051-2 must be filed on or before the last day of the second calendar month following the period for which the final return is filed. The requirements set forth in this paragraph (a)(3)(ii) do not apply to employers with respect to employees whose wages are for domestic service in the private home of the employer. See §31.6011(a)-1(a)(3).

(B) *Effective date.* This paragraph (a)(3)(ii) is effective January 1, 1997.

* * * * *

Par. 5. Section 31.6081(a)-1(a)(3) is revised to read as follows:

§31.6081(a)-1 Extensions of time for filing returns and other documents.

(a) * * *

(3) *Information returns of employers on Forms W-2 and W-3*—(i) *In general.* The Director, Martinsburg Computing Center, may grant an extension of time in which to file the Social Security Administration copy of Forms W-2 and the accompanying transmittal form which constitutes an information return under paragraph §31.6051-2(a). The request must contain a concise statement of the reasons for requesting the extension. The request must be mailed or delivered on or before the date on which the employer is required to file the Form W-2 with the Social Security Administration.

(ii) *Automatic Extension of Time.* The Commissioner may, in appropriate cases, publish procedures for automatic extensions of time to file Forms W-2 where the employer is required to file the Form W-2 on an expedited basis.

* * * * *

PART 301—PROCEDURE AND ADMINISTRATION

Par. 6. The authority citation for part 301 continues to read in part as follows:

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

Par. 7. Section 301.6011-2(c)(4)(i) is revised to read as follows:

§301.6011-2 Required use of magnetic media.

* * * * *

(c) * * *

(4) *Waiver.* (i) The Commissioner may waive the requirements of this section if hardship is shown in a request for waiver filed in accordance with this paragraph (c)(4)(i). The principal factor in determining hardship will be the amount, if any, by which the cost of filing the information returns in accordance with this section exceeds the cost of filing the returns on other media. Notwithstanding the forgoing, if an employer is required to make a final return on Form 941, or a variation thereof, and expedited filing of Forms W-2 is required, the unavailability of specifications for magnetic media filing will be treated as creating a hardship. See §31.6071(a)-1(a)(3)(ii). A request for waiver should be filed at least 45 days before the due date of the information return in order for the Service to have adequate time to respond to the request for waiver. The waiver will specify the type of information return and the period to which it applies and will be subject to such terms and conditions regarding the method of reporting as may be prescribed by the Commissioner.

* * * * *

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved December 12, 1995.

Leslie Samuels,
Assistant Secretary of the Treasury

(Filed by the Office of the Federal Register on December 20, 1995, 8:45 a.m., and published in the issue of the Federal Register for December 21, 1995, 60 F.R. 66139)

Section 6071.—Time for Filing Returns and Other Documents

26 CFR 31.6071(a)-1: Time for filing returns and other documents.

Time for filing Forms 940, 941, and 945 is provided. See Rev. Proc. 96-18, page 73.

26 CFR 31.6071(a)-1: Time for filing returns and other documents.

Time for filing Form 941 is provided. See Rev. Proc. 96-19, page 80.

Section 6302.—Mode or Time of Collection

26 CFR 31.6302-1: Federal tax deposit rules for withheld income taxes and taxes under the Federal Insurance Contributions Act (FICA) attributable to payments made after December 31, 1992.

Scope of a reporting agent's authorization to transmit federal tax deposit payments is described. See Rev. Proc. 96-17, page 69.

26 CFR 31.6302-1T: Federal tax deposit rules for withheld income taxes and taxes under the Federal Insurance Contributions Act (FICA)—deposits required to be made by electronic funds transfer after December 31, 1994 (temporary).

Scope of a reporting agent's authorization to transmit electronic federal tax deposits is described. See Rev. Proc. 96-17, page 69.

26 CFR 1.6061-1: Signing of returns and other documents by individuals.

What are the requirements for participation in the 1996 On-Line Filing Program for the Form 1040 series? See Rev. Proc. 96-20, page 88.

Section 6061.—Signing of Returns and Other Documents

26 CFR 31.6061-1: Signature of returns and other documents.

Procedures for signing a reporting agent authorization and tax returns are described. See Rev. Proc. 96-17, page 69.

Part III. Administrative, Procedural, and Miscellaneous

Statements to Recipients of Dividends and Patronage Dividends

Notice 96-4

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Partial withdrawal of a notice of proposed rulemaking.

SUMMARY: This document withdraws a portion of the notice of proposed rulemaking under sections 6042 and 6044 of the Internal Revenue Code that was published in the Federal Register on February 29, 1988, as proposed to be amended on September 27, 1990. The proposed regulations prescribed rules for official statements to recipients of dividends and patronage dividends paid after December 31, 1983.

DATE: This withdrawal is effective on December 21, 1995.

FOR FURTHER INFORMATION CONTACT: Renay France, (202) 622-4910 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On February 29, 1988, the IRS issued proposed regulations on backup withholding (INTL-52-86, 53 FR 5991 [1988-1 C.B. 892]). The proposed regulations related, in part, to official statements to recipients of dividends and patronage dividends under sections 6042 and 6044, respectively (proposed §§1.6042-5 and 1.6044-6). On September 27, 1990, the IRS issued additional proposed regulations on backup withholding (IA-224-82, 55 FR 39427). Those proposed regulations contained amendments to the regulations previously proposed under sections 6042 and 6044.

In *** [T.D. 8637, page 00, this Bulletin], the IRS is issuing final regulations relating to backup withholding that were proposed in INTL-52-86 and IA-224-82. Those final regulations do not include proposed §§1.6042-5 and 1.6044-6. Further, when the IRS issues additional final regulations that were proposed under INTL-52-86, those additional final regulations will not include proposed §§1.6042-5 and

1.6044-6. Accordingly, this document withdraws those proposed regulations sections. See §§1.6042-4 and 1.6044-5 of the final regulations for substantive rules proposed under the withdrawn sections.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Withdrawal of Portion of Notice of Proposed Rulemaking

Accordingly, under the authority of 26 U.S.C. 7805, proposed §§1.6042-5 and 1.6044-6 that were published in the Federal Register on February 29, 1988 (53 FR 5991) and amended in the Federal Register on September 27, 1990 (55 FR 39427) are withdrawn.

Margaret Milner Richardson,
*Commissioner of
Internal Revenue.*

(Filed by the Office of the Federal Register on December 20, 1995, 8:45 a.m., and published in the issue of the Federal Register for December 21, 1995, 60 F.R. 66227)

*26 CFR 601.201: Tax forms and instructions.
(Also Part I, §§ 3504, 6011, 6061, 6302;
31.3504-1, 31.6011(a)-7, 31.6061-1, 31.6302-1, 31.6302-1T)*

Rev. Proc. 96-17

Table of Contents

SECTION 1.	PURPOSE
SECTION 2.	BACKGROUND
SECTION 3.	SIGNIFICANT CHANGES FROM REV. PROC. 89-18
SECTION 4.	DEFINITIONS
SECTION 5.	SCOPE OF REPORTING AGENT AUTHORIZATION
SECTION 6.	COMPLETING A REPORTING AGENT AUTHORIZATION
SECTION 7.	SUBMITTING A REPORTING AGENT AUTHORIZATION
SECTION 8.	INTERNAL REVENUE SERVICE CONTACTS

SECTION 9. OTHER RELATED DOCUMENTS

SECTION 10. EFFECT ON OTHER DOCUMENTS

SECTION 11. EFFECTIVE DATE

SECTION 1. PURPOSE

.01 This revenue procedure provides the requirements for completing and submitting Form 8655, Reporting Agent Authorization for Magnetic Tape/Electronic Filers ("Authorization"). An Authorization allows a taxpayer to designate a Reporting Agent ("Agent") to do the following things on behalf of the taxpayer: (1) sign and file Forms 940, 941, and 945, on magnetic tape or electronically; (2) make federal tax deposit ("FTD") payments and submit FTD information on magnetic tape or electronically for the taxes deposited and reported on the Forms 940, 941, and 945, and certain other returns; and (3) receive duplicate copies of official notices, correspondence, transcripts, or other information with respect to such tax returns and FTDs.

.02 The technical specifications for filing Authorization information are published separately in Publication 1474, Technical Specification Guide for Reporting Agent Authorization for Magnetic Tape/Electronic Filers.

SECTION 2. BACKGROUND

.01 Section 31.6011(a)-7 of the Employment Taxes and Collection of Income Tax at Source Regulations provides that each return required under the regulations of this part, together with any prescribed copies or supporting data, must be filled in and disposed of in accordance with the forms, instructions, and regulations applicable thereto. The return may be made by an agent in the name of the person required to make the return if an acceptable power of attorney is filed with the Internal Revenue Service office with which such person is required to file returns and if such a return includes all taxes required to be reported by such person on such return.

.02 Section 31.6061-1 provides that the return may be signed for the taxpayer by an agent who is fully authorized in accordance with § 31.6011(a)-7 to make such return.

.03 Section 31.6302-1 provides taxpayers with the rules for depositing

withheld employment taxes. Section 31.6302-1T of the temporary regulations supplements these rules by implementing the mandate for the collection of federal depository taxes through an electronic funds transfer (“EFT”) system, as required by § 6302(h) of the Internal Revenue Code. EFT is any transfer of taxes made in accordance with Rev. Proc. 94-48, 1994-2 C.B. 694, or in accordance with procedures subsequently published by the Commissioner.

.04 The Service has prescribed the use of Form 8655 as the appropriate authorization form to use by a taxpayer for designating an Agent to:

(1) file and sign certain tax returns on magnetic tape or electronically;

(2) make FTD payments and submit FTD information on magnetic tape or electronically for certain tax returns;

(3) receive duplicate copies of official notices, correspondence, transcripts, or other information with respect to the magnetic tape or electronic returns filed by the Agent; or

(4) receive duplicate copies of official notices, correspondence, transcripts, frequency information, or other information with respect to FTDs submitted or to be submitted on magnetic tape or electronically by the Agent.

.05 Form 8655 provides an option for an Agent to receive deposit frequency information on magnetic tape (ASCII format on 10½ inch round tape 6250 BPI) or on paper. Deposit frequency information will be sent on magnetic tape to an Agent with 4,000 or more clients, unless that Agent elects on the Authorization not to receive the information via magnetic tape. Deposit frequency information will be sent on paper to an Agent with less than 4,000 clients, unless that Agent elects on the Authorization to receive the information on magnetic tape. The cost of producing the tape will be incurred by the Service. However, an Agent is responsible for reading the magnetic tape.

SECTION 3. SIGNIFICANT CHANGES FROM REV. PROC. 89-18

.01 The magnetic tape specifications are not included in this revenue procedure, but are published separately in Publication 1474.

.02 This revenue procedure has been updated to reflect the addition of:

(1) Form 945, Annual Return of Withheld Federal Income Tax, to the Authorization;

(2) electronic filing as a method for filing certain returns; and

(3) electronic submission of FTDs and FTD information as a method for payment.

.03 Section 4 defines certain terms used in connection with this revenue procedure.

.04 Section 5 clarifies the scope of an Authorization.

.05 Section 6 updates instructions for completing an Authorization.

.06 Section 7 provides the procedures for submitting Authorizations.

.07 Section 8 updates information on Internal Revenue Service contacts.

.08 Section 9 lists related documents.

SECTION 4. DEFINITIONS

.01 *Reporting Agent.* A Reporting Agent (“Agent”) is an accounting service, franchiser, bank, or other entity authorized to perform one or more of the following on behalf of a taxpayer:

(1) prepare and electronically file Form 941, Employer’s Quarterly Federal Tax Return; (2) prepare and use magnetic tape to file Form 940, Employer’s Annual Federal Unemployment (FUTA) Tax Return, Form 941, and Form 945, Annual Return of Withheld Federal Income Tax; and (3) make FTD payments and submit FTD information on magnetic tape or electronically for the taxes deposited and reported on Forms 940, 941, and 945, and the other returns covered by Rev. Proc. 89-48, 1989-2 C.B. 599, or Rev. Proc. 94-48.

.02 *Reporting Agent Authorization.* A Reporting Agent Authorization (“Authorization”) allows a taxpayer to designate an Agent to sign and to file Forms 940, 941, and 945, on magnetic tape or electronically, and to authorize the making of FTD payments and submission of FTD information on magnetic tape or electronically for the taxes deposited and reported on the Forms 940, 941, and 945, and the other returns covered by Rev. Proc. 89-48 or Rev. Proc. 94-48. The Authorization may also permit the Agent to receive duplicate copies of official notices, correspondence, transcripts, or other information with respect to such tax returns and FTDs. The Service has

prescribed Form 8655 as the appropriate authorization form to be used by a taxpayer for designating an Agent.

.03 *Reporting Agent’s List.* A Reporting Agent’s List (“Agent’s List”) identifies all taxpayers for whom an Agent will file tax returns, make FTD payments, or submit FTD information either on magnetic tape or electronically. A separate Authorization must be submitted for each taxpayer on the Agent’s List. The Agent’s List must contain each taxpayer’s employer identification number (“EIN”).

SECTION 5. SCOPE OF REPORTING AGENT AUTHORIZATION

.01 The scope of an Authorization for the magnetic tape or electronic filing of forms listed on Form 8655 is as follows:

(1) a taxpayer may authorize an Agent to sign and file all or any of the forms listed on Form 8655 on magnetic tape or electronically on the taxpayer’s behalf; and

(2) a taxpayer may authorize an Agent to receive copies of notices, correspondence, and transcripts or other information with respect to such returns filed by the Agent.

.02 The scope of an Authorization for making FTD payments and submitting FTD information on magnetic tape or electronically is as follows:

(1) a taxpayer may authorize an Agent to prepare and make FTD payments and submit FTD information on magnetic tape or electronically on the taxpayer’s behalf;

(2) a taxpayer who is not required, pursuant to § 6302(h) and the regulations thereunder, to make FTD payments through the EFT system may select the method for submission of FTD information (magnetic tape or electronic);

(3) an Agent must make FTD payments and submit payment information through the EFT system for a taxpayer that is mandated to make FTD payments and submit FTD information through the EFT system pursuant to § 6302(h), regardless of the taxpayer’s designation to the contrary; and

(4) an Authorization that authorizes an Agent to make FTD payments only entitles the Agent to receive copies of FTD-related notices and correspondence for the taxpayer. Such an Authorization also permits an Agent to request information or submit infor-

mation on the deposits submitted by the Agent, including any penalties that may result from such deposits.

.03 An Authorization becomes effective for the tax period designated by the Agent and taxpayer, and remains in effect for subsequent periods until revoked by the taxpayer, terminated by the Agent, or terminated by the Service, subject to the following:

(1) in the case of an Agent making an FTD payment on behalf of a taxpayer, the Authorization must be received by the Service prior to the Agent's making the FTD payment and submitting the FTD information on magnetic tape or electronically; and

(2) in the case of an Agent filing a return on behalf of a taxpayer, the Service must accept the Authorization and Agent's List (as set forth in the magnetic tape or electronic filing revenue procedure for the relevant return) before an Agent may file any returns. See section 9 of this revenue procedure for a list of other applicable revenue procedures.

.04 A new Authorization must be submitted for any increase or decrease in the scope of an Authorization between an Agent and the taxpayer. Receipt by the Service of a new Authorization revokes all prior Authorizations by the taxpayer but has no effect on any other power of attorney or authorization.

.05 An Authorization filed under this revenue procedure does not constitute the appointment of a recognized representative as described in § 601.502 of the Statement of Procedural Rules.

.06 An Authorization does not absolve the taxpayer of the responsibility to ensure that all tax returns are filed and all taxes are paid on time.

.07 An Agent may use an Authorization to file paper forms listed on Form 8655 only under the following circumstances:

(1) the late receipt of payroll information from a taxpayer that would jeopardize the timely submission of the taxpayer's return;

(2) the amendment of returns filed under the magnetic tape/electronic filing programs referenced in section 9 of this revenue procedure;

(3) the rejection of a magnetic tape/electronic filing that would jeopardize the timely submission of the taxpayer's return; or

(4) a request by the magnetic tape/electronic filing coordinator for an Agent participating in a magnetic tape/

electronic filing program referenced in section 9 of this revenue procedure to file paper returns.

.08 An Agent may prepare a paper tax return for the taxpayer's signature. A taxpayer's authorized representative that is not an Agent participating in a program covered by the Form 8655 (including a suspended Agent) must have a valid power of attorney in accordance with § 601.504(6) (usually Form 2848, Power of Attorney and Declaration of Representative) in order to sign and file a paper tax return on behalf of a taxpayer.

.09 Each paper tax return must be signed by the taxpayer, the taxpayer's authorized representative, or a participating Agent, to the extent permitted in section 5.07 of this revenue procedure.

.10 A copy of each Authorization should be kept at the Agent's principal place of business for examination by the Service until the statute of limitations for the last return filed under that Authorization expires.

SECTION 6. COMPLETING A REPORTING AGENT AUTHORIZATION

.01 An Authorization may be submitted on Form 8655, or any other instrument which clearly contains the same information required to be provided on Form 8655. The taxpayer may strike out the nonapplicable portions of the Form 8655. An Agent may fax the Authorization to the Service.

.02 An Authorization must be signed by:

(1) the taxpayer, or the taxpayer's authorized representative. If, however, the authorized representative is the holder of a power of attorney, the person executing the Authorization must be specifically authorized to sign tax returns on behalf of the taxpayer. If the taxpayer's authorized representative wishes to authorize an Agent to receive tax return notices, correspondence, and transcripts from the Service, or discuss taxpayer account information with Service representatives, the authorized representative must be someone with authority both to receive, and to designate others to receive, tax return information (as defined by § 6103(b)-(2)) of the taxpayer; or

(2) a person who is duly authorized in accordance with § 31.6011(a)-7 of the regulations, provided that the authorizing language explicitly states that the person may both receive and

designate recipients of the taxpayer's tax return information, if the form is used to designate the person as a recipient of tax return information.

.03 An Authorization executed after January 31, 1996, must be made on Form 8655 (with a revision date of October 1995 or later) or its equivalent.

.04 Except to the extent provided in section 6.05 of this revenue procedure, an Authorization will remain in effect until a new Authorization is received by the Service.

.05 The Service will not accept tax returns filed electronically by an Agent after December 31, 1996, unless the Service has received an Authorization on Form 8655 (with a revision date of October 1995 or later) or its equivalent that expressly permits the Agent to file tax returns electronically on behalf of the taxpayer. The Service will accept tax returns filed electronically by an Agent prior to January 1, 1997, unless the Service has received an Authorization that expressly precludes the Agent from filing tax returns electronically on behalf of the taxpayer.

SECTION 7. SUBMITTING A REPORTING AGENT AUTHORIZATION

.01 An Agent that desires to use an Authorization to file taxpayer tax returns on magnetic tape or electronically, or to make FTD payments, and submit FTD information on magnetic tape or electronically, must formally apply to the Service for these privileges. Currently, the required information for these applications is contained in the documents listed in section 9 of this revenue procedure. The applications governed by these documents must be accompanied by the individual Authorizations, signed by the taxpayer or the authorized representative, and an Agent's List (if required by the applicable revenue procedure).

.02 For specific information concerning the requirements for submitting and updating Agent's Lists, please refer to Publication 1474, the Service contacts listed in section 8 of this revenue procedure, and the documents listed in section 9 of this revenue procedure.

SECTION 8. INTERNAL REVENUE SERVICE CONTACTS

.01 Requests for Publication 1474, and questions regarding this revenue procedure, may be addressed to the Service at any one of the following service centers:

- (1) Northeast Region
 - (a) Andover
 - Andover Service Center
 - Management Support Branch
 - Mail Stop 105
 - 310 Lowell Street
 - Andover, MA 05501
 - Attn: Magnetic Tape Coordinator
 - (b) Brookhaven
 - Brookhaven Service Center
 - Stop 111
 - P.O. Box 400
 - Holtsville, NY 11742
 - Attn: Magnetic Tape Coordinator
 - (c) Cincinnati
 - Use the Philadelphia Service Center
 - (d) Philadelphia
 - Philadelphia Service Center
 - Mag Media Project Office
 - Mail Stop 115
 - 11601 Roosevelt Blvd.
 - Philadelphia, PA 19154
- (2) Southeast Region
 - (a) Atlanta
 - Atlanta Service Center
 - Stop 30
 - P.O. Box 47-421
 - Doraville, GA 30362
 - Attn: Magnetic Tape Coordinator
 - (b) Memphis
 - (i) Electronic filing
 - Memphis Service Center
 - ELF Coordinator, ELF Branch
 - P.O. Box 30309 AMF
 - Memphis, TN 38130
 - Attn: ELF Unit Stop 37
 - (ii) Magnetic tape filing
 - Use the Philadelphia Service Center
- (3) Midstates Region
 - (a) Austin
 - Austin Service Center
 - Quality Assurance Division
 - Mail Stop 1053
 - P.O. Box 934
 - Austin, TX 78767
 - Attn: National Reporting Agent Analyst
 - (b) Kansas City
 - Use the Fresno Service Center
- (4) Western Region
 - (a) Fresno
 - Fresno Service Center
 - Stop 44
 - P.O. Box 12866
 - Fresno, CA 93779
 - Attn: Magnetic Tape Coordinator
 - (b) Ogden
 - Use the Fresno Service Center

.02 All questions regarding this revenue procedure may also be addressed to the National Reporting Agent Analyst, Austin Service Center, at (512) 460-4201 (not a toll-free number).

SECTION 9. OTHER RELATED DOCUMENTS

The programs requiring an Authorization as a prerequisite to participation are described in the following documents:

(1) For magnetic tape filing of Forms 940, 941, and 945, see Rev. Proc. 96-18, page 73, this Bulletin.

(2) For electronic filing of Form 941, see Rev. Proc. 96-19, page 80, this Bulletin.

(3) For magnetic tape filing of FTD information, see Rev. Proc. 89-48, 1989-2 C.B. 599; and

(4) For electronic transmission of FTDs, see Rev. Proc. 94-48, 1994-2 C.B. 694.

SECTION 10. EFFECT ON OTHER DOCUMENTS

This revenue procedure supersedes Rev. Proc. 89-18, 1989-1 C.B. 828. In addition, this revenue procedure supersedes the Authorization information contained in the following revenue procedures: Rev. Proc. 94-59, 1994-2 C.B. 747; Rev. Proc. 94-18, 1994-1 C.B. 580; Rev. Proc. 93-46, 1993-2 C.B. 545; and Rev. Proc. 89-48, 1989-2 C.B. 599.

SECTION 11. EFFECTIVE DATE

This revenue procedure is effective January 22, 1995.

26 CFR. 601.602: Tax forms and instructions. (Also Part 1, Sections 3504, 6011; 31.3504-1, 31.6011(a)-8, 31.6071(a)-1.)

Rev. Proc. 96-18

Table of Contents

- SECTION 1. PURPOSE
- SECTION 2. BACKGROUND
- SECTION 3. SIGNIFICANT CHANGES
- SECTION 4. DEFINITIONS
- SECTION 5. APPLICATION FOR THE MAGNETIC TAPE PROGRAMS
- SECTION 6. ACCEPTANCE IN THE MAGNETIC TAPE PROGRAMS
- SECTION 7. ADDING AND DELETING TAXPAYERS ON THE REPORTING AGENT'S LIST
- SECTION 8. MAGNETIC TAPE FILING
- SECTION 9. ADJUSTMENTS
- SECTION 10. RESPONSIBILITIES OF A REPORTING AGENT
- SECTION 11. PAPER RETURNS
- SECTION 12. REVISION OF COMPUTER SPECIFICATIONS BY THE SERVICE
- SECTION 13. CHANGES IN COMPUTER EQUIPMENT BY AN AGENT
- SECTION 14. ADVERTISING STANDARDS FOR A REPORTING AGENT
- SECTION 15. REASONS FOR SUSPENSION
- SECTION 16. ADMINISTRATIVE REVIEW PROCESS FOR PROPOSED SUSPENSION
- SECTION 17. EFFECT OF SUSPENSION
- SECTION 18. APPEAL OF SUSPENSION
- SECTION 19. PENALTY FOR FAILURE TO TIMELY FILE A RETURN
- SECTION 20. FILING FORMS W-4 WITH THE INTERNAL REVENUE SERVICE
- SECTION 21. FILING FORMS W-2 (COPY A) WITH THE SOCIAL SECURITY ADMINISTRATION

SECTION 22. REQUESTING FORMS AND OTHER INFORMATION

SECTION 23. EFFECT ON OTHER DOCUMENTS

SECTION 24. EFFECTIVE DATE

SECTION 1. PURPOSE

.01 This revenue procedure sets forth the requirements of the various magnetic tape programs under which a Reporting Agent ("Agent" as defined in section 4.04 of this revenue procedure) may file the following forms on magnetic tape: (1) Form 941, Employer's Quarterly Federal Tax Return ("Form 941 Mag Tape Program"); (2) Form 940, Employer's Federal Unemployment Tax Return ("Form 940 Mag Tape Program"); and (3) Form 945, Annual Return of Withheld Income Tax ("Form 945 Mag Tape Program"). These magnetic tape programs are collectively referred to as the "Mag Tape Programs."

.02 The technical specifications for filing these forms on magnetic tape are published separately as follows: (1) Publication 1264, File Specifications, Processing Criteria and Records Layouts for Magnetic Tape Filing of Form 941, Employer's Quarterly Federal Tax Return; (2) Publication 1314, File Specifications, Processing Criteria and Records Layouts for Magnetic Tape Filing of Form 940, Employer's Federal Unemployment Tax Return; and (3) Publication 1833, File Specifications, Processing Criteria and Records Layouts for Magnetic Tape Filing of Form 945, Annual Return of Withheld Income Tax. Publications 1264, 1314, and 1833 are collectively referred to as "Publications."

.03 This revenue procedure supersedes Rev. Proc. 94-18, 1994-1 C.B. 580, Rev. Proc. 93-46, 1993-2 C.B. 545, and Rev. Proc. 94-59, 1994-2 C.B. 747.

SECTION 2. BACKGROUND

.01 Section 31.6011(a)-8 of the Employment Taxes and Collection of Income Tax at Source Regulations provides that the Commissioner may authorize the use, at the option of the person required to make a return, of a composite return in lieu of any form specified in 26 C.F.R. Part 31 (Employment Taxes and Collection of Income Tax at Source), subject to the

conditions, limitations, and special rules governing the preparation, execution, filing, and correction thereof as the Commissioner may deem appropriate.

.02 For purposes of this revenue procedure, a magnetically filed Form 941, 940, or 945 is a composite return consisting of the data transmitted on magnetic tape and a Form 4996, Electronic/Magnetic Media Filing Transmittal for Wage and Withholding Tax Returns. Form 4996 must be received by the Internal Revenue Service before any magnetically filed return is complete. A magnetically filed return must contain the same information as a return filed completely on paper.

.03 Section 31.6011(a)-7 provides that each return, together with any prescribed copies or supporting data, must be filled in and disposed of in accordance with the forms, instructions, and regulations applicable thereto. The return may be made by an Agent in the name of the person required to make the return if an acceptable power of attorney is filed with the Internal Revenue Service office with which such person is required to file returns and if such a return includes all taxes required to be reported by such person on such return. Form 8655, Reporting Agent Authorization for Magnetic Tape/Electronic Filers, is an acceptable power of attorney, if prepared in accordance with the requirements set forth in Rev. Proc. 96-17, page 00, this Bulletin.

.04 Section 31.6061-1 provides that the return may be signed for the taxpayer by an agent who is fully authorized in accordance with § 31.6011(a)-7 to make such return. An Agent may sign a magnetic tape return on behalf of a taxpayer who has a valid Form 8655 on file with the Service.

.05 Section 31.6071(a)-1 generally provides that each return required to be made under § 31.6011(a)-1 for the taxes imposed by the Federal Insurance Contributions Act (Form 941), or required to be made under § 31.6011(a)-4 for withheld income taxes (Form 941 and Form 945), or each return required to be made under § 31.6011(a)-3 for the taxes imposed by the Federal Unemployment Tax Act (Form 940), must be filed on or before the last day of the first calendar month following the period for which it is made. However, under § 31.6071(a)-1 a re-

turn may be filed on or before the 10th day of the second calendar month following such period if timely deposits under § 6302(c) of the Internal Revenue Code and the regulations thereunder have been made in full payment of such taxes due for the period.

.06 Procedures for the electronic filing of Form 941 ("Form 941 ELF Program") are in Rev. Proc. 96-19, page , this Bulletin, and the specifications are in the Technical Specifications Guide for the Electronic Filing System for Form 941, Employer's Quarterly Federal Tax Return.

.07 The submission of federal tax deposit ("FTD") information on magnetic tape is addressed in Rev. Proc. 89-48, 1989-2 C.B. 599. For taxpayers who are required to make FTDs by electronic funds transfer pursuant to § 6302(h), the submission of the FTD information along with the transfer of funds is addressed in Rev. Proc. 94-48, 1994-2 C.B. 694.

SECTION 3. SIGNIFICANT CHANGES

.01 The procedures in Rev. Procs. 94-18, 93-46, and 94-59 for the magnetic tape filing of Forms 941, 940, and 945, respectively, have been consolidated in this revenue procedure.

.02 The magnetic tape specifications in Rev. Procs. 94-18, 93-46, and 94-59 are published separately in Publications 1264, 1314, and 1833, respectively.

.03 Section 14 provides advertising standards for an Agent.

.04 Sections 15, 16, 17, and 18 add suspension and appeal procedures.

SECTION 4. DEFINITIONS

.01 *Error Rate*. The "Error Rate" is the percentage of the total volume of tax data records that are identified by the Service's computer program as containing errors (as defined in the applicable Publications).

.02 *Magnetic Tape Coordinator for Business Tax Returns* ("Coordinator"). A Magnetic Tape Coordinator for Business Tax Returns ("Coordinator") is responsible for the administration of the Mag Tape Programs at a particular Service Center. See section 22 of this revenue procedure for the addresses of the Coordinators.

.03 *Processing Interruption*. A "Processing Interruption" is an abnor-

mal termination of a program run caused by the magnetic tape data submitted by an Agent.

.04 *Reporting Agent*. A Reporting Agent ("Agent") is an accounting service, franchiser, bank, or other entity that complies with Rev. Proc. 96-17, and is authorized to prepare and file Forms 941, 940, and 945 on magnetic tape for a taxpayer.

.05 *Reporting Agent Authorization*. A Reporting Agent Authorization ("Authorization") allows a taxpayer to designate an Agent. The Authorization may be submitted on Form 8655, or any other instrument that complies with Rev. Proc. 96-17. An Authorization must be submitted for each taxpayer on the Reporting Agent's List.

.06 *Reporting Agent's List*. For purposes of the Mag Tape Programs, a Reporting Agent's List ("Agent's List") identifies all taxpayers for whom an Agent will file returns on magnetic tape. A separate Form 8655 must be submitted for each taxpayer on the Agent's List. The Agent's List must contain each taxpayer's employer identification number ("EIN").

.07 *Validated Reporting Agent's List*. A Validated Reporting Agent's List ("Validated Agent's List") is the source of the EIN and name control to be used as an identification of each taxpayer on magnetic tape by an Agent. A Validated Agent's List is a list of taxpayers and their EINs prepared by an Agent that is confirmed and assigned name controls by the Service. Once the Service returns a Validated Agent's List, the Agent must use it to fill in certain required fields (e.g., the name control field) on the magnetic tape. See the applicable Publications.

SECTION 5. APPLICATION FOR THE MAGNETIC TAPE PROGRAMS

.01 An Agent is automatically eligible to participate in the Mag Tape Program(s) for which the Agent files at least 100 Forms 941, 100 Forms 940, or 100 Forms 945 per tax period. An Agent that files less than 100 Forms 941, 940, or 945 per tax period and wishes to file on magnetic tape must obtain permission from the Coordinator at the service center where the Letter of Application ("Application") would be submitted. See section 5.06 of this revenue procedure for where to submit an Application and section 22 for the addresses of the Coordinators.

.02 An Agent (within the scope of section 5.01 of this revenue procedure) desiring to file Forms 941, 940, or 945 on magnetic tape must first submit an Application to participate in the appropriate Mag Tape Program(s).

.03 An Application must contain the following:

(1) the name, address, and EIN of the Agent submitting the Application;

(2) the name, title, and telephone number of the person to contact regarding the Application;

(3) a list of all the service centers with which the Agent must file returns on behalf of taxpayers. A request to consolidate filings at one service center may be made in the Application immediately after this list;

(4) the first tax period for which the Agent plans to file Forms 941, 940, or 945 on magnetic tape;

(5) the estimated volume of Forms 941, 940, or 945 the Agent plans to file at each service center by type of return;

(6) a statement that the Agent will keep a copy of all the Authorizations on file at the Agent's principal place of business for examination by the Service upon request;

(7) a representation that the Agent will comply with section 10 of this revenue procedure concerning responsibilities of an Agent;

(8) an acknowledgement of any prior suspension from any of the magnetic tape or electronic filing programs, if applicable; and

(9) the signature of the Agent or the Agent's employee authorized to prepare federal tax returns for taxpayers.

.04 An Application must include two types of attachments:

(1) an Agent's List; and

(2) an Authorization (Form 8655) for each taxpayer included on the Agent's List. See Rev. Proc. 96-17 for instructions on preparing Form 8655.

.05 An Agent must submit the Application to the appropriate service center (listed in section 22 of this revenue procedure) that serves the legal residence or principal business address of the largest number of taxpayers filing through that Agent. If the Agent would like to consolidate filings at another service center, the Agent must submit an Application requesting such consolidation to the service center with which the consolidated returns would be filed.

.06 To allow sufficient time for the approval process for the Form 941 Mag Tape Program, the Agent should submit the Application by the Application due dates preceding the quarter ending dates, as follows:

<i>Application Due Date</i>	<i>For Quarter Ending</i>
December 15 (prior year)	March 31
March 15	June 30
June 15	September 30
September 15	December 31

.07 To allow sufficient time for the approval process for the Form 940 or Form 945 Mag Tape Program, the Agent should submit the Application by August 15 of the year preceding the due date of the returns that the Agent will file on magnetic tape.

SECTION 6. ACCEPTANCE IN THE MAGNETIC TAPE PROGRAMS

.01 Within 30 days of receiving an Application, the service center will return a Validated Agent's List to the Agent. Failure to use the names and EINs provided on the Validated Agent's List may delay processing.

.02 After receiving a Validated Agent's List, an Agent must submit a test tape by the following due dates:

(1) in the case of the Form 941 Mag Tape Program, the Agent must submit a test tape by the due dates preceding the corresponding quarter ending dates, as follows:

<i>Test Tape Due Date</i>	<i>For Quarter Ending</i>
January 31	March 31
April 30	June 30
July 31	September 30
October 31	December 31

(2) in the case of the Form 940 or 945 Mag Tape Program, the Agent must submit a test tape by September 30 of the year preceding the due date of the return that will be filed on magnetic tape.

.03 The following criteria are used to evaluate a test tape:

(1) the test tape must be readable by the Service's computers without a Processing Interruption; and

(2) the processed data on the test tape must have an Error Rate of 5 percent or less.

.04 If a test tape fails to meet the evaluation criteria, the Coordinator will notify the Agent. To receive further consideration of the Application, the Agent must submit a new test tape within 30 days of the Service's notification. Submission of a test tape does not constitute the filing of tax returns.

.05 After testing the magnetic tape, the Service will notify the Agent in writing of approval or denial of magnetic tape filing privileges. An approval for each Mag Tape Program remains in effect unless the Agent is suspended from the particular Mag Tape Program. See section 17 of this revenue procedure for the effect of suspension.

.06 If a Agent is denied, or does not receive, approval for magnetic tape filing before the end of the tax period for which Forms 941, 940, or 945 will be filed, the Agent should file the returns on paper Forms 941, 940, or 945.

.07 If an Agent is denied acceptance into a Mag Tape Program, the Agent may reapply for a subsequent tax period by resubmitting an Application and test tape in accordance with sections 5 and 6 of this revenue procedure.

SECTION 7. ADDING AND DELETING TAXPAYERS ON THE REPORTING AGENT'S LIST

.01 After an Agent is notified that the Application for the magnetic tape filing of Forms 941, 940, or 945 has been approved, the Agent may want to add and delete taxpayers from the Mag Tape Program.

.02 To add taxpayers, the Agent must submit the added names and EINs (Add List) and an Authorization for each taxpayer added to a particular Mag Tape Program. The Service must validate the Add List and return it to the Agent before the Agent can file returns for these taxpayers on magnetic tape. The Service will generally validate and mail the Add List to the Agent within 10 business days of receiving the Add List.

.03 To delete taxpayers, the Agent must submit a list of those taxpayers to be deleted (Delete List) and, if known, a short statement indicating which taxpayers will not remain in business.

SECTION 8. MAGNETIC TAPE FILING

.01 An Agent must ensure that a magnetic tape return is filed on or

before the due date of the return. The due dates prescribed for filing paper returns with the Service also apply to returns filed under the Mag Tape Programs. Forms 941, 940, and 945 are due on or before the last day of the first calendar month following the period for which the return is made. However, a return for which all tax deposits were made when due for the filing period may be filed by the 10th day of the month following the due date. In no case may one magnetic tape include returns with more than one due date.

.02 The place for filing returns will be determined according to the following conditions:

(1) under § 6091(b), federal tax returns must be filed at the service center serving the legal residence or principal business address of the taxpayer. However, not all service centers process returns filed on magnetic tape. The service center processing the Application will inform the Agent of which service center serves the legal residence or principal business address of a taxpayer for magnetic tape filing purposes;

(2) an Agent may be required to file taxpayers' magnetic tape returns at more than one service center unless the Agent obtains permission to consolidate filings under section 8.02(4) of this revenue procedure;

(3) if, after submitting the Application, an Agent obtains clients that file at a service center other than a service center(s) listed in the Application, the Agent must provide written notice to the service center that processed the Application. The written notice must be submitted at least 60 days before filing with the additional service center; and

(4) if, after submitting the Application, an Agent wishes to consolidate filings at one service center, the Agent must request permission. Generally, a response will be provided within 21 calendar days. The place to send the request is as follows:

(a) if a request is made before any returns have been filed under a particular Mag Tape Program and the returns will not be filed under that program before the Service acts on the request for consolidation, the request must be sent to the service center processing (or that processed) the Application; or

(b) if magnetic tape returns have already been filed or will be filed

before the Service acts on the request for consolidation, the Agent must send the request to the service center where the Agent requests to consolidate. The request must include a list of all the service centers with which returns have been or will be filed.

.03 An Agent must file magnetic tape returns according to the following instructions:

(1) the first box of the magnetic tape shipment to the service center must contain a Form 4996 with one duplicate, and a list of taxpayers' names and addresses (address is optional) in EIN sequence whose returns are on the magnetic tape being submitted (Control List). These taxpayers must only be those on the Validated Agent's List returned to the Agent. Detailed packaging, shipping, and mailing instructions will be provided in the letter granting approval to file on magnetic tape;

(2) if the Form 4996 is missing, incomplete, or unsigned, the magnetic tape filing does not constitute a tax return. Failure to complete this form accurately will delay the magnetic tape processing; and

(3) in the case of the Form 941 mag tape program, if an employee's wages and tips are exempt from tax on social security or medicare, an Agent must inform the Service by following specific instructions in Publication 1264.

.04 A violation of the following restrictions will cause a Processing Interruption:

(1) in no case may one magnetic tape include returns with more than one due date; or

(2) the magnetic tape must include only data for one form of return (e.g., Form 941). Data for another form of return (e.g., Form 940 or Form 945) must be submitted on a separate magnetic tape.

.05 The service center will send notification to the Agent of receipt of the magnetic tape submission. Unless otherwise advised within 10 business days of the Service's receipt of the Form 4996, an Agent may consider the returns included in that submission timely filed if the postmark date is on or before the due date of the returns. If the Agent does not receive notification of receipt of Form 4996 within 15 days from the date it was sent, the Agent should contact the appropriate Coordinator listed in section 22 of this revenue procedure.

.06 A magnetic tape submission made on or before the due date that causes a Processing Interruption or that has an Error Rate exceeding 5 percent will not be accepted, and the Agent will be asked to submit a replacement magnetic tape, an accompanying Form 4996, and paper returns within 30 days of the Coordinator's request. If the Agent submits the replacement magnetic tape, Form 4996, and paper returns within 30 days, the returns will be considered timely filed. For the penalty for failure to file a timely return, see section 19 of this revenue procedure.

.07 If the replacement magnetic tape is unacceptable, the Coordinator will process the paper returns and notify the Agent. In such circumstances, an Agent is required to submit an acceptable test tape for the next filing date by the test tape due dates set forth in section 6.02 of this revenue procedure.

SECTION 9. ADJUSTMENTS

.01 In the case of a Form 941, adjustments may be made on returns filed on magnetic tape. Except for adjustments resulting from rounding fractions of cents or from third-party sick pay for which an employer is not responsible, any Form 941 filed on magnetic tape with an adjustment to preceding quarters must be supported by a written statement or Form 941c, Supporting Statement to Correct Information, submitted with the magnetic tape. The statement must identify the taxpayer and explain the adjustment. An Agent must send the paper supporting documents and the magnetic tape containing the Forms 941 in the same shipment. For specification details, see Publication 1264.

.02 In the case of a Form 940, an adjustment to a Form 940 filed on magnetic tape must be submitted on paper to the service center where the magnetic tape was filed.

.03 In the case of a Form 945, adjustments must be made as follows:

(1) except as provided in section 9.03(2), an adjustment to a Form 945 filed on magnetic tape must be submitted on paper to the service center where the magnetic tape was filed; and

(2) beginning with 1995 calendar year returns, an Agent may adjust a prior year's Form 945 by entering a correction in a new field on a magnetic tape. However, this adjustment field

only applies to correcting administrative errors. Any Form 945 filed on magnetic tape with an adjustment to a preceding year must be supported by a statement or Form 941c. The statement must identify the taxpayer and explain the adjustment. An Agent must send the paper supporting documents and the magnetic tape containing the corrections to Forms 945 in the same shipment. For specification details, see Publication 1833.

SECTION 10. RESPONSIBILITIES OF A REPORTING AGENT

.01 To ensure that complete returns are accurately and efficiently filed, an Agent must comply with the applicable Publication(s) for the Mag Tape Program(s) in which the Agent is participating. See Publication 1264 (Form 941), 1314 (Form 940), or 1833 (Form 945).

.02 The Agent must retain the following material for 4 years after the due date of the return (or if the return is filed late, for a period of 4 years from the filing date), unless otherwise notified by the Service:

(1) a complete copy of the magnetic tape portion of the return;

(2) a copy of the signed Form 4996;

(3) a copy of the Service's notification of receipt of Form 4996; and

(4) a copy of each Authorization.

.03 An Agent must:

(1) provide the taxpayer with a paper copy of the magnetic tape information that was sent to the Service. This information may be provided on a replica of an official form or on an unofficial form. However, data entries on an unofficial form must refer to the line numbers on an official form;

(2) provide the taxpayer with a copy of the Form 4996;

(3) advise the taxpayer to retain a complete copy of the return (a paper copy of both the magnetic tape information and Form 4996) and any supporting material;

(4) inform the taxpayer of the service center that processes the taxpayer's returns;

(5) advise the taxpayer that an amended return, if needed, must be mailed to the service center that processed the taxpayer's return; and

(6) provide, upon request, the taxpayer with the date the taxpayer's

return was postmarked and with the date of the Service's notification of receipt of the taxpayer's return.

SECTION 11. PAPER RETURNS

.01 An Agent may use a Mag Tape Program Authorization to file paper Forms 941, 940, or 945 only under the following circumstances:

(1) the late receipt of payroll or withholding information from a taxpayer that would jeopardize the timely submission of the taxpayer's return;

(2) the amendment of returns filed under the Mag Tape Programs;

(3) the rejection of a magnetic tape filing that would jeopardize the timely submission of the taxpayer's return; or

(4) a request by the Coordinator for an Agent participating in a Mag Tape Program to file paper returns instead of magnetic tape.

.02 An Agent without a valid power of attorney may prepare a paper return for the taxpayer's signature. A taxpayer's authorized representative that is not an Agent participating in a Mag Tape Program (including a suspended Agent) must have a valid power of attorney (usually a Form 2848, Power of Attorney and Declaration of Representative) that authorizes the Agent to sign and file a paper return on behalf of a taxpayer.

.03 Each paper return must be signed by the taxpayer, the taxpayer's authorized representative, or a participating Agent, to the extent permitted by section 11.01 of this revenue procedure.

SECTION 12. REVISION OF COMPUTER SPECIFICATIONS BY THE SERVICE

.01 If a Publication is revised, the Coordinator(s), if necessary, will advise all current Agents to submit test tapes prior to filing under the new specifications. Failure to submit a test tape may later result in a Processing Interruption or an Error Rate exceeding 5 percent on returns filed on magnetic tape for which an Agent may receive a notice of suspension. See section 15 of this revenue procedure concerning the reasons for suspension of magnetic tape filing privileges.

.02 If an Agent is unable to comply with the changes in specifications, the

Agent must contact the appropriate Coordinator(s) for further instructions. See section 22 of this revenue procedure for addresses.

SECTION 13. CHANGES IN COMPUTER EQUIPMENT BY AN AGENT

If an Agent changes computer equipment, a test tape must be submitted. The requirements in sections 6.02, 6.03, and 6.04 of this revenue procedure must be followed for the submission and acceptance of test tapes. Failure to submit a test tape may later result in a Processing Interruption or an Error Rate exceeding 5 percent on returns filed on magnetic tape for which an Agent may receive a notice of suspension. See section 15 of this revenue procedure.

SECTION 14. ADVERTISING STANDARDS FOR A REPORTING AGENT

.01 An Agent must comply with the advertising and solicitation provisions of 31 C.F.R. Part 10 (Treasury Department Circular No. 230). This circular prohibits the use or participation in the use of any form of public communication containing a false, fraudulent, misleading, deceptive, unduly influencing, coercive, or unfair statement or claim. In addition, advertising must not imply a special relationship with the Service, Financial Management Service (FMS), or the Treasury Department.

.02 An Agent must adhere to all the relevant federal, state, and local consumer protection laws.

.03 An Agent must not use the Service's name, "Internal Revenue Service" or "IRS", within a firm's name.

.04 An Agent must not use improper or misleading advertising in relation to the Mag Tape Programs.

.05 Advertising materials shall not carry the FMS, IRS, or other Treasury Seals.

.06 Advertising for a cooperative magnetic tape return project (public/private sector) must clearly state the names of all cooperating parties.

.07 If an Agent uses radio or television broadcasting to advertise, the broadcast must be pre-recorded. The Agent must keep a copy of the pre-recorded advertisement for a period of

at least 36 months from the date of the last transmission or use.

.08 If an Agent uses any direct mailing or fax communications to advertise, the Agent must retain a copy of the actual mailing or fax, along with a list or other description of persons to whom the communication was mailed, faxed, or otherwise distributed for a period of at least 36 months from the date of the last mailing, fax, or distribution.

.09 Acceptance to participate in any of the Mag Tape Programs does not imply endorsement by the Service or FMS of the software or quality of services provided.

SECTION 15. REASONS FOR SUSPENSION

.01 The Service reserves the right to suspend an Agent from a Mag Tape Program for the following reasons (this list is not all-inclusive):

(1) failing to submit tax returns on magnetic tape according to the applicable Publication(s) as provided in section 10.01 of this revenue procedure;

(2) failing to retain the required records for the period specified in section 10.02;

(3) failing to provide to the taxpayer the records, information, or advice required by section 10.03;

(4) submitting tax returns for which the Service did not receive Authorizations;

(5) repeatedly submitting tax returns that have an Error Rate exceeding 5 percent or that cause a Processing Interruption (regardless of whether replacement magnetic tapes have been provided timely);

(6) submitting tax returns that have an Error Rate exceeding 5 percent or that cause a Processing Interruption after failing to submit the test tape required by section 12 or 13;

(7) submitting tax returns that are not in full-paid status;

(8) failing to abide by the advertising standards in section 14; or

(9) significant complaints about an Agent's performance in the Mag Tape Program(s).

.02 If the Coordinator informs an Agent that a certain action is a reason for suspension and the action continues, the service center director may send a notice proposing suspension of the Agent. However, a notice proposing

suspension may be sent without a warning if the Agent's action indicates an intentional disregard of rules. A notice proposing suspension will describe the reason(s) for the proposed suspension, and indicate the length of the suspension and the conditions that need to be met before the suspension will terminate.

.03 An Agent has an obligation to notify taxpayers filing through the Agent if and when such Agent is suspended from filing under a particular Mag Tape Program as provided in section 17.04. The Service reserves the right to extend the period of suspension of any Agent that fails to comply with this requirement.

SECTION 16. ADMINISTRATIVE REVIEW PROCESS FOR PROPOSED SUSPENSION

.01 An Agent who receives a notice proposing suspension from one or more of the Mag Tape Programs may request an administrative review prior to the proposed suspension taking effect.

.02 The request for an administrative review must be in writing and contain detailed reasons, with supporting documentation, for withdrawal of the proposed suspension.

.03 The written request for an administrative review and a copy of the notice proposing suspension must be delivered to the Coordinator within 30 calendar days of the date on the notice proposing suspension. The Coordinator will forward the written request to the National Program Analyst for Magnetic Tape Program ("National Coordinator") if the service center director continues to believe that suspension is warranted.

.04 After consideration of the written request for an administrative review, the National Coordinator will either issue a suspension letter or notify the Agent in writing that the proposed suspension is withdrawn.

.05 If an Agent receives a suspension letter, a Coordinator's subsequent determination of whether a reason for suspension has been corrected is not subject to review or appeal.

.06 If an Agent does not timely submit a written request for an administrative review, the service center director will issue a suspension letter.

.07 Failure to submit a written request for an administrative review

within the 30-day period described in section 16.03 of this revenue procedure irrevocably terminates the Agent's right to an administrative review of the proposed suspension.

SECTION 17. EFFECT OF SUSPENSION

.01 The Agent's suspension will continue for the length of time specified in the suspension letter, or until the conditions for terminating the suspension have been met, whichever is later.

.02 If a return to which the suspension applies is due (without regard to extensions) within 60 days from the date on the suspension letter, the Agent may file the return under the Mag Tape Program. If a return to which the suspension applies is due (without regard to extensions) more than 60 days from the date on the suspension letter, the Agent may not file the return under that Mag Tape Program.

.03 A suspended Agent will be able to sign and file paper Forms 940, 941, or 945 for a taxpayer if the Agent has a power of attorney from the taxpayer that authorizes the Agent to sign and file such paper return(s). See section 11.02 of this revenue procedure. Form 8655 does not authorize the filing of paper returns outside of the Mag Tape Program.

.04 An Agent must provide written notification of a suspension to a taxpayer at least 45 days before the due date of the taxpayer's first return affected by the suspension. Such notification must be provided even though the Agent may believe that the Agent will be able to meet the conditions for terminating the suspension before the due date.

.05 An Agent will be able to file returns under the Mag Tape Program from which the Agent was suspended without reapplying to the Program after:

- (1) the stated suspension period expires; and
- (2) the reason(s) for suspension are corrected.

SECTION 18. APPEAL OF A SUSPENSION

.01 If an Agent receives a suspension letter from the National Coordinator, the Agent is entitled to appeal, by

written protest, to the National Director of Appeals. The written protest must be sent to the National Coordinator, who will forward it to the National Director of Appeals. During the appeals process, the suspension remains in effect.

.02 The written protest must be received by the National Coordinator within 30 calendar days of the date of the suspension letter. The written protest must contain detailed reasons, with supporting documentation, for withdrawal of the suspension.

.03 Within 15 calendar days of receipt of a written protest, the National Coordinator will forward the file on the Agent and the material described in section 18.02 of this revenue procedure to the National Director of Appeals.

.04 Failure to appeal within the 30-day period described in section 18.02 of this revenue procedure irrevocably terminates the Agent's right to appeal the suspension.

SECTION 19. PENALTY FOR A FAILURE TO TIMELY FILE A RETURN

Section 6651(a)(1) provides that for each month (or part thereof) a return is not filed when required (determined with regard to any extensions of time for filing), there is a penalty of 5 percent of the unpaid tax not to exceed 25 percent, absent reasonable cause. A taxpayer does not establish reasonable cause simply by engaging a competent Agent to file the taxpayer's return. However, if the Agent has reasonable cause under § 6651(a) for failing to timely file the taxpayer's return, the taxpayer will also have reasonable cause for that failure, and the failure-to-file penalty will be abated.

SECTION 20. FILING FORMS W-4 WITH THE INTERNAL REVENUE SERVICE

.01 An employer is required to send to the Service by the due date of the quarterly return copies of all Forms W-4, Employee's Withholding Allowance Certificates, received during the quarter from employees still employed at the end of the quarter who claim:

- (1) more than 10 withholding exemptions; or
- (2) exempt status and are expecting to earn more than \$200 a week.

Employers should not send other Forms W-4 unless notified by the Service in writing to do so.

.02 If an employer's Form 941 is filed under the Form 941 Mag Tape Program, copies of paper Forms W-4 along with a cover letter providing the employer's name, address, EIN, and the number of Forms W-4 included must be sent to the service center that would have received the employer's paper Form 941. See Publication 15, Circular E, Employer's Tax Guide, for more information on sending Forms W-4 to the Service.

.03 Forms W-4 information may also be filed on magnetic media (5¼ inch diskettes, 3½ inch diskettes, or

magnetic tape). See Publication 1245, Specifications for Filing Form W-4, Employee's Withholding Allowance Certificate, on Magnetic Tape, and 5¼- and 3½-Inch Magnetic Diskettes, for more information concerning magnetic media filing of Forms W-4.

SECTION 21. FILING FORMS W-2 (COPY A) WITH THE SOCIAL SECURITY ADMINISTRATION

Forms W-2, Wage and Tax Statements, must be filed directly with the Social Security Administration on magnetic media or paper. For information on magnetic media reporting of Form W-2, contact the Social Security Administration's Regional Magnetic Media Coordinators.

SECTION 22. REQUESTING FORMS AND OTHER INFORMATION

.01 To obtain forms and publications, use the order blank included in Publication 15, Circular E, Employer's Tax Guide.

.02 Requests for additional copies of this revenue procedure and other revenue procedures or publications concerning magnetic tape filing, applications for magnetic tape filing, copies of Forms 4996 and 8655, or requests for copies of Publication 1264, 1314, or 1833, should be addressed to the Service at any one of the following service centers:

Locations of Service Centers

(1) Northeast Region:

(a) Andover

Service Center Processing Magnetic Tape Filings for those locations

Andover Service Center
Management Support Branch
Mail Stop 105
310 Lowell Street
Andover, MA 05501
Attn: Magnetic Tape Coordinator

(b) Brookhaven

Brookhaven Service Center
Stop 111
P.O. Box 400
Holtsville, NY 11742
Attn: Magnetic Tape Coordinator

(c) Cincinnati

Magnetic tape filers use the Philadelphia Service Center

(d) Philadelphia

Philadelphia Service Center
Mag Media Project Office
Mail Stop 115
11601 Roosevelt Blvd.
Philadelphia, PA 19154

(2) Southeast Region:

(a) Atlanta

Atlanta Service Center
Stop 30
P.O. Box 47-421
Doraville, GA 30362
Attn: Magnetic Tape Coordinator

(b) Memphis

Magnetic tape filers use the Philadelphia Service Center

(3) Midstates Region:

(a) Austin

Magnetic tape filers use the Fresno Service Center

(b) Kansas City

Magnetic tape filers use the Fresno Service Center

(4) Western Region:

(a) Fresno

Fresno Service Center
Stop 44
P.O. Box 12866
Fresno, CA 93779
Attn: Magnetic Tape Coordinator

(b) Ogden

Magnetic tape filers use the Fresno Service Center

SECTION 23. EFFECT ON OTHER DOCUMENTS

This revenue procedure supersedes Rev. Proc. 94-18, 1994-1 C.B. 580, Rev. Proc. 93-46, 1993-2 C.B. 545, and Rev. Proc. 94-59, 1994-2 C.B. 747.

SECTION 24. EFFECTIVE DATE

This revenue procedure is effective for returns due after December 31, 1995 (without regard to extensions).

26 CFR. 601.602: Tax forms and instructions. (Also Part I, Sections 3504, 6011, 6071; 31.3504-1, 31.6011(a)-7, 31.6011(a)-8, 31.6071(a)-1.)

Rev. Proc. 96-19

Table of Contents

SECTION 1. PURPOSE
SECTION 2. BACKGROUND
SECTION 3. SCOPE
SECTION 4. DEFINITIONS
SECTION 5. APPLICATION FOR THE FORM 941 ELF PROGRAM
SECTION 6. ACCEPTANCE IN THE FORM 941 ELF PROGRAM
SECTION 7. ADDING AND DELETING TAXPAYERS ON THE REPORTING AGENT'S LIST
SECTION 8. ELECTRONIC FILING OF FORM 941
SECTION 9. ADJUSTMENTS TO FORM 941
SECTION 10. RESPONSIBILITIES OF AN ELECTRONIC FILER
SECTION 11. ALTERNATIVE FILING PROCEDURES
SECTION 12. REVISION OF COMPUTER SPECIFICATIONS BY THE SERVICE
SECTION 13. ADVERTISING STANDARDS FOR A REPORTING AGENT
SECTION 14. REASONS FOR SUSPENSION
SECTION 15. ADMINISTRATIVE REVIEW PROCESS FOR PROPOSED SUSPENSION
SECTION 16. EFFECT OF SUSPENSION
SECTION 17. APPEAL OF SUSPENSION

SECTION 18. PENALTY FOR FAILURE TO TIMELY FILE A RETURN

SECTION 19. FILING FORMS W-4 WITH THE INTERNAL REVENUE SERVICE

SECTION 20. FILING FORMS W-2 (COPY A) WITH THE SOCIAL SECURITY ADMINISTRATION

SECTION 21. INTERNAL REVENUE SERVICE CONTACT

SECTION 22. EFFECTIVE DATE

SECTION 1. PURPOSE

This revenue procedure sets forth the requirements of a program under which a taxpayer or a Reporting Agent ("Agent" as defined in section 4.06 of this revenue procedure) may electronically file Form 941, Employer's Quarterly Federal Tax Return ("Form 941 ELF Program"). The technical specifications for filing Form 941 electronically are published separately in the Technical Specifications Guide for the Electronic Filing System for Form 941, Employer's Quarterly Federal Tax Return ("Specifications Guide").

SECTION 2. BACKGROUND

.01 Section 31.6011(a)-8 of the Employment Taxes and Collection of Income Tax at Source Regulations provides that the Commissioner may authorize the use, at the option of the person required to make a return, of a composite return in lieu of any form specified in 26 C.F.R. Part 31 (Employment Taxes and Collection of Income Tax at Source), subject to the conditions, limitations, and special rules governing the preparation, execution, filing, and correction thereof as the Commissioner may deem appropriate.

.02 For purposes of this revenue procedure, an electronically filed Form 941 is a composite return consisting of the electronically transmitted Form 941 data and a Form 4996, Electronic/Magnetic Media Filing Transmittal for Wage and Withholding Tax Returns. Form 4996 must be received by the Internal Revenue Service before any electronically filed return is complete. An electronically filed return must contain the same information as a return filed completely on paper.

.03 Section 31.6011(a)-7 provides that each return, together with any prescribed copies or supporting data, must be filled in and disposed of in accordance with the forms, instructions, and regulations applicable thereto. The return may be made by an agent in the name of the person required to make the return if an acceptable power of attorney is filed with the Internal Revenue Service office with which such person is required to file returns and if such a return includes all taxes required to be reported by such person on such return. Form 8655, Reporting Agent Authorization for Magnetic Tape/Electronic Filers, is an acceptable power of attorney, if prepared in accordance with the requirements set forth in Rev. Proc. 96-17, page 00, this Bulletin.

.04 Section 31.6061-1 provides that the return may be signed for the taxpayer by an agent who is fully authorized in accordance with § 31.6011(a)-7 to make such return. An Agent may sign the Form 941 on behalf of a taxpayer who has a valid Form 8655 on file with the Service.

.05 Section 31.6071(a)-1 generally provides that each return required to be made under § 31.6011(a)-1 for taxes imposed by the Federal Insurance Contributions Act, or required to be made under § 31.6011(a)-4 for withheld income taxes, must be filed on or before the last day of the first calendar month following the period for which it is made. However, under § 31.6071(a)-1 a return may be filed on or before the 10th day of the second calendar month following such period if timely deposits under § 6302(c) of the Internal Revenue Code and the regulations thereunder have been made in full payment of such taxes due for the period.

.06 The Service has conducted a test of the electronic filing of Forms 941 in Electronic Data Interchange ("EDI") format developed by the American National Standards Institute.

.07 Procedures for the magnetic filing of Form 941 are in Rev. Proc. 96-18, page , this Bulletin, and the specifications are in Publication 1264, File Specifications, Processing Criteria and Record Layouts for Magnetic Tape Filing of Form 941, Employer's Quarterly Federal Tax Return.

.08 The submission of federal tax deposit ("FTD") information on magnetic tape is addressed in Rev. Proc. 89-48, 1989-2 C.B. 599. For taxpayers

who are required to make FTDs by electronic funds transfer pursuant to § 6302(h), the submission of the FTD information along with the transfer of funds is addressed in Rev. Proc. 94-48, 1994-2 C.B. 694.

SECTION 3. SCOPE

.01 The electronic filing of Forms 941 test referenced in section 2.06 of this revenue procedure is being replaced by this revenue procedure. The Service will now accept electronically filed Forms 941 in EDI format filed by an Electronic Filer (as defined in section 4.01 of this revenue procedure) that meets the requirements of this revenue procedure.

.02 An Electronic Filer in the Form 941 ELF Program must use asynchronous communications protocols to transmit electronic returns. See the Specifications Guide for further information regarding communications and formatting requirements.

.03 The Form 941 ELF Program accepts timely current returns that are zero balance or refund returns. The Form 941 ELF Program will not accept the electronic filing of the following returns:

- (1) balance due returns;
 - (2) amended returns;
 - (3) corrected returns;
 - (4) returns containing attachments;
- or
- (5) untimely returns.

A violation of any of these restrictions will cause a Processing Interruption (as defined in section 4.05 of this revenue procedure).

SECTION 4. DEFINITIONS

.01 *Electronic Filer.* After acceptance in the Form 941 ELF Program, an Agent or taxpayer (i.e., employer) that files Forms 941 electronically will be referred to as an "Electronic Filer."

.02 *Electronic Filing Help Desk.* The Electronic Filing Help Desk ("ELF Help Desk") is responsible for the administration of the Form 941 ELF Program. See section 21 of this revenue procedure for the address and telephone number of the ELF Help Desk.

.03 *Error Rate.* The "Error Rate" is the percentage of the total volume of tax data records that are identified by the Service's computer program as containing errors (as defined in the Specifications Guide).

.04 *Personal Identification Number.* A Personal Identification Number ("PIN") is a number assigned by the Service to a person named by the Electronic Filer who is authorized to sign Form 941.

.05 *Processing Interruption.* A "Processing Interruption" is an abnormal termination of a program run caused by the electronic data submitted by an Electronic Filer.

.06 *Reporting Agent.* A Reporting Agent ("Agent") is an accounting service, franchiser, bank, or other entity that complies with Rev. Proc. 96-17, and is authorized to prepare and file Form 941 electronically for a taxpayer.

.07 *Reporting Agent Authorization.* A Reporting Agent Authorization ("Authorization") allows a taxpayer to designate an Agent. The Authorization may be submitted on Form 8655, or any other instrument that complies with Rev. Proc. 96-17. An Authorization must be submitted for each taxpayer on the Reporting Agent's List.

.08 *Reporting Agent's List.* For purposes of the Form 941 ELF Program, a Reporting Agent's List ("Agent's List") identifies all taxpayers for whom an Agent will file Forms 941 electronically. A separate Form 8655 must be submitted for each taxpayer on the Agent's List. The Agent's List must contain each taxpayer's employer identification number ("EIN").

.09 *User identification/password.* The user identification/password ("userid/password") consists of an identification number (userid) issued by the Service and a confidential set of characters (password) that, when used in conjunction with each other, permit an Electronic Filer access to the Form 941 ELF system.

.10 *Validated Reporting Agent's List.* A Validated Reporting Agent's List ("Validated Agent's List") is the source of the EIN and name control to be used as an identification of each taxpayer by an Electronic Filer that is an Agent. A Validated Agent's List is a list of taxpayers and their EINs prepared by an Agent that is confirmed and assigned name controls by the Service. Once the Service returns a Validated Agent's List, the Agent must use it to fill in certain required fields (e.g., the name control field) of the electronic transmission. See the Specifications Guide.

SECTION 5. APPLICATION FOR THE FORM 941 ELF PROGRAM

.01 A prospective Electronic Filer desiring to file Form 941 electronically must first submit a Letter of Application ("Application") to participate in the Form 941 ELF Program.

.02 An Application must contain the following:

(1) the name, address, and EIN of the prospective Electronic Filer submitting the Application;

(2) the name, title, and telephone number of the person to contact regarding the Application;

(3) the first tax period for which the prospective Electronic Filer plans to file Forms 941 electronically;

(4) the estimated volume of returns the prospective Electronic Filer plans to file under the Form 941 ELF Program;

(5) the brand name of the software translation package and the EDI version to be used;

(6) a statement that the prospective Electronic Filer will keep a copy of all the Authorizations on file at the prospective Electronic Filer's principal place of business for examination by the Service upon request;

(7) a representation that the prospective Electronic Filer will comply with section 10 of this revenue procedure concerning responsibilities of an Electronic Filer;

(8) an acknowledgement of any prior suspension from any of the magnetic tape or electronic filing programs, if applicable;

(9) the signature of the prospective Electronic Filer's authorized signatory for filing federal tax returns for the prospective Electronic Filer; and

(10) the name and title of the person who is authorized to use the PIN for returns filed under the Form 941 ELF Program. See Exhibit 1 of this revenue procedure for a sample Application.

.03 In the case of an Electronic Filer that is an Agent, an Application must include two types of attachments:

(1) an Agent's List; and

(2) an Authorization (Form 8655) for each taxpayer included on the Agent's List fulfilling the following requirements:

(a) an Authorization executed after January 31, 1996, must be made

on Form 8655 (with a revision date of October 1995 or later) or its equivalent;

(b) except to the extent provided in section 5.03(2)(c) of this revenue procedure, an Authorization will remain in effect until a new Authorization is received by the Service.

(c) the Service will not accept Forms 941 filed electronically by an Agent after December 31, 1996, unless the Service has received an Authorization on Form 8655 (with a revision date of October 1995 or later) or its equivalent that expressly permits the Agent to file tax returns electronically on behalf of the taxpayer. The Service will accept Forms 941 filed electronically by an Agent prior to January 1, 1997, unless the Service has received an Authorization that expressly precludes the Agent from filing tax returns electronically on behalf of the taxpayer. See Rev. Proc. 96-17 for instructions on preparing Form 8655.

.04 To allow sufficient time for the approval process, the prospective Electronic Filer should submit the Application by the Application due dates preceding the quarter ending dates, as follows:

<i>Application Due Date</i>	<i>For Quarter Ending</i>
December 15 (prior year)	March 31
March 15	June 30
June 15	September 30
September 15	December 31

.05 The Application must be submitted to the Service at the address provided in section 21 of this revenue procedure.

.06 An Application *may not* include a request to file Forms 941, 940, and 945 on magnetic tape or make FTD payments and submit FTD information to the Service on magnetic tape or electronically. A prospective Electronic Filer interested in participating in such programs should submit an Application in accordance with the following revenue procedures: Rev. Proc. 96-18 (magnetic tape filing of Forms 941, 940, and 945); Rev. Proc. 94-48, 1994-2 C.B. 694 (electronic transmission of FTDs); and Rev. Proc. 89-48, 1989-2 C.B. 599 (magnetic tape filing of FTD information).

SECTION 6. ACCEPTANCE IN THE FORM 941 ELF PROGRAM

.01 In the case of an Electronic Filer that is an Agent, within 30 days of receiving the Agent's Application, the Memphis Service Center will return a Validated Agent's List to the Agent. Failure to use the names and EINs provided on the Validated Agent's List may delay processing.

.02 A prospective Electronic Filer must contact the ELF Help Desk at the numbers listed in section 21 of this revenue procedure to notify the Service that the prospective Electronic Filer is ready to begin the testing process. In the case of an Electronic Filer that is an Agent, the Agent must contact the ELF Help Desk after receiving the Validated Agent's List.

.03 A prospective Electronic Filer must transmit an initial test electronic transmission of Form 941 ("test file") by the test file due dates preceding the corresponding quarter due dates, as follows:

<i>Initial Test File Due Date</i>	<i>For Quarter Ending</i>
April 10	March 31
July 10	June 30
October 10	September 30
January 10	December 31

Subsequent test files may be transmitted at any time *except* during months when returns are filed (*e.g.*, May, August, November and February), unless an exception is granted by the ELF Help Desk. Transmission of a test file does not constitute the filing of a tax return. See Specifications Guide for specific testing procedures.

.04 After evaluating the test file, the Service will notify a prospective Electronic Filer in writing of approval or denial of electronic filing privileges. An approval remains in effect unless the Electronic Filer:

- (1) fails to comply with the Authorization requirements of section 5.03(2) of this revenue procedure; or
- (2) is suspended from the Form 941 ELF Program. See section 16 of this revenue procedure for effect of suspension.

.05 If an Application is approved, the Service will send the Electronic Filer the following two documents:

- (1) a notification of approval that will contain the userid/password, and

information and procedures regarding signing onto the system for filing electronic Forms 941; and

- (2) a PIN that may only be used by the authorized employee named in the Application.

.06 Upon receipt of each document referenced in section 6.05 of this revenue procedure, the Electronic Filer must return the following documents to the Service:

- (1) an acknowledgement signed by each employee recipient of the userid/password indicating possession of, and responsibility for, the userid/password; and

- (2) an acknowledgement signed by the Electronic Filer's authorized signatory indicating possession of, and responsibility for, the PIN.

See Exhibit 2 of this revenue procedure for a sample userid/password and PIN receipt.

.07 The Service will activate the PIN and the userid/password upon receiving the Electronic Filer's acknowledgements of the receipt of the two documents referenced in section 6.05 of this revenue procedure.

.08 If a prospective Electronic Filer's test file fails to meet the evaluation criteria, the prospective Electronic Filer must, within 15 days of the Service's notification of the failure, transmit a new test file or contact the ELF Help Desk to make other arrangements.

.09 If a prospective Electronic Filer is denied, or does not receive, approval for participating in the Form 941 ELF Program before the end of the tax quarter for which the Forms 941 will be filed, the prospective Electronic Filer should file the returns on paper Forms 941 (or on magnetic tape if the prospective Electronic Filer meets the requirements of Rev. Proc. 96-18).

.10 If an Electronic Filer is denied acceptance into the Form 941 ELF Program, the Electronic Filer may reapply for a subsequent tax quarter by resubmitting an Application and test file in accordance with sections 5 and 6 of this revenue procedure.

SECTION 7. ADDING AND DELETING TAXPAYERS BY A REPORTING AGENT

.01 After an Electronic Filer that is an Agent is notified that the application for electronic filing of Forms 941 has

been approved, the Agent may want to add and delete taxpayers from the Form 941 ELF Program.

.02 To add taxpayers, the Agent must submit the added names and EINs (Add List) and an Authorization for each taxpayer added to the Form 941 ELF Program. The Service must validate the Add List and return it to the Agent before the Agent can electronically file returns for these taxpayers. The Service will generally validate and mail the Add List to the Agent within 10 business days of receiving the Add List.

.03 To delete taxpayers, the Agent must submit a list of those taxpayers to be deleted (Delete List) and, if known, a short statement indicating which taxpayers will not remain in business.

SECTION 8. ELECTRONIC FILING OF FORM 941

.01 An Electronic Filer must ensure that an electronic return is filed on or before the due date of the return. The due dates prescribed for filing paper Forms 941 with the Service also apply to returns filed under the Form 941 ELF Program. Forms 941 are due on or before the last day of the first calendar month following the period for which the return is made. However, a return for which all tax deposits were made when due for the quarter may be filed by the 10th day of the month following the due date. In no case may one electronic transmission include returns with more than one due date.

.02 An Electronic Filer must complete Form 4996 and submit it within one work day after the Electronic Filer receives acknowledgement that the electronic portion of the taxpayer's return has been accepted for processing.

.03 An Electronic Filer that is an Agent must also submit with the Form 4996 a list of taxpayers' names and addresses (address is optional) in EIN sequence whose returns are on the electronic transmission (Control List). The taxpayers on the Control List should be only those on the Validated Agent's List returned to the Agent.

.04 A tax return is not considered filed until the electronic portion of the tax return has been acknowledged as accepted for processing and a completed and signed Form 4996 has been received by the Service. If the Form 4996 is missing, incomplete, or un-

signed, the electronic transmission does not constitute a tax return. However, if the electronic portion of a return is transmitted on or before the due date and the Electronic Filer complies with section 8.02 (sections 8.02 and 8.03 for Agents) of this revenue procedure, the return will be deemed timely filed. If the electronic portion of the return is initially transmitted on or shortly before the return due date and is ultimately rejected, but the Electronic Filer complies with section 8.05 of this revenue procedure, the return will be deemed timely filed.

.05 An electronic transmission that causes a Processing Interruption or that has an Error Rate exceeding 5 percent will not be accepted, and the Electronic Filer will be asked to resubmit the return(s). If the electronic transmission is acknowledged as rejected by the Service, the Electronic Filer should correct the error(s) and retransmit the return(s) on the same calendar day. If the Electronic Filer chooses not to have the previously rejected return retransmitted, or if the return still cannot be accepted for processing, a paper Form 941 (or a Form 941 on magnetic tape if the Electronic Filer meets the requirements of Rev. Proc. 96-18) must be filed by the later of: (1) the due date of the return; or (2) within five calendar days of the rejection or notice that the return cannot be retransmitted, with an explanation of why the return is being filed after the due date. For the penalty for failure to file a timely return, see section 18 of this revenue procedure.

.06 If the Service does not receive Form 4996 within 3 business days of the electronic transmission, the Service will contact the Electronic Filer. Unless otherwise advised within 15 days of the electronic transmission, an Electronic Filer may consider the returns included in that transmission timely filed if the postmark date on the envelope submitting the Form 4996 is on or before the due date of the returns, and the Electronic Filer has received acknowledgement that the electronic portion of the taxpayers' returns have been accepted by the Service for processing.

SECTION 9. ADJUSTMENTS TO FORM 941

Forms 941 filed under the Form 941 ELF Program must not contain adjustments other than adjustments resulting from rounding fractions of cents or

from third-party sick pay for which an employer is not responsible. Returns with other adjustments must be filed on magnetic tape or on paper.

SECTION 10. RESPONSIBILITIES OF AN ELECTRONIC FILER

.01 To ensure that complete returns are accurately and efficiently filed, an Electronic Filer must comply with the Specifications Guide.

.02 The Electronic Filer must retain the following material for 4 years after the due date of the return (or if the return is filed late, for a period of 4 years from the filing date), unless otherwise notified by the Service:

- (1) a complete copy of the electronic portion of the return;
- (2) a copy of the signed Form 4996;
- (3) a copy of the Service's acknowledgement of receipt of the return; and
- (4) a copy of each Authorization.

.03 An Electronic Filer that is an Agent must:

- (1) provide the taxpayer with a paper copy of the electronic information that was sent to the Service. This information may be provided on a replica of an official form or on an unofficial form. However, data entries on an unofficial form must refer to the line numbers on an official form;
- (2) provide the taxpayer with a copy of the Form 4996;
- (3) advise the taxpayer to retain a complete copy of the return (a paper copy of both the electronic information and Form 4996) and any supporting material;
- (4) inform the taxpayer of the service center that processes the taxpayer's returns;
- (5) advise the taxpayer that an amended return, if needed, must be filed as a paper return and mailed to the Memphis Service Center. See section 9 of this revenue procedure for adjustments to Forms 941; and

(6) provide, upon request, the taxpayer with the date the taxpayer's return was postmarked and with the date of the Service's acknowledgment of receipt of the electronic portion of the taxpayer's return.

.04 An Electronic Filer must comply with the following PIN and user/id/password requirements:

(1) an authorized employee of the Electronic Filer must submit a signed receipt acknowledging receipt of the userid/password, and accepting the associated responsibilities. See Exhibit 2 of this revenue procedure for a sample userid/password receipt;

(2) after submitting the userid/password receipt to the Service and receiving the PIN, the authorized signatory for the Electronic Filer must submit a signed receipt acknowledging receipt of the PIN, and accepting the associated responsibilities. See Exhibit 2 of this revenue procedure for a sample PIN receipt;

(3) the Electronic Filer is responsible for ensuring that the PIN remains the confidential information of the Electronic Filer's authorized signatory. If the Electronic Filer suspects that the confidentiality of the PIN and/or password has been compromised, the Electronic Filer must contact the ELF Help Desk within 24 hours for instructions on how to proceed. See section 21 of this revenue procedure for Service contact information; and

(4) if the authorized signatory for an Electronic Filer changes, the Electronic Filer must notify the Service of the name and title of the new authorized signatory for the electronically filed Form 941 and apply for a new PIN no later than 15 days before the filing of another return. After such notification, the Service will deactivate the current PIN, and issue a new PIN to the new authorized signatory. The authorized signatory must submit a PIN receipt as specified in section 10.04(2) of the revenue procedure in order to activate the PIN.

SECTION 11. ALTERNATIVE FILING PROCEDURES

.01 Procedures for the filing of Form 941 on magnetic tape are in Rev. Proc. 96-18 and the specifications are in Publication 1264.

.02 An Electronic Filer that is an Agent may use a Form 941 ELF Program Authorization to file a paper Form 941 under the Form 941 ELF Program only under the following circumstances:

(1) the late receipt of payroll information from a taxpayer that would jeopardize the timely submission of the taxpayer's return;

(2) the amendment of returns filed under the Form 941 ELF Program;

(3) the rejection of an electronic transmission that would jeopardize the timely submission of the taxpayer's return; or

(4) a request by the Service for an Electronic Filer participating in the Form 941 ELF Program to file paper Forms 941 instead of electronically filed Forms 941.

.03 An Agent without a valid power of attorney may prepare a paper Form 941 for the taxpayer's signature. A taxpayer's authorized representative that is not an Agent participating in the Form 941 ELF Program (including a suspended Agent) must have a valid power of attorney (usually a Form 2848, Power of Attorney and Declaration of Representative) that authorizes an Agent to sign and file a paper Form 941 on behalf of a taxpayer.

.04 Each paper Form 941 must be signed by the taxpayer, the taxpayer's authorized representative, or a participating Agent, to the extent permitted under section 11.02 of this revenue procedure.

SECTION 12. REVISION OF COMPUTER SPECIFICATIONS BY THE SERVICE

.01 If the Specifications Guide is revised, the Service, if necessary, will advise all current Electronic Filers to submit test files prior to filing under the new specifications. Failure to submit a test file may later result in a Processing Interruption or an Error Rate exceeding 5 percent on returns filed electronically for which a Electronic Filer may receive a notice of suspension. See section 14 of this revenue procedure concerning the reasons for suspension of electronic filing privileges.

.02 If an Electronic Filer is unable to comply with the changes in specifications, the Electronic Filer must contact the ELF Help Desk for further instructions. See section 21 of this revenue procedure.

SECTION 13. ADVERTISING STANDARDS FOR A REPORTING AGENT

.01 In the case of an Electronic Filer that is an Agent, the following advertising standards apply. An Electronic Filer must:

(1) comply with the advertising and solicitation provisions of 31 C.F.R.

Part 10 (Treasury Department Circular No. 230). This circular prohibits the use or participation in the use of any form of public communication containing a false, fraudulent, misleading, deceptive, unduly influencing, coercive, or unfair statement or claim. In addition, advertising must not imply a special relationship with the Service, Financial Management Service (FMS), or the Treasury Department;

(2) adhere to all the relevant federal, state, and local consumer protection laws;

(3) not use the Service's name, "Internal Revenue Service" or "IRS", within a firm's name;

(4) not use improper or misleading advertising in relation to the Form 941 ELF Program;

(5) not carry the FMS, IRS, or other Treasury Seals on its advertising material;

(6) clearly state the names of all cooperating parties if advertising for a cooperative electronic return project (public/private sector);

(7) pre-record radio or television advertisement and keep a copy of such advertisement for a period of at least 36 months from the date of the last transmission or use; and

(8) retain a copy of any actual direct mailing or fax communications, along with a list or other description of persons to whom the communication was mailed, faxed, or otherwise distributed for a period of at least 36 months from the date of the last mailing, fax, or distribution.

.02 Acceptance to participate in the Form 941 ELF Program does not imply endorsement by the Service or FMS of the software or quality of services provided.

SECTION 14. REASONS FOR SUSPENSION

.01 The Service reserves the right to suspend an Electronic Filer from the Form 941 ELF Program for the following reasons (this list is not all-inclusive):

(1) failing to submit electronic tax returns according to the Specifications Guide as provided in section 10.01 of this revenue procedure;

(2) failing to retain the required records for the period specified in section 10.02;

(3) repeatedly submitting tax returns that have an Error Rate exceeding

5 percent or that cause a Processing Interruption; (4) submitting tax returns that have an Error Rate exceeding 5 percent or that cause a Processing Interruption after failing to submit the test file required by section 12; or

(5) submitting tax returns that are not in full-paid status.

.02 The Service reserves the right to suspend an Electronic Filer that is an Agent from the Form 941 ELF Program for the following additional reasons (this list is not all-inclusive):

(1) failing to provide to the taxpayer the records, information, or advice required by section 10.03;

(2) submitting tax returns for which the Service did not receive Authorizations;

(3) failing to abide by the advertising standards in section 13; or

(4) significant complaints about an Agent's performance in the Form 941 ELF Program.

.03 If the Chief, Customer Service and Electronic Filing Branch ("Branch Chief") informs an Electronic Filer that a certain action is a reason for suspension and the action continues, the service center director may send the Electronic Filer a notice proposing suspension of the Electronic Filer. However, a notice proposing suspension may be sent without a warning if the Electronic Filer's action indicates an intentional disregard of rules. A notice proposing suspension will describe the reason(s) for the proposed suspension, and indicate the length of the suspension and the conditions that need to be met before the suspension will terminate.

.04 An Electronic Filer that is an Agent has an obligation to notify taxpayers filing through the Agent if and when such Agent is suspended from filing under the Form 941 ELF Program as provided in section 16.02 of this revenue procedure. The Service reserves the right to extend the period of suspension of any Agent that fails to comply with this requirement.

SECTION 15. ADMINISTRATIVE REVIEW PROCESS FOR PROPOSED SUSPENSION

.01 An Electronic Filer that receives a notice proposing suspension may request an administrative review prior to the proposed suspension taking effect.

.02 The request for an administrative review must be in writing and contain detailed reasons, with supporting documentation, for withdrawal of the proposed suspension.

.03 The written request for an administrative review and a copy of the notice proposing suspension must be delivered to the Branch Chief within 30 calendar days of the date on the notice proposing suspension. The Branch Chief will forward the written request to the National Program Analyst for Electronic Filing of Business Returns ("National Coordinator") if the service center director continues to believe that suspension is warranted.

.04 After consideration of the written request for an administrative review, the National Coordinator will either issue a suspension letter or notify the Electronic Filer in writing that the proposed suspension is withdrawn.

.05 If an Electronic Filer receives a suspension letter, the Branch Chief's subsequent determination of whether a reason for suspension has been corrected is not subject to review or appeal.

.06 If an Electronic Filer does not timely submit a written request for an administrative review, the service center director will issue a suspension letter.

.07 Failure to submit a written request for an administrative review within the 30-day period described in section 15.03 of this revenue procedure irrevocably terminates the Electronic Filer's right to an administrative review of the proposed suspension.

SECTION 16. EFFECT OF SUSPENSION

.01 An Electronic Filer's suspension will continue for the length of time specified in the suspension letter, or until the conditions for terminating the suspension have been met, whichever is later.

.02 In the case of an Electronic Filer that is an Agent, the following additional rules apply:

(1) if a Form 941 is due (without regard to extensions) within 60 days from the date on the suspension letter, the Agent may file the Form 941 under the Form 941 ELF Program;

(2) if a Form 941 is due (without regard to extensions) more than 60 days from the date on the suspension

letter, the Agent may not file the Form 941 under the Form 941 ELF Program;

(3) if a suspended Agent has a power of attorney from a taxpayer that authorizes the Agent to sign and file Form 941, the suspended Agent will be able to sign and file paper Form 941 for the taxpayer. See section 11.03 of this revenue procedure. Form 8655 does not authorize the filing of paper Forms 941 outside of the Form 941 ELF Program; and

(4) an Agent must provide written notification of a suspension to a taxpayer at least 45 days before the due date of the taxpayer's first return affected by the suspension. Such notification must be provided even though the Agent may believe that the Agent will be able to meet the conditions for terminating the suspension before the due date.

.03 An Electronic Filer will be able to file returns under the Form 941 ELF Program from which the Electronic Filer was suspended, without reapplying to the Form 941 ELF Program, after:

(1) the stated suspension period expires; and

(2) the reason(s) for suspension are corrected.

SECTION 17. APPEAL OF SUSPENSION

.01 If an Electronic Filer receives a suspension letter from the National Coordinator, the Electronic Filer is entitled to appeal, by written protest, to the National Director of Appeals. The written protest must be sent to the National Coordinator, who will forward it to the National Director of Appeals. During the appeals process, the suspension remains in effect.

.02 The written protest must be received by the National Coordinator within 30 calendar days of the date of the suspension letter. The written protest must contain detailed reasons, with supporting documentation, for withdrawal of the suspension.

.03 Within 15 calendar days of receipt of a written protest, the National Coordinator will forward the file on the Electronic Filer and the material described in section 17.02 of this revenue procedure to the National Director of Appeals.

.04 Failure to appeal within the 30-day period described in section 17.02

of this revenue procedure irrevocably terminates the Electronic Filer's right to appeal the suspension.

SECTION 18. PENALTY FOR A FAILURE TO TIMELY FILE A RETURN

Section 6651(a)(1) provides that for each month (or part thereof) a return is not filed when required (determined with regard to any extensions of time for filing), there is a penalty of 5 percent of the unpaid tax not to exceed 25 percent, absent reasonable cause. A taxpayer does not establish reasonable cause simply by engaging a competent Agent to file the taxpayer's return. However, if the Agent has reasonable cause under § 6651(a) for failing to timely file the taxpayer's return, the taxpayer will also have reasonable cause for that failure, and the failure-to-file penalty will be abated.

SECTION 19. FILING FORMS W-4 WITH THE INTERNAL REVENUE SERVICE

.01 An employer is required to send to the Service by the due date of the quarterly return copies of all Forms W-4, Employee's Withholding Allowance Certificates, received during the quarter from employees still employed at the end of the quarter who claim:

(1) more than 10 withholding exemptions; or

(2) exempt status and are expecting to earn more than \$200 a week. Employers should not send other Forms W-4 unless notified by the Service in writing to do so.

.02 If an employer's Form 941 is filed under the Form 941 ELF Program, copies of paper Forms W-4 along with a cover letter providing the employer's name, address, EIN, and the number of Forms W-4 included must be sent to the service center that would have received the employer's paper Form 941. See Publication 15, Circular E, Employer's Tax Guide, for more information on sending Forms W-4 to the Service.

.03 Forms W-4 information may also be filed on magnetic media (5¼ inch diskettes, 3½ inch diskettes, or magnetic tape). See Publication 1245, Specifications for Filing Form W-4, Employee's Withholding Allowance Certificate, on Magnetic Tape, and 5¼- and 3½-Inch Magnetic Diskettes, for more information concerning magnetic media filing of Forms W-4.

SECTION 20. FILING FORMS W-2 (COPY A) WITH THE SOCIAL SECURITY ADMINISTRATION

Forms W-2, Wage and Tax State-

ments, must be filed directly with the Social Security Administration on magnetic media or paper. For information on magnetic media reporting of Form W-2, contact the Social Security Administration's Regional Magnetic Media Coordinators.

SECTION 21. INTERNAL REVENUE SERVICE CONTACT

All questions regarding this revenue procedure should be directed to the following address and telephone number:

Internal Revenue Service
Memphis Service Center
Electronic Filing Help Desk
P.O. Box 30309 AMF
Memphis, TN 38130
Attention: ELF Unit Stop 37

The telephone number of this office is (901) 546-2690 extension 1009 (not a toll-free number).

SECTION 22. EFFECTIVE DATE

This revenue procedure is effective for returns due after December 31, 1995 (without regard to extensions).

Letter of Application

AAA Payroll, Inc
111 Main St.
Columbus, NY 11111
EIN XX-XXXXXXX

[Date]

Internal Revenue Service
Memphis Service Center
Electronic Filing Help Desk
P.O. Box 30309 AMF
Memphis, TN 38130
Attention: ELF Unit Stop 37

To whom it may concern:

This letter is an application to participate in the electronic filing program for Forms 941 (“Form 941 ELF Program”).

I understand and agree to the following points which are prerequisites for participation in the Form 941 ELF Program:

1. I will keep copies of the Form 8655, Reporting Agent Authorization for Magnetic Tape/Electronic Filers (or its equivalent) on file at my principal place of business for a period no less than required under the period of limitation for assessment for the last return filed under its authority. I will provide these Authorizations for examination by the Service upon request.

2. I will abide by the recordkeeping requirements as set forth in section 10.02 of Rev. Proc. 96-19.

3. I will provide my clients documentation of filed returns as set forth in section 10.03 of Rev. Proc. 96-19.

4. I will comply with all electronic security restrictions as set forth in section 10.04 of Rev. Proc. 96-19 and the Technical Specifications Guide for the Electronic Filing System for Form 941, Employer’s Quarterly Federal Tax Return.

[Name, title] of [firm name] is the individual to contact concerning the userid/password. [Name] can be reached at [telephone number]. [Name] has read and understands the rules that apply to the use of the userid/password.

[Name, title] of [firm name and address] is the designated recipient of the Personal Identification Number (PIN). [Name] is authorized to administer and use the PIN for the returns being submitted under the Form 941 ELF Program.

I will begin submitting returns using the Form 941 ELF Program for returns due XX quarter 19XX. I estimate that I will be submitting XXX number of returns.

I expect to use [software brand name] translation software and EDI release version [number] for electronic transmissions.

I have included with this application a Reporting Agent’s List and an Authorization for each taxpayer on my Reporting Agent’s List.

Please contact [name, title & telephone #] to discuss this letter of application.

[Signature of Electronic Filer’s
authorized signatory]

PIN/Userid/Password Receipt

I, [insert "name of authorized signatory, title, firm name and address"] acknowledge receipt of the [insert "userid/password" or "PIN" as appropriate] for the Form 941 ELF Program.

I understand that I am bound by the requirements and responsibilities regarding [insert userid/password, or "PIN" as appropriate] as set forth in Rev. Proc. 96-19 and the Specifications Guide for Electronic Filers of Employer's Quarterly Federal Tax Returns.

For userid/password: [Signature of employee recipient]

For PIN: [Signature of Electronic Filer's authorized signatory]

NOTE: Separate receipts are required for a user identification/password and PIN.

26 CFR 601.602: Tax forms and instructions. (Also Part 1, Sections 6012, 6061; 1.6012-5, 1.6061-1.)

Rev. Proc. 96-20

CONTENTS

SECTION 1 PURPOSE
 SECTION 2 BACKGROUND AND CHANGES
 SECTION 3 ON-LINE FILING PARTICIPANTS—DEFINITIONS
 SECTION 4 ACCEPTANCE INTO THE ON-LINE FILING PROGRAM
 SECTION 5 RESPONSIBILITIES OF AN ON-LINE FILER
 SECTION 6 PENALTIES
 SECTION 7 FORM 8453-OL, U.S. INDIVIDUAL TAX DECLARATION FOR ON-LINE SERVICE ELECTRONIC FILING
 SECTION 8 INFORMATION AN ON-LINE FILER MUST PROVIDE TO THE TAXPAYER
 SECTION 9 DIRECT DEPOSIT OF REFUNDS
 SECTION 10 BALANCE DUE RETURNS
 SECTION 11 ADVERTISING STANDARDS FOR ON-LINE FILERS
 SECTION 12 MONITORING AND SUSPENSION OF AN ON-LINE FILER

SECTION 13 ADMINISTRATIVE REVIEW PROCESS FOR DENIAL OF PARTICIPATION IN THE ON-LINE FILING PROGRAM
 SECTION 14 ADMINISTRATIVE REVIEW PROCESS FOR SUSPENSION FROM THE ON-LINE FILING PROGRAM
 SECTION 15 EFFECT ON OTHER DOCUMENTS
 SECTION 16 EFFECTIVE DATE
 SECTION 17 INTERNAL REVENUE SERVICE OFFICE CONTACT

SECTION 1. PURPOSE

This revenue procedure informs those who participate in the 1996 On-Line Service Electronic Filing Program ("On-Line Filing Program") for Form 1040 and Form 1040A, U.S. Individual Income Tax Return, and Form 1040EZ, Income Tax Return for Single and Joint Filers With No Dependents, of their obligations to the Internal Revenue Service, taxpayers, and other participants. This revenue procedure updates Rev. Proc. 95-13, 1995-1 C.B. 514.

SECTION 2. BACKGROUND AND CHANGES

.01 During the 1995 federal income tax filing season, the Service conducted a limited On-Line Filing Program that allowed selected on-line service providers to transmit tax returns submitted for on-line electronic filing by a

limited number of subscribers. For the 1996 federal income tax filing season, the On-Line Filing Program is expanded to allow additional participants to transmit tax returns submitted for on-line electronic filing.

.02 Section 1.6012-5 of the Income Tax Regulations provides that the Commissioner may authorize the use, at the option of a person required to make a return, of a composite return in lieu of any form specified in 26 C.F.R. Part 1 (Income Tax), subject to the conditions, limitations, and special rules governing the preparation, execution, filing, and correction thereof as the Commissioner may deem appropriate.

.03 For purposes of this revenue procedure, an on-line electronically filed Form 1040, Form 1040A, or Form 1040EZ is a composite return consisting of electronically transmitted data and certain paper documents. The non-electronic portion of the return consists of Form 8453-OL, U.S. Individual Income Tax Declaration for On-Line Service Electronic Filing, and other paper documents that cannot be electronically transmitted. Form 8453-OL must be received by the Service before an on-line electronically filed return is complete. An on-line electronically filed return must contain the same information that a return filed completely on paper contains. See section 7 of this revenue procedure for procedures for completing Form 8453-OL.

.04 The Service will periodically issue a publication that lists the forms and schedules associated with a Form

1040 that can be electronically transmitted.

.05 A Form 1040, a Form 1040A, or a Form 1040EZ cannot be electronically filed after October 15, 1996, notwithstanding the fact that the taxpayer has been granted an extension to file a return beyond that date.

.06 An amended tax return cannot be electronically filed. A taxpayer must file an amended tax return on paper in accordance with the instructions for Form 1040X, Amended U.S. Individual Income Tax Return.

.07 A tax return that has a foreign address for the taxpayer cannot be electronically filed. Army/Air Force (APO) and Fleet (FPO) post offices are not considered foreign addresses.

.08 A tax return for a decedent cannot be electronically filed. The decedent's spouse or personal representative must file a paper tax return for the decedent.

.09 This revenue procedure updates Rev. Proc. 95-13, which applied to the On-Line Filing Program for the 1995 filing season. The updates include changes in the On-Line Filing Program for the 1996 filing season, clarifications of prior On-Line Filing Program statements, and additional guidance derived from other Service documents that relate to the On-Line Filing Program. Some of the updates are:

(1) additions to the types of entities that may participate in the On-Line Filing Program for the 1996 filing season (section 3.02);

(2) additions to the information required on Form 8633 (section 4.02);

(3) additions to the reasons to submit a revised Form 8633 (section 4.03);

(4) certain officers of publicly held corporations and bank officials may not need to submit fingerprints with their applications (section 4.08);

(5) additions to the reasons that may result in the rejection of an application to participate in the On-Line Filing Program (sections 4.11(11) and 4.11(12));

(6) an On-Line Filer must notify the Service when it discontinues participation in the program (section 5.06);

(7) additions to the responsibilities of an On-Line Service Provider (section 5.09);

(8) additions to the requirements for accepting and transmitting the electronic portions of returns (section 5.13);

(9) additions to the information that must be provided to a taxpayer (sections 5.14 and 5.15);

(10) additions to the methods of notifying a taxpayer of the status of a transmitted return (section 5.17);

(11) a Transmitter is required to bundle Forms 8453-OL received from taxpayers and send the forms to the Austin Service Center on a weekly basis (section 5.18);

(12) taxpayer inquiries regarding the status of a refund should be referred to the IRS Tele-Tax system or the Austin Service Center Customer Service Department (section 8.04);

(13) On-Line Filers must adhere to all relevant federal, state, and local consumer protection laws that relate to advertising and soliciting (section 11.02);

(14) the effect of suspending a Principal or Responsible Official on entities that listed the Principal or Responsible Official on Form 8633 (section 12.02);

(15) clarification of the two-year period for denial or suspension (section 12.09); and

(16) modifications to the administrative review processes for denials and suspensions (sections 13 and 14).

SECTION 3. ON-LINE FILING PARTICIPANTS—DEFINITIONS

.01 After acceptance into the On-Line Filing Program, as described in section 4 of this revenue procedure, a participant is referred to as an "On-Line Filer."

.02 An On-Line Filer is categorized as follows:

(1) **ON-LINE SERVICE PROVIDER.** An "On-Line Service Provider" is an on-line information service organization that provides paying subscribers dial-up access to a variety of data bases. For purposes of the On-Line Filing Program, an On-Line Service Provider must also have:

(a) an established subscriber or client base to whom the On-Line Service Provider offers services on a continuing basis and about which the On-Line Service Provider maintains certain minimum information identifying the subscriber. Such information could include the subscriber's name, account number, or credit card or demand deposit account number;

(b) a port capacity of at least 1,000 lines or the ability to simultaneously service 1,000 customers;

(c) a network of personal computers that are linked by modems;

(d) access to a broad spectrum of information and/or entertainment services; and

(e) a client base that has the ability to communicate using electronic mail.

(2) **SOFTWARE DEVELOPER.** A "Software Developer" develops software for the purposes of (a) formatting returns according to the Service's electronic return specifications; and/or (b) transmitting electronic returns directly to the Service. A Software Developer may also sell its software.

(3) **TRANSMITTER.** A "Transmitter" transmits the electronic portion of a return directly to the IRS Data Communications Subsystem. An entity that provides a "bump-up" service is a Transmitter. A "bump-up" service provider increases the transmission rate or line speed of formatted or reformatted information that is being sent to the Service via a public switched telephone network. For example, a bump-up service provider may increase the transmission rate or line speed of information from 4800 bits per second (BPS) to 9600 BPS. Service specifications for electronic filing require an asynchronous speed of 300 BPS to 19,200 BPS or a bisynchronous speed of 4800 BPS to 19,200 BPS.

.03 The On-Line Filer categories are not mutually exclusive. For example, an On-line Service Provider can, at the same time, be considered a Transmitter or Software Developer depending on the function(s) performed.

SECTION 4. ACCEPTANCE IN THE ON-LINE FILING PROGRAM

.01 The Service reviewed and processed applications received on or before December 1, 1995, for acceptance into the 1996 On-Line Filing Program. Revised applications described in section 4.03 of this revenue procedure must be submitted within 14 days of the change(s) reflected on the revised Form 8633, Application to Participate in the Electronic Filing Program.

.02 Applicants were required to submit a new Form 8633 with fingerprint cards for appropriate individuals to the Austin Service Center, check the "new" box at the top of the form, and write the letters "OLF" next to this box, if:

(1) the applicant had never actively participated in the On-Line Filing Program;

(2) the applicant had previously been denied participation in the On-Line Filing Program; or

(3) the applicant had been suspended from the On-Line Filing Program.

.03 Participants in the 1995 On-Line Filing Program must submit a revised Form 8633 to the Austin Service Center, check the "revised" box at the top of the form, and write the letters "OLF" next to this box, to participate in the 1996 On-Line Filing Program if:

(1) the participant functioned solely as a Software Developer during the 1995 On-Line Filing Program and intends to function as an On-Line Service Provider or Transmitter during the 1996 On-Line Filing Program;

(2) there is an additional Principal, such as a partner or corporate officer, that must be listed on Form 8633, line 1k(1), "Principals of Your Firm or Organization";

(3) there is a "Principal" listed on Form 8633, line 1k(1), that should be deleted;

(4) the "Responsible Official" on Form 8633, line 1k(2) changes; or

(5) there is any change to:

(a) the Firm name or Doing Business As (DBA) name;

(b) the business mailing address;

(c) the contact representative or the alternate contact representative's name or telephone number;

(d) the On-Line Filer's form of organization, as described on Form 8633 line 1k; or

(e) the electronic functions performed by an On-Line Filer, other than an On-line Filer that functions solely as a Software Developer.

.04 A Form 8633 submitted pursuant to section 4.03 (1) through (4) of this revenue procedure must have completed fingerprint cards attached for the appropriate individual(s). All Principals and the Responsible Official must sign the Form 8633.

.05 A Form 8633 submitted pursuant to section 4.03(5) of this revenue procedure needs to include only entries on lines 1a through 1i and the information being revised. A Principal or Responsible Official must sign the Form 8633.

.06 To be accepted into the 1996 On-Line Filing Program, an applicant or a 1995 On-Line Filing Program participant that is described in section 4.03(1) through (4) of this revenue procedure had to:

(1) file a properly completed Form 8633 with the Austin Service Center; and

(2) successfully complete the necessary testing at the Austin Service Center if the applicant intends to function as a Transmitter or Software Developer.

.07 Each individual listed as a Principal or a Responsible Official must:

(1) be a United States citizen or an alien admitted for lawful permanent residence as described in 8 U.S.C. § 1101(a)(20) (1988);

(2) have attained the age of 21 as of the date of application;

(3) submit with Form 8633 one standard fingerprint card with a full set of fingerprints taken by a law enforcement agency, except as provided in subsection 4.08 of this revenue procedure; and

(4) pass a suitability check that includes a credit check and a fingerprint check.

.08 An individual may choose to submit evidence of the individual's professional status in lieu of one standard fingerprint card if the individual is:

(1) an attorney in good standing of the bar of the highest court of any State, possession, territory, Commonwealth, or the District of Columbia, and is not currently under suspension or disbarment from practice before the Service;

(2) a certified public accountant who is duly qualified to practice as a certified public accountant in any State, possession, territory, Commonwealth, or the District of Columbia, and is not currently under suspension or disbarment from practice before the Service;

(3) an enrolled agent pursuant to part 10 of 31 C.F.R. Subtitle A;

(4) an officer of a publicly held corporation; or

(5) a banking official who is bonded and has been fingerprinted within the last two years.

.09 The Service will issue to eligible applicants for the 1996 On-Line Filing Program, as well as participants in the 1995 On-Line Filing Program that do not have to reapply pursuant to section 4.03 of this revenue procedure:

(1) a letter of acceptance into the On-Line Program for the 1996 filing season;

(2) an Electronic Filing Identification Number (EFIN); and

(3) if appropriate, an Electronic Transmitter Identification Number (ETIN).

No one without these credentials may participate in the 1996 On-Line Filing Program.

.10 If an On-Line Filer is a Software Developer that performs no other function in the On-Line Filing Program but software development, no Principal or Responsible Official needs to pass a suitability check.

.11 The following reasons may have resulted in the rejection of an application to participate in the 1996 On-Line Filing Program (this list is not all-inclusive):

(1) conviction of any criminal offense under the revenue laws of the United States, or of any offense involving dishonesty or breach of trust;

(2) failure to file timely and accurate business or personal tax returns;

(3) failure to timely pay personal or business tax liabilities;

(4) assessment of penalties;

(5) suspension/disbarment from practice before the Service;

(6) other facts or conduct of a disreputable nature that would reflect adversely on the On-Line Filing Program;

(7) misrepresentation on an application;

(8) suspension or rejection from either the Electronic Filing Program or the On-Line Filing Program in a prior year;

(9) unethical practices in return preparation;

(10) stockpiling returns prior to official acceptance into the On-Line Filing Program (see section 5.20 of this revenue procedure);

(11) knowingly and directly or indirectly employing or accepting assistance from any person who has been denied acceptance into the Electronic Filing Program or the On-Line Filing Program, or is suspended from the Electronic Filing Program or the On-Line Filing Program. This includes any individual whose actions resulted in the rejection or suspension of a corporation or a partnership from the Electronic

Filing Program or the On-Line Filing Program; or

(12) knowingly and directly or indirectly accepting employment as an associate, correspondent, or as a sub-agent from, or sharing fees with, any person who has been denied acceptance into the Electronic Filing Program or the On-Line Filing Program, or is suspended from the Electronic Filing Program or the On-Line Filing Program. This includes any individual whose actions resulted in the rejection or suspension of a corporation or a partnership from the Electronic Filing Program or the On-Line Filing Program.

SECTION 5. RESPONSIBILITIES OF AN ON-LINE FILER

.01 To ensure that complete returns are accurately and efficiently filed, an On-Line Filer must comply with all the publications and notices of the Service. Currently, these publications and notices include:

(1) Rev. Proc. 95-49, 1995-50 I.R.B. 5;

(2) Handbook for Electronic Filers of Individual Income Tax Returns, Publication 1345;

(3) Electronic Return File Specifications and Record Layouts for Individual Income Tax Returns, Publication 1346;

(4) Test Package for Electronic Filing of Individual Income Tax Returns, Test Package 1436; and

(5) Electronic Filing System Bulletin Board (EFS Bulletin Board).

.02 An On-Line Filer must maintain a high degree of integrity, compliance, and accuracy.

.03 An On-Line Filer may only accept returns for on-line electronic filing directly from taxpayers or from another On-Line Filer.

.04 If an On-Line Filer charges a fee for the electronic transmission of a tax return, the fee may not be based on a percentage of the refund amount or on the amount of taxes saved. An On-Line Filer may not charge a separate fee for Direct Deposit. See section 9 of this revenue procedure.

.05 An On-Line Filer that has been accepted into the 1996 On-Line Filing Program must submit a revised Form 8633 to the Austin Service Center when any of the conditions or changes described in section 4.03 of this revenue procedure occur.

.06 An On-Line Filer must notify the Austin Service Center within 14 days of discontinuing its participation in the On-Line Filing Program.

.07 An On-Line Filer must ensure that an on-line electronic return is filed on or before the due date of the return. A tax return is not considered filed until the electronic portion of the tax return has been acknowledged by the Service as accepted for processing and a completed and signed Form 8453-OL has been received by the Service. However, if the electronic portion of a return is successfully transmitted on or shortly before the due date and the taxpayer complies with section 7.01 of this revenue procedure, the return will be deemed timely filed. If the electronic portion of a return is initially transmitted on or shortly before the due date and is ultimately rejected, but the taxpayer complies with section 5.16 of this revenue procedure, the return will be deemed timely filed. In the case of a balance due return, see section 10 of this revenue procedure for instructions on how to make a timely payment of tax.

.08 An On-Line Filer must ensure that no other entity uses its EFIN or ETIN. An On-Line Filer must not transfer its EFIN or ETIN by sale, loan, gift, or otherwise to another entity.

.09 An On-Line Filer that functions as an On-Line Service Provider must:

(1) provide assistance to a subscriber in transmitting the electronic portion of a tax return;

(2) ensure that no more than three tax returns are filed electronically by one subscriber;

(3) not provide to a subscriber software that has a Service-assigned production password built into the software;

(4) immediately deliver to a subscriber the information provided by a Transmitter under section 5.14 or 5.15 of this revenue procedure; and

(5) if requested, inform a subscriber that information regarding a refund can be obtained by using the IRS Tele-Tax system or contacting the Austin Service Center Customer Service Department.

.10 An On-Line Filer that functions as a Software Developer must:

(1) promptly correct any software error which causes an electronic return to be rejected;

(2) promptly distribute any software correction;

(3) ensure that any software package that will be used to transmit any returns from multiple On-Line Filers has the capability of combining returns from these On-Line Filers into one Service transmission file taking into account the sorting requirements of the Declaration Control Number (DCN); and

(4) not incorporate into its software a Service-assigned production password.

.11 An On-Line Filer that functions as a Transmitter must:

(1) assign (as prescribed in Publication 1345) a Declaration Control Number (DCN) to the electronic portion of each return received from a taxpayer;

(2) include the assigned DCN in the transmission of the electronic portion of a return;

(3) transmit all electronic returns within three calendar days of receipt;

(4) retrieve the acknowledgement file within two work days of transmission;

(5) promptly correct any transmission error that causes an electronic transmission to be rejected;

(6) match the acknowledgement file to the original transmission file and notify the taxpayer of the status of a transmitted return as prescribed in section 5.17 of this revenue procedure;

(7) immediately contact the Electronic Filing Unit at the Austin Service Center for further instructions if an acknowledgement of acceptance for processing has not been received by the Transmitter within two work days of transmission or if the Transmitter receives an acknowledgement for a return that was not transmitted on the designated transmission;

(8) contact the Austin Service Center Electronic Filing Unit for assistance if a return has been rejected after three transmission attempts;

(9) ensure the security of all transmitted data;

(10) retain, until the end of the calendar year in which a return was filed, an acknowledgement file received from the Service;

(11) retain, until the end of the calendar year in which a return was filed, a complete copy of the electronic portion of the return (may be retained on magnetic media) that can be readily

and accurately converted into an electronic transmission that the Service can process;

(12) ensure that it does not transmit or accept for transmission more than three electronic returns originating from one software package; and

(13) ensure that it does not use software that has a Service-assigned production password built into the software.

.12 A Transmitter that provides transmission services to other unrelated On-Line Filers must only accept electronic returns for transmission to the IRS Data Communications Sub-system from accepted On-Line Filers. A Transmitter must include an On-Line Service Provider's EFIN on each return that the Transmitter accepts from an On-Line Service Provider.

.13 A Transmitter may only accept electronic portions of returns for transmitting that contain a consent to disclose statement. The Transmitter must remove the consent to disclose statement from the electronic portion of the return prior to transmission of that return to the Austin Service Center. The Transmitter must retain the consent to disclose statement until the end of the calendar year in which the return was filed.

.14 If the electronic portion of a taxpayer's return is acknowledged as accepted by the Service, the Transmitter must notify the taxpayer, as prescribed in section 5.17 of this revenue procedure, of the following:

(1) the date the transmission was accepted;

(2) the DCN;

(3) where to put the DCN on Form 8453-OL;

(4) the requirement to properly complete and timely submit a Form 8453-OL with accompanying paper documents within one work day;

(5) the Transmitter's address to which Form 8453-OL with accompanying paper documents must be sent;

(6) that a Form 8453-OL must be received by the Service before an on-line electronically filed return is complete; and

(7) the taxpayer's failure to timely submit a Form 8453-OL with accompanying paper documents could result in the Service not allowing the taxpayer to file a tax return through the On-Line Filing Program in the future.

.15 If the electronic portion of a taxpayer's return is acknowledged as

rejected by the Service, the Transmitter must notify the taxpayer, as prescribed in section 5.17 of this revenue procedure, of the following:

(1) that the electronic portion of the return submitted by the taxpayer has not been accepted for processing;

(2) the date of the rejection;

(3) what the reject code means;

(4) what steps the taxpayer needs to take to correct the error that caused the rejection; and

(5) the information contained in section 5.16 of this revenue procedure.

.16 If the taxpayer chooses not to have the rejected return retransmitted or if the return cannot be accepted for processing, the taxpayer, in order to file a timely return, must file a paper return by the later of:

(1) the due date of the return; or

(2) within ten calendar days of the Service's acknowledgment that the return is rejected or the notice that the return cannot be retransmitted, with an explanation of why the return is being filed after the due date.

.17 A Transmitter that transmits a return of a taxpayer who is a subscriber of an On-Line Service Provider must notify the taxpayer by sending an electronic transmission to the On-Line Service Provider within two work days of retrieving the acknowledgement file. A Transmitter that transmits a return of a taxpayer who is not a subscriber of an On-Line Service Provider must notify the taxpayer by:

(1) sending an electronic transmission to the taxpayer within two work days of retrieving the acknowledgement file; or

(2) mailing a written notification to the taxpayer within one work day of retrieving the acknowledgement file.

.18 A Transmitter must prepare batches of Forms 8453-OL (as prescribed in Publication 1345) and send the batches to the Austin Service Center on a weekly basis.

.19 A Transmitter must, if requested, make available to the Service all items required by this section to be retained until the end of the calendar year in which a return was filed. The Transmitter must make this material available either at the business address of the Transmitter or from the contact person named on Form 8633.

.20 A Transmitter is responsible for ensuring that stockpiling does not occur. Stockpiling means collecting

returns from taxpayers prior to official acceptance into the On-Line Filing Program, or, after official acceptance into the On-Line Filing Program, waiting more than three calendar days to transmit a return to the Service after receiving the information necessary for an electronic transmission of a tax return.

.21 An On-Line Filer may not offer, nor in any way participate in or facilitate, a Refund Anticipation Loan (RAL) in connection with any return filed under the On-Line Filing Program. A RAL is money borrowed by a taxpayer that is based on a taxpayer's anticipated income tax refund.

.22 An On-Line Filer may not charge a separate fee for a Direct Deposit.

.23 In addition to the specific responsibilities described in this section, an On-Line Filer must meet all the requirements in this revenue procedure to keep the privilege of participating in the On-Line Filing Program.

SECTION 6. PENALTIES

.01 Penalties for Disclosure or Use of Information.

(1) An On-Line Filer, except a Software Developer, is a tax return preparer (Preparer) under the definition of § 301.7216-1(b) of the Regulations on Procedure and Administration. A Preparer is subject to a criminal penalty for disclosure or use of tax return information, as described in § 301.7216-1(a). In general, that regulation provides that any preparer who discloses or uses any tax return information for a purpose other than preparing, assisting in preparing, or obtaining or providing services in connection with the preparation of a tax return is guilty of a misdemeanor. In addition, § 6713 of the Internal Revenue Code provides for civil penalties that may be assessed against a preparer who makes an unauthorized disclosure or use of tax return information.

(2) Under § 301.7216-2(h), disclosure of tax return information among accepted On-Line Filers for the purpose of preparing a return is permissible. For example, it is permissible for an On-Line Service Provider to pass on tax return information to a Transmitter for the purpose of having an on-line electronic return formatted and trans-

mitted to the Service. However, if the tax return information is disclosed or used in any other way, an On-Line Filer may be guilty of a misdemeanor as described in section 6.01(1) of this revenue procedure.

.02 Other Preparer Penalties.

(1) Preparer penalties may be asserted against an individual or firm who meets the definition of an income tax return preparer under § 7701(a)(36) and § 301.7701-15. Examples of preparer penalties that may be asserted under appropriate circumstances include, but are not limited to, those set forth in §§ 6694, 6695, and 6713.

(2) Under § 301.7701-15(d), an On-Line Filer is not an income tax return preparer for the purpose of assessing most preparer penalties as long as the On-Line Filer's services are limited to "typing, reproduction, or other mechanical assistance in the preparation of a return or claim for refund."

(3) If an On-Line Filer alters the return information in a nonsubstantive way, this alteration will be considered to come under the "mechanical assistance" exception described in § 301.7701-15(d)(1). A nonsubstantive change is a correction or change limited to a transposition error, misplaced entry, spelling error, or arithmetic correction that falls within the following tolerances:

(a) the Total Tax amount, Withholding amount, Refund amount, or Amount Owed shown on Form 8453-OL differs from the corresponding amount on the electronic portion of the tax return by no more than \$7;

(b) the Total Income amount shown on Form 8453-OL differs from the corresponding amount on the electronic portion of the tax return by no more than \$25; or

(c) dropping cents and rounding to whole dollars.

(4) If an On-Line Filer alters the return information in a substantive way, rather than having the taxpayer alter the return, the On-Line Filer will be considered to be an income tax return preparer for purposes of § 7701(a)(36).

(5) If an On-Line Filer goes beyond mechanical assistance, the On-Line Filer may be held liable for income tax return preparer penalties.

Rev. Rul. 85-189, 1985-2 C.B. 341, describes a situation where a Software Developer was determined to be an income tax return preparer and subject to certain preparer penalties.

.03 In addition to the above specified provisions, the Service reserves the right to assert all appropriate preparer, nonpreparer, and disclosure penalties against an On-Line Filer as warranted under the circumstances.

SECTION 7. FORM 8453-OL, U.S. INDIVIDUAL INCOME TAX DECLARATION FOR ON-LINE SERVICE ELECTRONIC FILING

.01 Procedures for Completing Form 8453-OL.

(1) Form 8453-OL must be completed by the taxpayer in accordance with the instructions for Form 8453-OL.

(2) The taxpayer(s)'s name, address, social security number(s), tax return information, and direct deposit of refund information in the electronic transmission must be identical to the information on the Form 8453-OL that the taxpayer(s) signs and will mail to the Transmitter.

(3) An On-Line Filer's address must not appear on Form 8453-OL or anywhere in the electronic portion of a return.

(4) If the electronic portion of a return was filed as a joint return, both spouses' signatures are required on Form 8453-OL.

(5) The taxpayer's Form 8453-OL must be sent to the address provided by Transmitter within one work day after the taxpayer is provided notification that the electronic portion of the taxpayer's return has been accepted for processing.

.02 If the Service determines that a Form 8453-OL is missing, the taxpayer must provide the Service with a replacement. A taxpayer must also provide a copy of any Form W-2, Wage and Tax Statement, Form W-2G, Certain Gambling Winnings, Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., and all other attachments to Form 8453-OL.

.03 If a substitute Form 8453-OL is used, it must be approved by the Service prior to use. See Rev. Proc. 95-16, 1995-1 C.B. 525.

SECTION 8. INFORMATION AN ON-LINE FILER MUST PROVIDE TO THE TAXPAYER

.01 The Transmitter must advise a taxpayer to retain a complete copy of the return and any supporting material.

.02 The Transmitter must advise the taxpayer that an amended return, if needed, must be filed as a paper return and mailed to the service center that would handle the taxpayer's paper return.

.03 The Transmitter must give the taxpayer the Declaration Control Number (DCN) for the taxpayer's Form 8453-OL and instructions to the taxpayer for entering the DCN on Form 8453-OL.

.04 If a taxpayer inquires about the status of a refund, the Transmitter, or On-Line Service Provider if the taxpayer is a subscriber, must advise the taxpayer to use the IRS Tele-Tax system or contact the Austin Service Center Customer Service Department. The Transmitter or On-Line Service Provider should also advise the taxpayer to wait at least three weeks from the acceptance date of the electronic return before making an inquiry regarding the status of a refund.

.05 The Transmitter must inform the taxpayer that the address on the electronic portion of the return, once processed, will be used to update the taxpayer's address of record. The Internal Revenue Service uses the taxpayer's address of record for various notices that are required to be sent to a taxpayer's "last known address" under the Internal Revenue Code and for refunds of overpayments of tax (unless otherwise specifically directed by the taxpayer, such as by Direct Deposit).

SECTION 9. DIRECT DEPOSIT OF REFUNDS

.01 The Service will ordinarily process a request for Direct Deposit but reserves the right to issue a paper refund check.

.02 The Service does not guarantee a specific date by which a refund will be directly deposited into the taxpayer's financial institution account.

.03 Neither the Service nor Financial Management Service (FMS) is responsible for the misapplication of a Direct Deposit that is caused by error, negligence, or malfeasance on the part of

the taxpayer, On-Line Filer, financial institution, or any of their agents.

SECTION 10. BALANCE DUE RETURNS

.01 An electronically filed balance due return is transmitted to the Austin Service Center in the same manner that a refund or zero balance return is filed. A balance due return is not complete unless and until the Service receives Form 8453-OL completed and signed by the taxpayer.

.02 The Transmitter must furnish Form 1040-V, Electronic Payment Voucher, to a taxpayer who electronically files a balance due return.

.03 To expedite the crediting of a tax payment, a taxpayer who electronically files a balance due return should mail his or her tax payment with either Form 1040-V or the scannable payment voucher that is included in some tax packages. Each of these options has specific mailing instructions.

.04 A taxpayer who electronically files a balance due return must make a full and timely payment of any tax that is due.

Failure to make full payment of any tax that is due on or before April 15, 1996, will result in the imposition of interest and may result in the imposition of penalties.

SECTION 11. ADVERTISING STANDARDS FOR ON-LINE FILERS

.01 An On-Line Filer must comply with the advertising and solicitation provisions of 31 C.F.R. Part 10 (Treasury Department Circular No. 230). This circular prohibits the use or participation in the use of any form of public communication containing a false, fraudulent, misleading, deceptive, unduly influencing, coercive, or unfair statement or claim. In addition, advertising must not imply a special relationship with the Service, FMS, or the Treasury Department. Any claims concerning faster refunds by virtue of electronic filing must be consistent with the language in official Service publications.

.02 An On-Line Filer must adhere to all relevant federal, state, and local consumer protection laws that relate to advertising and soliciting.

.03 An On-Line Filer must not use the Service's name, "Internal Revenue Service" or "IRS", within a firm's name.

.04 An On-Line Filer must not use improper or misleading advertising in relation to the On-Line Filing Program (including the time frames for refunds).

.05 Use of Direct Deposit name and logo.

(1) The name "Direct Deposit" will be used with initial capital letters or all capital letters.

(2) The logo/graphic for Direct Deposit will be used whenever feasible in advertising copy.

(3) The color or size of the Direct Deposit logo/graphic may be changed when used in advertising pieces.

.06 Advertising materials shall not carry the FMS, IRS, or other Treasury Seals.

.07 Advertising for a cooperative electronic return project (public/private sector) must clearly state the names of all cooperating parties.

.08 If an On-Line Filer uses radio or television broadcasting to advertise, the broadcast must be pre-recorded. The On-Line Filer must keep a copy of the pre-recorded advertisement for a period of at least 36 months from the date of the last transmission or use.

.09 If an On-Line Filer uses direct mail or fax communications to advertise, the On-Line Filer must retain a copy of the actual mailing or fax, along with a list or other description of persons to whom the communication was mailed, faxed, or otherwise distributed for a period of at least 36 months from the date of the last mailing, fax, or distribution.

.10 Acceptance to participate in the On-Line Filing Program does not imply endorsement by the Service or FMS of the software or quality of services provided.

SECTION 12. MONITORING AND SUSPENSION OF AN ON-LINE FILER

.01 The Service will monitor an On-Line Filer for conformity with this revenue procedure. The Service can immediately suspend, without notice, an On-Line Filer from the On-Line Filing Program. However, in most circumstances, a suspension from participation in the On-Line Filing Program is effective as of the date of the

letter informing the On-Line Filer of the suspension. Before suspending an On-Line Filer, the Service may issue a warning letter that describes specific corrective action for deviations from this revenue procedure.

.02 If a Principal or Responsible Official is suspended from the On-Line Filing Program, every entity that listed the suspended Principal or Responsible Official on its Form 8633 may also be suspended.

.03 The Service will monitor the timely receipt of Forms 8453-OL, as well as their overall legibility (especially the recording of the DCN).

.04 The Service will monitor the quality of an On-Line Filer's transmissions throughout the filing season. The Service will also monitor electronic returns and tabulate rejections, errors, and other defects. If quality deteriorates, the On-Line Filer will receive a warning from the Service.

.05 The Service will monitor complaints about an On-Line Filer and issue a warning or suspension letter as appropriate.

.06 The Service reserves the right to suspend the electronic filing privilege of any On-Line Filer that violates any provision of this revenue procedure. Generally, the Service will advise a suspended On-Line Filer concerning the requirements for reacceptance into the On-Line Filing Program. The following reasons may lead to a warning letter and/or suspension of an On-Line Filer from the On-Line Filing Program (this list is not all-inclusive):

(1) the reasons listed in section 4.11 of this revenue procedure;

(2) deterioration in the format of individual transmissions;

(3) unacceptable cumulative error or rejection rate;

(4) stockpiling returns at any time while participating in the On-Line Filing Program;

(5) failure on the part of a Transmitter to retrieve acknowledgement files within two work days of transmission by the Service;

(6) failure on the part of a Transmitter to notify the taxpayer, as prescribed in section 5.17 of this revenue procedure, of the status of a transmitted return within two work days of receipt of the acknowledgement files from the Service;

(7) failure on the part of a Transmitter to batch and send Forms 8453-

OL to the Austin Service Center on a weekly basis;

(8) significant complaints about an On-Line Filer;

(9) failure on the part of an On-Line Filer to ensure that no other entity uses its EFIN and/or ETIN;

(10) having more than one EFIN for the same business entity at the same location (the business entity is generally the entity that reports on its return the income derived from electronic filing), unless the Service has issued more than one EFIN to a business entity.

(11) failure on the part of an On-Line Filer to cooperate with the Service's efforts to investigate electronic filing abuse;

(12) violation of the advertising standards described in section 11 of this revenue procedure;

(13) failure to maintain and make available records as described in section 5.19 of this revenue procedure;

(14) failure to supply a taxpayer with an accurate DCN;

(15) failure to give effective instructions to a taxpayer concerning the entry of the DCN on Form 8453-OL;

(16) failure to timely pay any applicable fees, as implemented by subsequent guidance; or

(17) failure to timely submit a revised Form 8633 notifying the Service of changes described in section 4.03 of this revenue procedure.

.08 The Service will list in the Internal Revenue Bulletin, district office listings, district office newsletters, and on the EFS Bulletin Board the name and owner(s) of any entity suspended from the On-Line Filing Program and the effective date of the suspension.

.09 Denials of applications and suspensions of participation in the On-Line Filing Program will result in:

(1) a rejected applicant not being reconsidered for participation in the On-Line Filing Program for at least two years; and

(2) a suspended On-Line Filer not being reconsidered for participation in the On-Line Filing Program for at least two years.

For purposes of this section 12.09, two years means the remaining months in the calendar year of denial of participation or suspension and the following two calendar years.

SECTION 13. ADMINISTRATIVE REVIEW PROCESS FOR DENIAL OF PARTICIPATION IN THE ON-LINE FILING PROGRAM

.01 An applicant that has been denied participation in the On-Line Filing Program has the right to an administrative review. During the administrative review process, the denial of participation remains in effect.

.02 In response to the submission of a Form 8633, the appropriate district office will either (1) accept an applicant into the On-Line Filing Program, or (2) issue a proposed letter of denial that explains to the applicant why the district office proposes to reject the application to participate in the On-Line Filing Program.

.03 An applicant who receives a proposed letter of denial may respond, in writing, to the district office that issued the proposed letter of denial. The applicant's response must address the district office's explanation for proposing the denial to participate. The district office must receive the applicant's response within 30 calendar days of the date of the proposed letter of denial.

.04 Upon receipt of an applicant's written response, the district office will reconsider its proposed letter of denial. The district office may (1) withdraw its proposed letter of denial and admit the applicant into the On-Line Filing Program, or (2) finalize its proposed letter of denial and issue it to the applicant.

.05 If an applicant receives a final letter from the district office that denies the applicant participation in the On-Line Filing Program, the applicant is entitled to an appeal, in writing, to the Director of Practice.

.06 The appeal must be filed with the district office that issued the denial letter within 30 calendar days of the date of the denial letter. An applicant's written appeal must contain a detailed explanation, with supporting documentation, of why the denial should be reversed. In addition, the applicant must include a copy of the applicant's Form 8633 and a copy of the denial letter.

.07 The district office whose denial is being appealed will, upon receipt of a written appeal to the Director of Practice, forward to the Director of Practice its file on the applicant and the material described in section 13.06 of this revenue procedure that the appli-

cant has submitted to the district office. The district office will forward to the Director of Practice these materials within 15 calendar days of receipt of the applicant's appeal to the Director of Practice.

.08 Failure to respond within the 30-day periods described in sections 13.03 and 13.06 of this revenue procedure irrevocably terminates an applicant's right to an administrative review or appeal.

SECTION 14. ADMINISTRATIVE REVIEW PROCESS FOR SUSPENSION FROM THE ON-LINE FILING PROGRAM

.01 An On-Line Filer that has been suspended from participation in the On-Line Filing Program has the right to an administrative review. During the administrative review process, the suspension remains in effect.

.02 If an On-Line Filer receives a proposed suspension letter from a district office or a service center, the On-Line Filer may submit a detailed written explanation, with supporting documentation, of why the proposed suspension letter should be withdrawn. The On-Line Filer must ensure that the district office or service center that issued the proposed suspension letter receives the On-Line Filer's written response within 30 calendar days of the date of the proposed suspension letter.

.03 Upon receipt of the On-Line Filer's written response, the district office or service center will reconsider its proposed suspension of the On-Line Filer. The district office or service center will either withdraw its proposed suspension letter and reinstate the On-Line Filer or finalize the suspension letter and issue it to the On-Line Filer.

.04 If the On-Line Filer receives a suspension letter from a district office or a service center, the On-Line Filer is entitled to an appeal, in writing, to the Director of Practice.

.05 The On-Line Filer must ensure that the district office or service center that issued the suspension letter receives the On-Line Filer's written appeal for review by the Director of Practice within 30 calendar days of the date of the suspension letter. The On-Line Filer's written appeal for review must contain detailed reasons, with supporting documentation, for reversal of the suspension. In addition, the On-Line Filer must include a copy of its

Form 8633 and a copy of the suspension letter.

.06 The district office or service center whose decision to suspend is being appealed will, upon receipt of a written appeal to the Director of Practice, forward to the Director of Practice its file on the On-Line Filer and the material described in section 14.05 of this revenue procedure that the On-Line Filer has submitted to the district office or the service center. The district office or the service center will forward to the Director of Practice these materials within 15 calendar days of the receipt of an On-Line Filer's written request for appeal.

.05 Failure to appeal within the 30-day period described in section 14.05 of this revenue procedure irrevocably terminates an On-Line Filer's right to an appeal.

SECTION 15. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 95-13, 1995-1 C.B. 514, is superseded.

SECTION 16. EFFECTIVE DATE

This revenue procedure is effective December 29, 1995.

SECTION 17. INTERNAL REVENUE SERVICE OFFICE CONTACT

All questions regarding the electronic filing aspects of the On-Line Filing Program should be directed to the Electronic Filing Office. The telephone number for this purpose is (202) 283-1010 (not a toll-free number). All questions regarding the on-line aspects of this program should be directed to the National Office Productivity Enhancement Section. The telephone number for this purpose is (202) 283-0265 (not a toll-free number).

26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability. (Also Part I, §§ 1221, 1502; 1.1221-2(g)(5)(i), 1.1502-13.)

Rev. Proc. 96-21

SECTION 1. PURPOSE

This revenue procedure describes the

manner and time for consolidated groups to make the retroactive single-entity election under § 1.1221-2(g)(5)(i) of the Income Tax Regulations for purposes of the definition of a hedging transaction. This revenue procedure provides alternative procedures for making the election depending on whether the group has any taxable years before the Service on January 8, 1996.

SECTION 2. BACKGROUND

Under § 1.1221-2(b), a transaction is a hedging transaction only if (among other things) the transaction is entered into primarily to reduce the taxpayer's risk. In general, under § 1.1221-2(d)(1), if the taxpayer is a member of a consolidated group, the risk of all of the members of the group is considered in determining whether a transaction reduces the taxpayer's risk (the single-entity approach). Under § 1.1221-2(d)(2), however, a consolidated group can elect out of single-entity treatment by making a separate-entity election.

Although § 1.1221-2 is generally retroactive, the single-entity approach of § 1.1221-2(d)(1) applies only to transactions entered into on or after March 8, 1996. A consolidated group, however, may elect to apply the single-entity approach of the regulations retroactively. If the group does so, the single-entity approach applies to all transactions entered into in the election year and in all subsequent consolidated return years until the effective date of any separate-entity election made by the group under § 1.1221-2(d)(2). Section 1.1221-2(g)(5)(i).

SECTION 3. SCOPE

This revenue procedure applies to a consolidated group making the retroactive single-entity election under § 1.1221-2(g)(5)(i).

SECTION 4. DEFINITIONS

.01 *Election year.* As provided by § 1.1221-2(g)(5)(i), the election year is the earliest taxable year subject to the single-entity election. The election year must begin prior to March 8, 1996. A group may use a particular taxable year as the election year only if that year and each subsequent taxable year are still open for assessment under section

6501 on July 1, 1996 (or such earlier date as the Commissioner may allow). (Section 9, below, provides an earlier date in some situations.) Section 1.1221-2(g)(5)(i).

.02 *Affected years.* Affected years are the election year and all subsequent consolidated return years beginning before March 8, 1996.

.03 *Before the Service.* A taxable year is before the Service from the time the consolidated group has been contacted in any manner by a representative of the Service for the purpose of scheduling any type of examination of its federal income tax return for that year until the receipt of a "no-change" letter for that year, the execution of a waiver of restrictions on assessment and collection of deficiency in tax and acceptance of overassessment, the expiration of the period for filing a petition with the Tax Court for that year, or the filing of a petition with the Tax Court.

SECTION 5. STATEMENT OF ELECTION

A consolidated group makes the retroactive single-entity election by filing a separate statement by the time, and in the manner, prescribed in Section 6 or 7, as applicable. The statement must be signed by the common parent and must say, "[INSERT NAME AND EMPLOYER IDENTIFICATION NUMBER OF COMMON PARENT] hereby elects the retroactive application of section 1.1221-2(d)(1) (the single-entity approach) beginning with [IDENTIFY THE ELECTION YEAR]." The statement of election must also contain a list of the affected years for which the federal income tax returns are inconsistent with the single-entity election or must state that the federal income tax returns for all affected years are consistent with the single-entity election.

SECTION 6. GROUPS WITH ONE OR MORE YEARS BEFORE THE SERVICE ON JANUARY 8, 1996

If the consolidated group has one or more affected years before the Service on January 8, 1996, then, except as provided in Section 6.04, the group must satisfy the requirements in Section 6.01 and, as applicable, Sections 6.02 and 6.03.

.01 Filing the statement of election and delivering copies of the statement of election.

The group must file the statement of election with the Service personnel handling the earliest affected year before the Service. If other affected years are before the Service on the date the group files the statement of election, the group must also deliver copies of the statement to the Service personnel handling those years. In addition, if an affected year is before a federal court on the date the group files the statement of election, the group must deliver a copy of the statement to the lawyer representing the Government with respect to the year. The requirements in this Section 6.01 must be satisfied no later than March 8, 1996.

.02 Furnishing computations.

In the case of any affected year that is before the Service on the date the group files the statement of election, if the federal income tax return for the year is inconsistent with the single-entity election, then computations necessary to support any adjustment in tax must be delivered to the Service personnel handling the year.

If the year is before the Service on January 8, 1996, the computations must be delivered no later than March 8, 1996.

If the year is not before the Service on January 8, 1996, but becomes a year before the Service prior to the filing of the statement of election, then the computations must be delivered no later than July 1, 1996.

.03 Filing amended returns.

In the case of any affected year that is not before the Service on the date the group files the statement of election, if the federal income tax return for the year is inconsistent with the single-entity election, then an amended return containing a copy of the statement of election must be filed on or before July 1, 1996. If the year becomes a year before the Service between the filing of the statement of election and July 1, 1996, then, in lieu of filing an amended return, the group may satisfy the requirement in the preceding sentence by, not later than July 1, 1996, delivering to the Service

personnel handling the year a copy of the statement and the computations necessary to support any adjustment in tax.

.04 Years that cease to be before the Service on or before the date the group files the statement of election.

If an affected year is before the Service on January 8, 1996, but ceases to be before the Service by the earlier of March 8, 1996, or the date the group files the statement of election, then, for purposes of this revenue procedure, the year is treated as not being before the Service on January 8, 1996. Thus, if no other affected years are before the Service on that date, the group must follow the procedures in Section 7 in lieu of those in this Section 6; and, if other affected years are before the Service on that date, the group must follow the procedures in this Section 6.

SECTION 7. GROUPS WITH NO YEARS BEFORE THE SERVICE ON JANUARY 8, 1996

If the consolidated group is not governed by Section 6, then it must satisfy the requirements in Section 7.01 and, as applicable, Sections 7.02 and 7.03.

.01 Filing the statement of election and delivering copies of the statement of election.

(1) In general.

If the due date (including extensions) of the federal income tax return for the election year is later than July 1, 1996, the group must file the statement of election by attaching it to the timely filed federal income tax return for the election year. If the due date (including extensions) of the federal income tax return for the election year is on or before July 1, 1996, then, except as provided in Section 7.01(2) of this revenue procedure, the group must file the statement by attaching it to either the federal income tax return for the election year or an amended return for the election year, and the return or amended return must be filed on or before July 1, 1996.

(2) Groups with one or more affected years that have become years before the Service.

If one or more affected years have become years before the Service when the group files the statement of election, then, in lieu of attaching the statement to an original or amended return for the election year, the group must file the statement of election by delivering it to the Service personnel handling the earliest affected year that is then before the Service and by delivering copies of the statement to the Service personnel handling any other affected years that are then before the Service.

(3) Year before a federal court.

In addition to the requirements stated in Sections 7.01(1) and 7.01(2), if an affected year is before a federal court when the group files the statement of election, then, on the date the statement is filed, the group must deliver a copy of the statement to the lawyer representing the Government with respect to the year.

.02 Furnishing computations.

If the federal income tax return for an affected year is inconsistent with the single-entity election and if the affected year is before the Service when the group files the statement of election, computations necessary to support any adjustment in tax for the year must be delivered with the statement of election (or the copy of the statement) that is required under Section 7.01(2) of this revenue procedure.

.03 Filing other amended returns.

If the federal income tax return for an affected year is inconsistent with the single-entity election and if the affected year is not before the Service when the group files the statement of election, an amended return for the year containing a copy of the statement must be filed on or before July 1, 1996. If, on or before July 1, 1996, the year becomes a year before the Service, then, in lieu of filing an amended return, the group may satisfy the requirement in the preceding sentence by, not later than July 1, 1996, delivering to the Service

personnel handling that year a copy of the statement of election and computations necessary to support any adjustment in tax.

SECTION 8. HOW TO FILE OR DELIVER MATERIAL TO SERVICE PERSONNEL HANDLING A YEAR BEFORE THE SERVICE

If, under Section 6 or 7, a group is required to file or deliver material to the Service personnel handling a particular affected year that, on the date of filing or delivery, is before the Service, the group must file or deliver the material as follows —

.01 Year under examination. If the affected year is under examination and not under consideration by an Appeals office of the Service, the group must deliver the material to the District Director with jurisdiction over that year and, at the same time, must deliver a copy of the material to the principal

examining agent or team coordinator with jurisdiction over that year.

.02 Year under Appeals consideration. If the affected year is under consideration by an Appeals office of the Service, the group must deliver the material to the Chief of the Appeals office with jurisdiction over the year and, at the same time, must deliver a copy of the material to the principal Appeals officer or team chief with jurisdiction over that year.

SECTION 9. MAKING THE ELECTION FOR AFFECTED YEARS THAT CLOSE BEFORE JULY 1, 1996

The Commissioner hereby allows a group to select a particular year as the election year even if the resulting affected years will include one or more years that are not still open for assessment under section 6501 on July 1, 1996. This permission is granted

only if, in addition to meeting the other requirements and filing deadlines of this revenue procedure, the group files the statement of election before the statute of limitations expires for any affected year and, for each affected year that is not still open for assessment on July 1, 1996, the group meets all requirements with respect to that year before the statute of limitations expires for that year.

SECTION 10. EFFECTIVE DATE

This revenue procedure is effective January 8, 1996.

DRAFTING INFORMATION

The principal author of this revenue procedure is Jo Lynn Ricks of the Office of Assistant Chief Counsel (Financial Institutions and Products). For further information regarding this revenue procedure contact Ms. Ricks on (202) 622-3920 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking

Effective Date of Temporary Backup Withholding Regulations

IA-33-95

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: In *** [T.D. 8637, page 00, this Bulletin], the IRS is issuing temporary regulations relating to the effective date of the Temporary Employment Tax Regulations under the Interest and Dividend Tax Compliance Act of 1983, relating to backup withholding, statement mailing requirements, and due diligence. The text of those temporary regulations also serves as the text of these proposed regulations.

DATES: Written comments and requests for a public hearing must be received by March 20, 1996.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (IA-33-95), Room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (IA-33-95), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Renay France, (202) 622-4910; concerning submissions, Michael Slaughter, (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Temporary regulations in *** [T.D. 8637, page 00, this Bulletin] amend the Temporary Employment Tax Regulations under the Interest and Dividend Tax Compliance Act of 1983 (26 CFR

part 35a). The temporary regulations contain rules relating to the effective date of §§35a.9999-1, 35a.9999-2, 35a.9999-3, 35a.9999-3A, 35a.9999-4T, and 35a.9999-5.

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

Special Analyses

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

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying. A public hearing may be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the Federal Register.

Drafting Information

The principal author of the regulations is Renay France, Office of Assistant Chief Counsel (Income Tax and Accounting), IRS. However, other personnel from IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 31

Employment taxes, Income taxes, Penalties, Pensions, Railroad retirement, Reporting and recordkeeping requirements, Social security, Unemployment compensation.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 31 is proposed to be amended as follows:

PART 31—EMPLOYMENT TAXES AND COLLECTION OF INCOME TAX AT SOURCE

Paragraph 1. The authority citation for part 31 continues to read in part as follows:

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

Par. 2. Section 31.9999-0 is added to read as follows:

§31.9999-0 Effective date.

[The text of this proposed section is the same as the text of §35a.9999-0T published elsewhere in *** [T.D. 8637, this Bulletin].

Margaret Milner Richardson,
*Commissioner of
Internal Revenue.*

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ADMINISTRATIVE INITIATIVES TO ENHANCE TAXPAYER RIGHTS

ANNOUNCEMENT 96-5.

AGENCY: Internal Revenue Service (IRS), Treasury

ACTION: Administrative actions to enhance taxpayer rights.

BACKGROUND

The IRS and Treasury worked closely with Congress throughout its drafting of the "Taxpayer Bill of Rights 2" ("TBOR 2"), a part of the now vetoed Revenue Reconciliation

Act of 1995. The IRS and Treasury wish to ensure that the bi-partisan momentum that led to TBOR 2 is not lost.

This Announcement identifies the TBOR 2 proposals that Treasury and the IRS have already adopted administratively or will soon implement. For those TBOR 2 provisions requiring legislative action, the IRS and Treasury intend to work with Congress to enact such provisions as are necessary and appropriate to continue the ongoing process of enhancing taxpayer rights.

This Announcement also describes certain regulatory and guidance projects that were not part of TBOR 2 but which Treasury and the IRS either have already implemented or intend to implement in the next few months to reduce taxpayer burdens and enhance taxpayer protections.

NEW ADMINISTRATIVE ACTIONS BASED ON TBOR 2 PROVISIONS

The IRS administratively adopts the following TBOR 2 provisions, as passed by the House of Representatives.

1. Increased Taxpayer Ombudsman Authority to Address Taxpayer Concerns.

The Taxpayer Ombudsman was authorized by Congress in 1988 to issue Taxpayer Assistance Orders (“TAOs”) to resolve taxpayer problems. Section 7811 of the Code gives the Ombudsman the authority to issue a TAO to direct IRS officials to stop certain actions to alleviate a hardship faced by a taxpayer. The Commissioner delegated additional authority to the Ombudsman to issue TAOs to take positive actions to relieve taxpayer hardship.

The Commissioner of Internal Revenue (“Commissioner”) is issuing a Delegation Order, effective immediately, to clarify the Taxpayer Ombudsman’s expanded authority to issue TAOs. For example, the Ombudsman has the authority to issue a TAO directing the IRS to pay a refund immediately to a taxpayer eligible for a refund to relieve severe hardship facing such a taxpayer. In addition, a TAO can temporarily stay an IRS collection action in order to allow the IRS to review the appropriateness of the action.

The Delegation Order will also direct the Ombudsman to prepare an annual report on the most serious problems that taxpayers face with the IRS and suggest administrative and legislative solutions to these problems.

2. Commissioner’s Directive to Track IRS Response to Taxpayer Ombudsman Annual Reports

The Commissioner is issuing a Delegation Order, effective immediately, to require the Ombudsman to track the IRS response to the administrative problems identified in the Ombudsman’s annual report.

3. Greater Protection for Taxpayer Assistance Orders

Treasury and the IRS will publish proposed regulations early in 1996 under section 7811 of the Code to limit the authority to modify or rescind a TAO to only the Commissioner, Deputy Commissioner, or Ombudsman. Section 7811 currently allows a greater number of specified individuals to do so.

In addition, the Commissioner is issuing a Delegation Order, effective immediately, that voluntarily adopts this new TAO rescission and modification limitation.

4. Increased Stature of Taxpayer Ombudsman Within the IRS

The Commissioner intends to take the steps necessary to increase the stature of the Taxpayer Ombudsman within the IRS by raising the Ombudsman’s compensation to that of the highest level official reporting directly to the Deputy Commissioner.

5. Greater Participation of Ombudsman in Selection of Local Problem Resolution Officers

The Commissioner is issuing a Directive, effective immediately, that requires the Ombudsman or his delegate, normally the regional Problem Resolution Officers (“PROs”), to participate in the selection and evaluation of local district PROs. The Ombudsman’s office will thus have a strong voice in choosing field personnel who have a high degree of familiarity with taxpayer concerns.

6. New Procedures to Allow Taxpayers to Appeal Liens, Levies, and Seizures

Effective April 1, 1996, taxpayers will have the right to appeal liens, levies, and seizures proposed by the IRS. Each taxpayer subject to a lien, levy, or seizure will receive Publication 1660, “Collection Appeal Rights for Liens, Levies and Seizures”, which will explain the taxpayer’s right to make such an appeal and the procedure for requesting an appeal. Form 9423, “Collection Appeal Request”, is also being updated with a summary of the information included in Publication 1660 on its reverse side. Further, Publication 594, “Understanding the Collection Process,” is being amended to inform taxpayers about the new appeal process. The IRS will also amend the Internal Revenue Manual to direct IRS personnel on the appeals process and taxpayers’ rights to such appeals.

7. Notification of Collection Activity to Divorced and Separated Spouses

The IRS plans to adopt a rule by March 1996 to allow its personnel to notify one spouse of collection activity against the other spouse to collect a joint return liability. The IRS will amend the Internal Revenue Manual (“IRM”) to give IRS personnel uniform procedures to make such notifications while providing sufficient privacy safeguards to each spouse.

8. Prohibition on Compromising Informant’s Tax Liability

The IRS is issuing procedures to formalize its longstanding practice of prohibiting special agents from compromising the tax liability of an informant in exchange for information about another taxpayer. The procedure, effective immediately, will be included in § 9373.31:(8) of the IRM.

9. Voluntary Payor Telephone Numbers on Forms 1099

Effective immediately, the IRS will request that payors include their telephone numbers on the taxpayers’ copies of Forms 1099. Taxpayers may thus find it easier to resolve their

disputes with payors without IRS involvement.

10. *Study of interest netting*

Treasury and the IRS are beginning a formal study of issues relating to the IRS's current and future interest netting procedures. Treasury and the IRS will soon issue a Notice that will ask for public comment on specific legal and administrative issues.

TBOR 2 PROVISIONS THAT HAVE ALREADY BEEN ADOPTED ADMINISTRATIVELY

The IRS and Treasury have already administratively adopted the following TBOR 2 provisions.

1. *Study of Joint Return Issues For Divorced and Separated Spouses*

The IRS has begun a formal study of the unique tax issues facing divorced and separated spouses who filed joint returns. The study's goal is to recommend specific legislative and administrative actions, where possible. The IRS and Treasury will soon issue a Notice asking for public comment on specific legal and administrative issues.

2. *Increased IRS Investigation of Disputed Information Returns*

The IRS will amend §424(16) of the IRM, effective January 31, 1996, to increase current IRS efforts to investigate tax information reported by payors where a taxpayer challenges the accuracy of the information, such as wage income reported to the IRS on Forms W-2 or other income payments reported on Forms 1099.

3. *30 Day Notice Before Terminating or Modifying Installment Agreements*

Regulation § 1.6159-1(c)(4) and internal IRS procedures already provide a taxpayer with 30 days notice before the taxpayer's installment agreement with the IRS is either terminated or modified.

4. *Penalty for Trust Fund Taxes Under § 6672*

The IRM provides that taxpayers liable for trust fund taxes should be

given 60 days notice before being assessed a non-payment penalty. An IRS policy statement prevents the IRS from assessing this non-payment penalty against honorary or volunteer trustees not involved in an organization's daily operations.

5. *Annual Reminders of Outstanding Delinquent Accounts*

The IRM directs IRS personnel to provide annual, and sometimes semianual, reminders to taxpayers with outstanding delinquent tax accounts.

6. *Notice of Overpayments*

The IRM requires the IRS to notify a taxpayer as soon as reasonably possible if the IRS receives a payment not apparently related to a taxpayer's liability or not identifiable to a proper taxpayer account. This notification generally takes place well before the 60 days specified in TBOR 2.

7. *Limitations on the Use of a Designated Summons*

The IRS is adopting a policy statement, effective immediately, that formalizes the current IRS practice of requiring Regional Counsel to review designated summonses before issuance. The policy statement also reemphasizes the current IRS policy of issuing designated summonses only to large corporate taxpayers under the Coordinated Examination Program ("CEP"), except in unique circumstances.

PUBLISHED PRIORITY GUIDANCE LIST ITEMS THAT IMPROVE TAXPAYER RIGHTS

Treasury and the IRS are committed to completing the following administrative and regulatory projects that were included on the 1995 published priority guidance list and ease compliance burdens on taxpayers.

1. *Early Appeal of Employment Tax Issues*

Treasury and the IRS will soon issue a revenue procedure to allow employers to appeal employment tax issues while an examination is still in progress. This procedure, modeled on the CEP early referral procedures in Rev. Proc. 96-9, should reduce the

time and expense necessary to resolve employment tax issues, such as the classification of a worker as an employee or independent contractor.

2. *Appeals Mediation Procedure*

A one-year test of an Appeals mediation procedure began on October 30, 1995, as described in Announcement 95-86. The mediation procedure allows taxpayers with certain cases in Appeals, but not docketed in any court, to request mediation of one or more issues. Mediation has already been used to resolve a multi-million dollar valuation dispute.

3. *Obtaining Advance Valuation of Artworks*

Valuing artwork is important for such tax purposes as estate and gift taxes and the charitable contribution deduction. Recently released Rev. Proc. 96-15 tells taxpayers how to obtain IRS review of a taxpayer's valuation of a work of art before filing a return.

4. *Making Taxpayer Identification Numbers Available*

Taxpayers must obtain Taxpayer Identification Numbers ("TINs") under §6109 of the Code. An individual's Social Security Number ("SSN") generally serves as a TIN. For taxpayers ineligible to obtain SSNs, Treasury and the IRS will soon propose regulations to provide a method to obtain a TIN.

5. *Obtaining Section 9100 Relief*

Taxpayers can obtain relief in connection with certain requests for changes of accounting method or period under Treas. Reg. § 301.9100-1. Revenue Procedure 92-85, which sets forth the procedures for obtaining such relief, will be revised.

6. *Allow Automatic Extensions Without Payment*

Section 6081 of the Code authorizes the IRS to grant reasonable extensions of time to file required returns. The regulations currently allow individuals to obtain an automatic 4-month extension of time to file their returns if they pay any balance due. Notice 93-22 eliminated the requirement that the tax be fully paid upon application for the

extension. Treasury and the IRS issued temporary and proposed regulations on January 4, 1996, to make this change permanent. Taxpayers may still be subject to failure to pay penalties and interest if they obtain an extension for a return with a balance due.

7. Permit Use of Imaging Systems to Store Tax Records

A revenue procedure will be issued to give taxpayers the option of using

computer imaging systems, rather than paper copies, to store the tax records necessary to support their tax returns.

8. Electronic Filing of Form 941

Most employers must file Form 941, "Employer's Quarterly Federal Tax Return," to report the income tax and Federal Insurance Contributions Act ("FICA") tax paid by the employer and withheld from employees. Recently released Rev. Proc. 96-19 sets forth the

procedures to be used by taxpayers who wish to file Form 941 electronically.

9. Simultaneous Appeals/Competent Authority Procedure

In December 1995, the Service issued Rev. Proc.s 96-13 and 14 which authorize a new simultaneous Appeals/Competent Authority procedure. Taxpayers may now request the involvement of Appeals on issues under competent authority jurisdiction.

Definition of Terms

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

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

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

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

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior

ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

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

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

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If

If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case the previously published ruling is first modified and then, as modified, is superseded.

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

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

Abbreviations

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

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C.—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.

E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contribution Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign Corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.

PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statements of 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.

Numerical Finding List¹

Bulletins 1996-1 through 1996-3

Announcements:

96-1, 1996-2 I.R.B. 57
96-2, 1996-2 I.R.B. 57
96-3, 1996-2 I.R.B. 57
96-4, 1996-3 I.R.B. 50

Notices:

96-2, 1996-2 I.R.B. 15
96-1, 1996-3 I.R.B. 30

Proposed Regulations:

EE-34-95, 1996-3 I.R.B. 49

Revenue Procedures:

96-1, 1996-1 I.R.B. 8
96-2, 1996-1 I.R.B. 60
96-3, 1996-1 I.R.B. 82
96-4, 1996-1 I.R.B. 94
96-5, 1996-1 I.R.B. 129
96-6, 1996-1 I.R.B. 151
96-7, 1996-1 I.R.B. 185
96-8, 1996-1 I.R.B. 187
96-9, 1996-2 I.R.B. 15
96-10, 1996-2 I.R.B. 17
96-11, 1996-2 I.R.B. 18
96-12, 1996-3 I.R.B. 30
96-13, 1996-3 I.R.B. 31
96-14, 1996-3 I.R.B. 41
96-15, 1996-3 I.R.B. 41
96-16, 1996-3 I.R.B. 45

Revenue Rulings:

96-1, 1996-1 I.R.B. 7
96-2, 1996-2 I.R.B. 5
96-3, 1996-2 I.R.B. 14
96-6, 1996-2 I.R.B. 8
96-4, 1996-3 I.R.B. 16
96-5, 1996-3 I.R.B. 29
96-7, 1996-3 I.R.B. 12

Treasury Decisions:

8630, 1996-3 I.R.B. 19
8631, 1996-3 I.R.B. 7
8634, 1996-3 I.R.B. 17
8635, 1996-3 I.R.B. 5
8640, 1962-2 I.R.B. 10

¹A cumulative list of all Revenue Rulings, Revenue Procedures, Treasury Decisions, etc., published in Internal Revenue Bulletins 1995-27 through 1995-52 will be found in Internal Revenue Bulletin 1996-1, dated January 2, 1996.

Finding List of Current Action on Previously Published Items¹

Bulletins 1996-1 through 1996-3

*Denotes entry since last publication

Revenue Procedures:

65-17

Modified by
96-14, 1996-3 I.R.B. 41

66-49

Modified by
96-15, 1996-3 I.R.B. 41

88-32

Obsoleted by
96-15, 1996-3 I.R.B. 41

88-33

Obsoleted by
96-15, 1996-3 I.R.B. 41

91-22

Modified by
96-1, 1996-1 I.R.B. 8

91-22

Amplified by
96-13, 1996-3 I.R.B. 31

91-23

Superseded by
96-13, 1996-3 I.R.B. 31

91-24

Superseded by
96-14, 1996-3 I.R.B. 41

91-26

Superseded by
96-13, 1996-3 I.R.B. 31

92-20

Modified by
96-1, 1996-1 I.R.B. 8

92-85

Modified by
96-1, 1996-1 I.R.B. 8

93-16

Superseded by
96-11, 1996-2 I.R.B. 18

95-1

Superseded by
96-1, 1996-1 I.R.B. 8

95-2

Superseded by
96-2, 1996-1 I.R.B. 60

95-3

Superseded by
96-3, 1996-1 I.R.B. 82

Revenue Procedures—Continued

95-4

Superseded by
96-4, 1996-1 I.R.B. 94

95-5

Superseded by
96-5, 1996-1 I.R.B. 129

95-6

Superseded by
96-6, 1996-1 I.R.B. 151

95-7

Superseded by
96-7, 1996-1 I.R.B. 185

95-8

Superseded by
96-8, 1996-1 I.R.B. 187

95-50

Superseded by
96-3, 1996-1 I.R.B. 82

96-3

Amplified by
96-12, 1996-3 I.R.B. 30

Revenue Rulings:

66-307

Obsoleted by
96-3, 1996-2 I.R.B. 14

72-437

Modified by
96-13, 1996-3 I.R.B. 31

80-80

Obsoleted by
96-3, 1996-2 I.R.B. 14

82-80

Modified by
96-14, 1996-3 I.R.B. 41

92-19

Supplemented in part
96-2, 1996-2 I.R.B. 5

92-75

Clarified by
96-13, 1996-3 I.R.B. 31

95-10

Supplemented and superseded by
96-4, 1996-3 I.R.B. 16

95-11

Supplemented and superseded by
96-5, 1996-3 I.R.B. 29

¹A cumulative finding list for previously published items mentioned in Internal Revenue Bulletins 1995-27 through 1995-52 will be found in Internal Revenue Bulletin 1996-1, dated January 2, 1996.