

Internal Revenue bulletin

Bulletin No. 2001-5
January 29, 2001

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

T.D. 8930, page 433.

Final regulations under section 41 of the Code relate to the computation of the credit for increasing research activities and the definition of qualified research. These regulations provide guidance concerning the requirements to qualify for the credit and rules for electing and revoking the election of the alternative incremental credit.

Rev. Rul. 2001-5, page 451.

LIFO; price indexes; department stores. The November 2000 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, 2000.

REG-106542-98, page 473.

Proposed regulations relate to an election under section 645 of the Code to have certain revocable trusts treated and taxed as part of an estate. A public hearing is scheduled for February 21, 2001.

Notice 2001-10, page 459.

Split-dollar insurance arrangements. This notice clarifies prior rulings issued by the IRS regarding the taxation of split-dollar arrangements, provides taxpayers with interim guidance on the tax treatment of split-dollar arrangements pending publication of further guidance, and requests tax-

payer comments on the interim guidance and a number of unresolved issues. Rev. Rul 55-747 revoked. Rev. Ruls. 64-328 and 66-110 modified.

Notice 2001-11, page 464.

This notice provides additional guidance to financial institutions located in U.S. possessions in relation to the section 1441 nonresident alien withholding regulations that were published as T.D. 8734 (1997-2 C.B. 109) and T.D. 8881 (2000-23 I.R.B. 1158). Those regulations will apply to certain payments of income to foreign persons after December 31, 2000.

EXEMPT ORGANIZATIONS

Rev. Proc. 2001-15, page 465.

This procedure provides a modified and supplemented list of Indian tribal governments that are to be treated similarly to states for specified purposes under the Internal Revenue Code. Rev. Procs. 83-87 and 92-19 superseded.

ESTATE TAX

T.D. 8912, page 452.

Final regulations under section 2601 of the Code relate to the retention of a trust's exempt status for generation-skipping transfer tax purposes in the case of modifications, etc., to a trust.

Actions Relating to Court Decisions is on the page following the Introduction.

Finding Lists begin on page ii.

Announcements of Disbarments and Suspensions begin on page 482.



Department of the Treasury
Internal Revenue Service

The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities

and by applying the tax law with integrity and fairness to all.

Introduction

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

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

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

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and proce-

dures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.

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

Part II.—Treaties and Tax Legislation.

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

Part III.—Administrative, Procedural, and Miscellaneous.

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

Part IV.—Items of General Interest.

This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

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

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

Actions Relating to Decisions of the Tax Court

It is the policy of the Internal Revenue Service to announce at an early date whether it will follow the holdings in certain cases. An Action on Decision is the document making such an announcement. An Action on Decision will be issued at the discretion of the Service only on unappealed issues decided adverse to the government. Generally, an Action on Decision is issued where its guidance would be helpful to Service personnel working with the same or similar issues. Unlike a Treasury Regulation or a Revenue Ruling, an Action on Decision is not an affirmative statement of Service position. It is not intended to serve as public guidance and may not be cited as precedent.

Actions on Decisions shall be relied upon within the Service only as conclusions applying the law to the facts in the particular case at the time the Action on Decision was issued. Caution should be exercised in extending the recommendation of the Action on Decision to similar cases where the facts are different. Moreover, the recommendation in the Action on Decision may be superseded by new legislation, regulations, rulings, cases, or Actions on Decisions.

Prior to 1991, the Service published acquiescence or nonacquiescence only in certain regular Tax Court opinions. The Service has expanded its acquiescence program to include other civil tax cases where guidance is determined to be helpful. Accordingly, the Service now may acquiesce or nonacquiesce in the holdings of memorandum Tax Court opinions, as well as those of the United States District Courts, Claims Court, and Circuit Courts of Appeal. Regardless of the court deciding the case, the recommendation of any Action on Decision will be published in the Internal Revenue Bulletin.

The recommendation in every Action on Decision will be summarized as acquiescence, acquiescence in result only, or nonacquiescence. Both “acquiescence” and “acquiescence in result only” mean that the Service accepts the holding of the court in a case and that the Service will follow it in disposing of cases with the same controlling facts. However, “acquiescence” indicates neither approval nor disapproval of the reasons assigned by the court for its conclusions; whereas, “acquiescence in result only” indicates disagreement or concern with some or all

of those reasons. “Nonacquiescence” signifies that, although no further review was sought, the Service does not agree with the holding of the court and, generally, will not follow the decision in disposing of cases involving other taxpayers. In reference to an opinion of a circuit court of appeals, a “nonacquiescence” indicates that the Service will not follow the holding on a nationwide basis. However, the Service will recognize the precedential impact of the opinion on cases arising within the venue of the deciding circuit.

The Actions on Decisions published in the weekly Internal Revenue Bulletin are consolidated semiannually and appear in the first Bulletin for July and the Cumulative Bulletin for the first half of the year. A semiannual consolidation also appears in the first Bulletin for the following January and in the Cumulative Bulletin for the last half of the year.

The Commissioner ACQUIESCES in the following decision:

Security State Bank v. Commissioner,¹
214 F.3d 1254 (10th Cir. 2000),
aff'g 111 T.C. 210 (1998)

¹ Acquiescence as to whether a cash method bank that makes short-term loans in the ordinary course of its business is subject to accrual of the stated interest on those loans under section 1281(a)(2) or, in the alternative, under section 1281(a)(1).

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

Section 41.—Credit for Increasing Research Activities

26 CFR 1.41-1: Credit for increasing research activities.

T.D. 8930

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

Credit for Increasing Research Activities

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the computation of the credit under section 41(c) and the definition of *qualified research* under section 41(d). These regulations are intended to provide guidance concerning the requirements necessary to qualify for the credit for increasing research activities, guidance in computing the credit for increasing research activities, and rules for electing and revoking the election of the alternative incremental credit. These regulations reflect changes to section 41 made by the Tax Reform Act of 1986 (the 1986 Act), the Revenue Reconciliation Act of 1989, the Small Business Job Protection Act of 1996, the Taxpayer Relief Act of 1997, the Tax and Trade Relief Extension Act of 1998 (the 1998 Act), and the Tax Relief Extension Act of 1999 (the 1999 Act). These regulations also provide certain technical amendments to the existing regulations.

DATES: *Effective Dates:* These regulations are effective January 3, 2001.

Applicability Dates: For dates of applicability of these regulations, see Effective Dates under SUPPLEMENTARY INFORMATION. FOR FURTHER INFORMATION CONTACT: Lisa J. Shuman or Leslie H. Finlow at (202) 622-3120 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in §1.41-8(b) of this final rule have been

reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507) under the number 1545-1625. Responses to these collections of information are mandatory.

The reporting burden contained in §1.41-8(b)(2) (relating to the election of the alternative incremental credit) is reflected in the burden of Form 6765.

Estimated average annual burden hours per respondent under §1.41-8(b)(3) (relating to the revocation of the election to use the alternative incremental credit) is 250 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, W:CAR:MP:FP:S:O, 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.

The collections of information contained in §1.41-4(d) of this final rule have been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget (OMB) under 44 U.S.C. 3507 and assigned control number 1545-1625. This information is required to assist in the examination of the research credit and to ensure that the research credit is properly targeted to serve as an incentive to engage in qualified research. This information will be used to verify that the amounts treated as qualified research expenses were paid or incurred for activities intended to discover information that exceeds, expands, or refines the common knowledge of skilled professionals in the relevant field of science or engineering. This collection of information is required to obtain a benefit. The likely recordkeepers are businesses or other for-profit institutions.

Estimated total annual recordkeeping burden for §1.41-4(d) is 18,000 hours. The annual estimated burden per respondent varies from .5 hours to 2.5 hours, depending on the circumstances, with an estimated average of 1.5 hours.

The estimated number of recordkeepers is 12,000.

Comments on the collection of infor-

mation should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, W:CAR:MP:FP:S:O, Washington, DC 20224. Comments on the collection of information should be received by March 4, 2001. Comments are specifically requested concerning:

Whether the collection of information is necessary for the proper performance of the functions of the Internal Revenue Service, including whether the information will have practical utility;

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

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

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

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

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

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

Background

On January 2, 1997, the IRS and Treasury published in the **Federal Register** (62 F.R. 81) a notice of proposed rulemaking (REG-209494-90, 1997-1 C.B. 723) under section 41 describing when computer software that is developed by (or for the benefit of) a taxpayer primarily for the taxpayer's internal use can qualify for the credit for increasing research activities (the 1997 proposed regulations). Comments responding to the 1997 pro-

posed regulations were received and a public hearing was held on May 13, 1997.

On December 2, 1998, the IRS and Treasury published in the **Federal Register** (63 F.R. 66503) a notice of proposed rule-making (REG-105170-97, 1998-2 C.B. 729) under section 41 relating to the credit for increasing research activities (the 1998 proposed regulations). The 1998 proposed regulations propose rules and examples relating to (1) the definition of gross receipts for purposes of computing the base amount under section 41(c), (2) the application of the consistency rule in computing the base amount, (3) the definition of qualified research under section 41(d), (4) the application of the exclusions from the definition of qualified research, (5) the application of the shrinking-back rule, and (6) the election of the alternative incremental credit. The 1998 proposed regulations also propose certain technical amendments to the existing regulations. Comments responding to the 1998 proposed regulations were received and a public hearing was held on April 29, 1999.

In the 1999 Act, Congress extended the credit for a five-year period. The Conference Report accompanying the 1999 Act included the following language addressing the proposed regulations:

In extending the research credit, the conferees are concerned that the definition of qualified research be administered in a manner that is consistent with the intent Congress has expressed in enacting and extending the research credit. The conferees urge the Secretary to consider carefully the comments he has and may receive regarding the proposed regulations relating to the computation of the credit under section 41(c) and the definition of qualified research under section 41(d), particularly regarding the "common knowledge" standard. The conferees further note the rapid pace of technological advance, especially in service-related industries, and urge the Secretary to consider carefully the comments he has and may receive in promulgating regulations in connection with what constitutes "internal use" with regard

to software expenditures. The conferees also wish to observe that software research, that otherwise satisfies the requirements of section 41, which is undertaken to support the provision of a service, should not be deemed "internal use" solely because the business component involves the provision of a service.

The conferees wish to reaffirm that qualified research is research undertaken for the purpose of discovering new information which is technological in nature. For purposes of applying this definition, new information is information that is new to the taxpayer, is not freely available to the general public, and otherwise satisfies the requirements of section 41. Employing existing technologies in a particular field or relying on existing principles of engineering or science is qualified research, if such activities are otherwise undertaken for purposes of discovering information and satisfy the other requirements of section 41.

The conferees also are concerned about unnecessary and costly taxpayer record keeping burdens and reaffirm that eligibility for the credit is not intended to be contingent on meeting unreasonable record keeping requirements.

H.R. Conf. Rep. No. 106-478, at 132 (1999).

After considering the comments received, the statements made at the public hearings, and the legislative history for the research credit, the proposed regulations are adopted as revised by this Treasury decision.

Explanation of Provisions

This document amends 26 CFR part 1 to provide additional rules under section 41. Section 41 contains the rules for the credit for increasing research activities.

I. Basic Principles

A number of commentators objected to the inclusion of the basic principles

statement in §1.41-1(a) of the proposed regulations. They stated that the inclusion of a basic principles section was unusual, and that the basic principles section could be read to impose additional and unwarranted conditions for credit eligibility. In response to these comments, and because IRS and Treasury have concluded that the requisite principles are adequately reflected in the provisions of the regulations, the final regulations omit a separate statement of basic principles. The clarifications that the credit may be available where the technological advance sought is evolutionary, where the taxpayer is not the first to achieve the advance, and where the taxpayer fails to achieve the intended advance have been incorporated elsewhere in the regulations.

II. Gross Receipts

When Congress revised the computation of the research credit to incorporate a taxpayer's gross receipts, neither the statute nor the legislative history defined the term *gross receipts*, other than to provide that gross receipts for any taxable year are reduced by returns and allowances made during the tax year, and, in the case of a foreign corporation, that only gross receipts effectively connected with the conduct of a trade or business within the United States are taken into account. See section 41(c)(6).

The proposed regulations generally defined gross receipts as the total amount derived by a taxpayer from all activities and sources. However, in recognition of the fact that certain extraordinary gross receipts might not be taken into account when a business determines its research budget, the proposed regulations provided that certain extraordinary items (such as receipts from the sale or exchange of capital assets) would be excluded from the computation of gross receipts.

Several commentators objected to the definition of gross receipts in the proposed regulations. Referring to the inclusion in a House Budget Report of the term *sales growth* as an apparent short-hand reference to an increase in gross receipts, some commentators argued that gross receipts should be limited to income from sales. See H.R. Rep. No. 101-247, at 1200 (1989). In determining its research budget, however, a

business may take into account any expected income stream, regardless of whether or not the income is derived from sales or from other active business activities. Moreover, many businesses do not generate any income in the form of sales. Accordingly, the final regulations do not adopt this suggestion.

The final regulations also do not adopt suggestions that the definition of gross receipts be narrowed to exclude those items not directly related to the conduct of the taxpayer's trade or business. As noted above, any expected income stream may be taken into account in determining a business' research budget, regardless of the source of the income. Moreover, IRS and Treasury believe that a subjective narrowing of the term *gross receipts*, as suggested by these commentators, could leave the definition of the term, and thus the computation of the base amount, vulnerable to manipulation.

For example, a narrower definition allowing taxpayers to exclude items not derived in the ordinary course of business might prompt a taxpayer to assert that certain royalties received in the 1980s were derived in the ordinary course of business and are includible as gross receipts (thus decreasing the taxpayer's fixed-base percentage), but that certain interest income received in the years preceding the credit year was not derived in the ordinary course of business and was not includible in gross receipts (thus decreasing the base amount). Nor would a rule of consistency be effective in preventing such manipulation. While the taxpayer described above would be characterizing the nature of its income items as derived or not derived in the ordinary course of a trade or business so as to maximize the amount of the credit, the taxpayer would not be taking inconsistent positions with respect to the same items of income.

Several commentators objected to the definition of gross receipts in the proposed regulations as it applies to start-up firms with pre-operating interest income. If pre-operating interest income is treated as a gross receipt, many start-up firms would be precluded from using the start-up rules to compute their fixed-base percentages, because the application of the start-up rules is conditioned on a taxpayer not having both gross receipts and qualified research expenses in certain taxable

years during the 1980s. Moreover, because a start-up firm whose only gross receipt is pre-operating interest income likely would have significant qualified research expenses relative to gross receipts (and thus a high fixed-base percentage), such a firm likely would derive less benefit from the credit.

IRS and Treasury recognize that the start-up rules appear to contemplate that there will be years in which a taxpayer has qualified research expenses but no gross receipts. However, it would be difficult to conceive of such a year if gross receipts are defined to include pre-operating investment income. To address these concerns and pursuant to the regulatory authority of section 41(c)(3)(B)(iii), the final regulations exclude from the definition of gross receipts any income received by a taxpayer in a taxable year that precedes the first taxable year in which the taxpayer derives more than \$25,000 in gross receipts other than investment income. For this purpose, investment income is defined as interest or distributions with respect to stock (other than the stock of a 20-percent owned corporation as defined in section 243(c)(2) of the Code).

Some commentators suggested that the definition of gross receipts should be clarified to exclude certain payments made by pharmaceutical manufacturers to various insurers, managed care organizations and state governments. The final regulations do not adopt any provision specifically addressing such payments.

III. *The Discovery Requirement*

To qualify for the research credit, section 41(d) requires that a taxpayer undertake research for the purpose of discovering information which is technological in nature, and the application of which is intended to be useful in the development of a new or improved business component of the taxpayer. Section 1.41-4(a)(3) of the proposed regulations defines the phrase *discovering information* as obtaining knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science or engineering.

Commentators criticized this definition of discovering information, arguing that the definition imposes a discovery requirement that was not mandated by the statute. Commentators suggested that the phrase *discovering information*, as used in the

statute, was not intended as an additional requirement, but was simply used as a phrase to link the term *research* with the types of information required as the subject of the research. Commentators argued that a taxpayer who seeks to resolve its own subjective uncertainty as to the information at issue is undertaking sufficient discovery for purposes of section 41(d).

Consistent with the legislative history and case law as described below, however, IRS and Treasury continue to believe that section 41 conditions credit eligibility on an attempt to discover information that goes beyond the common knowledge of skilled professionals in the particular field of science or engineering.

The legislative history to the 1986 Act, which narrowed the definition of the term *qualified research*, explained that Congress had originally enacted the research credit to encourage business firms to perform the research necessary to increase the innovative qualities and efficiency of the U.S. economy. H.R. Rep. No. 99-426, at 177-78; S. Rep. No. 99-313, at 694-95. Congress was concerned that taxpayers had applied the original definition of qualified research "too broadly," that some taxpayers had claimed the credit for "virtually any expenses relating to product development" and that many of these taxpayers were "in industries that do not involve high technology or its application in developing technologically new and improved products or methods of production." *Id.* In an illustration of the changes enacted, the legislative history explained that, under the new definition: "Research does not rely on the principles of computer science merely because a computer is employed. Research may be treated as undertaken *to discover information* that is technological in nature, however, if the research is *intended to expand or refine existing principles of computer science.*" H.R. Conf. Rep. No. 99-841, at II-71 n.3 (1986) (emphasis added).

Following the 1986 Act changes to the credit, a discovery requirement has been applied in several recent cases. *See, e.g., United Stationers, Inc. v. United States*, 163 F.3d 440 (7th Cir. 1998), *Norwest v. Commissioner*, 110 T.C. 454 (1998), and *WICOR, Inc. v. United States*, 116 F. Supp. 2d 1028 (E.D. Wis. 2000).

In reaffirming the scope of the term *qualified research*, the Conference Report to the 1998 Act noted that:

evolutionary research activities intended to improve functionality, performance, reliability, or quality are eligible for the credit, as are research activities intended to achieve a result that has already been achieved by other persons *but is not yet within the common knowledge* (e.g., freely available to the general public) of the field (provided that the research otherwise meets the requirements of section 41, including not being excluded by subsection (d)(4)).

H.R. Conf. Rep. No. 105–825, at 1548 (1998) (emphasis added). In particular, it is noteworthy that the conferees clarified that the credit is available for research intended to achieve a result that has been achieved by others but is not yet within the common knowledge. The negative inference is that the credit is not available for research intended to achieve a result that has been achieved by others and is within the common knowledge of the field.

The discovery requirement as set forth in the final regulations also is consistent with the legislative history to the 1999 Act (the text of which is set forth above under **Background**). In that legislative history, for example, the conferees stated that:

[e]mploying existing technologies in a particular field or relying on existing principles of engineering or science is qualified research, if such activities are otherwise undertaken *for purposes of discovering information* and satisfy the other requirements under section 41.

H.R. Conf. Rep. No. 106–478, at 132 (emphasis added). By referring separately to a requirement that the research be undertaken for purposes of discovering information, this legislative history again confirmed that the phrase “discovering information” is a separate substantive requirement and not merely a phrase used to link the term *research* with the types of information required as the subject of the research.

In light of the case law and the legislative history, the final regulations retain the requirement that a taxpayer seek to dis-

cover information that exceeds, expands, or refines the common knowledge of skilled professionals in the particular field of science or engineering. However, consistent with the legislative history to the 1999 Act, IRS and Treasury have carefully considered comments relating to the “common knowledge” standard, and made a number of changes to address specific taxpayer concerns about the discovery requirement.

In response to comments regarding the application of the discovery requirement, the final regulations clarify that the phrase “common knowledge of skilled professionals in a particular field of science or engineering” means information that should be known to skilled professionals had they performed, before the research in question was undertaken, a reasonable investigation of the existing level of information in the particular field of science or engineering. Thus, in order to satisfy the discovery requirement, research must be undertaken for the purpose of discovering information that is beyond the knowledge that *should be* known to skilled professionals had they performed a reasonable investigation of the existing level of knowledge in the particular field of science or engineering. There is no requirement, however, that a taxpayer actually conduct such an investigation in order to claim the credit. To further clarify the application of the discovery requirement, the final regulations also state, as an example, that trade secrets generally are not within the common knowledge of skilled professionals because they are not reasonably available to skilled professionals not employed, hired, or licensed by the owner of such trade secrets.

Also, in response to comments, the discovery requirement in the final regulations has been reworded to refer to the common knowledge of skilled professionals in a particular field of science or engineering (rather than a particular field of technology or science, as in the proposed regulations). As in the proposed regulations, the common knowledge of skilled professionals is intended to serve as an objective standard for the baseline knowledge that a credit-eligible taxpayer must seek to exceed, expand, or refine. The reference to the common knowledge of skilled professionals is not intended to impose qualification requirements on the

personnel that the taxpayer uses to conduct qualified research.

Several commentators raised concerns that the discovery requirement in the proposed regulations required that taxpayers must “prove a negative;” in response to these concerns about the potential burden imposed on taxpayers to demonstrate that they satisfy the discovery requirement, IRS and Treasury have added to the final regulations a rebuttable presumption. The final regulations provide that, if a taxpayer demonstrates with credible evidence that research activities were undertaken to obtain the information described in documentation prepared before or during the early stages of the research and if that documentation also sets forth the basis for the taxpayer’s belief that obtaining this information would exceed, expand, or refine the common knowledge of skilled professionals in the particular field of science or engineering, then the research activities are presumed to satisfy the discovery requirement. This rebuttable presumption would arise, however, only if the taxpayer cooperates with reasonable requests by the IRS for witnesses, information, documents, meetings, and interviews.

In a case where the rebuttable presumption arises, the final regulations provide that the Commissioner may overcome this presumption by demonstrating that the information described in the taxpayer’s documentation was within the common knowledge of skilled professionals in the particular field of science or engineering. That is, the Commissioner would have to demonstrate that the information would have been known to such skilled professionals had they performed (before the research was undertaken) a reasonable investigation of the existing level of information in the particular field of science or engineering.

By way of further clarification, a provision has been added and several examples have been changed or eliminated to remove any implication that the underlying principles of science or engineering used in the research must themselves be novel. IRS and Treasury recognize that virtually all research utilizes existing scientific principles and technology. The requirement that a taxpayer seek to exceed, expand, or refine the common knowledge of skilled professionals does

not mean that the tools and principles used in the attempt to achieve the technological advance must themselves be beyond the common knowledge.

Also, in response to commentators' suggestions, the final regulations provide that a taxpayer is conclusively presumed to have obtained knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in the relevant field of science or engineering, if that taxpayer was awarded a patent for the business component. Section 101 of title 35 of the United States Code provides that "[w]hoever invents or discovers any new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof, may obtain a patent therefor, subject to the conditions and requirements of [title 35]." Such an invention or discovery may be patentable if it was not previously known, used, patented, or described, as set forth in 35 U.S.C. 102, and the differences between the invention and the prior art are such that the invention would not have been obvious to a person having ordinary skill in the relevant art. See 35 U.S.C. 102.

The final regulations contain a patent safe harbor because IRS and Treasury believe that information leading to a patentable invention constitutes information that exceeds, expands, or refines the common knowledge of skilled professionals in the relevant field. Of course, qualification under the patent safe harbor does not necessarily establish that the discovery requirement is satisfied with respect to all of the research associated with the patentable invention (for example, some of the research might relate to style).

The final regulations emphasize that a patent is not a precondition for credit eligibility. Because not all research succeeds in achieving its objective and for other reasons, it is obvious that not all research intended to discover information that goes beyond the common knowledge results in a patent. Thus, the absence of a patent should have no bearing on credit eligibility. The factors underlying the denial of a patent application, on the other hand, may be relevant to the determination of whether the discovery requirement is satisfied.

Because section 41(d)(3)(B) provides that the credit is not available for research

related to style, taste, cosmetic, or seasonal design factors, the patent safe harbor does not include patents for design, as defined by 35 U.S.C. 171.

In light of these changes, modifications have been made to several examples in the proposed regulations, including an example in the proposed regulations relating to research undertaken to develop a new tire. This example has been moved to the section of the final regulations that illustrates the exclusion for research conducted after the beginning of commercial production (discussed in *VII. Research After Commercial Production* of this Preamble).

To address concerns expressed by a number of commentators that the common knowledge standard may be difficult for taxpayers and examiners to apply, and may give rise in practice to inconsistent treatment of similarly situated taxpayers (especially where examiners have limited expertise in a particular scientific field) IRS and Treasury have initiated measures to promote fair and consistent application of the discovery requirement and the other conditions for credit eligibility. Consistent with the suggestion of one commentator, IRS has met with Revenue Canada to discuss Canada's joint industry/government initiative to improve administration of the Canadian research credit. IRS also has met with various industry associations to form joint initiatives to devise guidelines for the administration and examination of the credit in particular industries. Similar efforts with respect to other industry groups are anticipated.

IV. Process of Experimentation

Commentators objected to §1.41-4(a)(5) of the proposed regulations, which defines a process of experimentation to include a prescribed four-step process. Commentators argued that while the four-step process may accurately have described the pure scientific method of conducting experiments, commercial and industrial practice does not always conform precisely to such requirements. Commentators also argued that the four-step process required by the proposed regulations was adapted from a description in the legislative history of the 1986 Act that was included for illustrative purposes and not as a comprehensive definition of the term *process of experimentation*.

In light of these comments, the final regulations provide that taxpayers con-

ducting a process of experimentation may, but are not required to, engage in the four-step process.

Consistent with the legislative history, the final regulations provide further clarification on the manner in which a process of experimentation differs from research and development in the experimental or laboratory sense, as required by §1.174-2(a). A process of experimentation is a process to evaluate more than one alternative designed to achieve a result where the capability or method of achieving that result is uncertain at the outset, but (in contrast to expenditures that qualify under section 174) does not include the evaluation of alternatives to establish the appropriate design of a business component when the capability and method for developing or improving the business component are not uncertain. See H.R. Conf. Rep. No. 99-841, at II-72 ("The term process of experimentation means a process involving the evaluation of more than one alternative designed to achieve a result where the means of achieving that result is uncertain at the outset."); *United Stationers*, 163 F.3d at 446; *Norwest*, 110 T.C. at 496.

V. Recordkeeping Requirement

Part of the four-step process of experimentation test prescribed in §1.41-4(a)(5) of the proposed regulations was a requirement that taxpayers record the results of their experiments. Maintaining that this requirement was particularly burdensome, commentators argued that, in the industrial or commercial setting, the recording of results is not necessarily inherent in a *bona fide* process of experimentation.

For these reasons, the final regulations do not contain a requirement that taxpayers record the results of their experiments. Moreover, reference to the recording of results has been eliminated from the illustrative (non-mandatory) description of a four-step process of experimentation.

To assist in the examination of claims for the credit and to ensure that the credit is properly targeted to serve as an incentive to engage in qualified research, the final regulations do include a less burdensome contemporaneous documentation requirement. Under the final regulations, taxpayers must prepare and retain written documentation before or during the early stages of the research project that

describes the principal questions to be answered and the information the taxpayer seeks to obtain that exceeds, expands, or refines the common knowledge of skilled professionals in the relevant field of science or engineering. Taxpayers also must comply with the general recordkeeping requirements of section 6001.

As noted above, taxpayers may also avail themselves of a rebuttable presumption that they satisfy the discovery requirement if their contemporaneous documentation also sets forth the basis for the taxpayer's belief that obtaining this information would exceed, expand, or refine the common knowledge of skilled professionals in the particular field of science or engineering.

VI. The Shrinking-back Rule

Under §1.41-4(b) of the proposed regulations, and consistent with the legislative history to the 1986 Act, if the requirements of section 41(d) are not met for an entire product, then the credit may be available with respect to the next most significant subset of elements of that product. This shrinking back continues until either a subset of elements of the product that satisfies the requirements is reached, or the most basic element of the product is reached and such element fails to satisfy the test.

The final regulations clarify that this shrinking-back rule applies only if the taxpayer incurs some research expenses with respect to the overall business component that would constitute qualified research expenses with respect to that business component but for the fact that less than substantially all of the research activities with respect to that component constitute elements of a process of experimentation that relates to a new or improved function, performance, reliability or quality. In cases where the substantially-all test is satisfied with respect to the overall business component, those research expenses with respect to the overall business component that are qualified research expenses are credit eligible, and there is no need for a taxpayer to shrink back to apply the tests with respect to subsets of elements of the business component. Of course, the mere fact that taxpayers are not required to shrink back to a smaller business component does not mean that all of the research expenses with respect to the overall credit are credit eligible. Research expenses that are not quali-

fied research expenses, for example because they relate to style, taste, cosmetic, or seasonal design factors, remain ineligible for the credit.

In response to commentators' suggestions, the final regulations also clarify that, if the original product is not eligible for the credit, the application of the shrinking-back rule may result in credit eligibility for multiple business components that are subsets of the original product. The regulations clarify that the shrinking-back rule may not itself be applied as a reason to exclude research activities from credit eligibility. Finally, an example has been added to illustrate these concepts.

VII. Research After Commercial Production

Several commentators addressed the section of the proposed regulations providing that activities conducted after the beginning of commercial production of a business component are not qualified research. Under the proposed regulations, activities are conducted after the beginning of commercial production of a business component if such activities are conducted after the component is developed to the point where it is ready for commercial sale or use, or meets the basic functional and economic requirements of the taxpayer for the component's sale or use. Moreover, certain specified activities (like preproduction planning for a finished business component and trial production runs) are deemed to occur after the beginning of commercial production.

Because the provisions set forth above closely reflect the legislative history of the post-production exclusion, these tests have been retained in the final regulations. See H.R. Conf. Rep. No. 841, at II-74-75. However, several changes have been made in response to commentators' concerns.

First, a change has been made to the list of activities that are *per se* deemed to occur after the beginning of commercial production. In the proposed regulations, one of the items on that list was "debugging or correcting flaws in a business component." Consistent with the legislative history, IRS and Treasury continue to believe that debugging should be conclusively presumed to occur after the beginning of commercial production. However, many activities conducted before the beginning of commercial production could be construed

as the correction of flaws. Thus, the *per se* list contained in the final regulations has been changed to refer to debugging activities but not to the correction of flaws.

Second, an example has been added to clarify that a new research project to improve a business component is not disqualified merely because the new research project commences after the commercial production of the unimproved business component. Other examples have been changed to eliminate references to and factual assertions about specific industries.

Third, the final regulations incorporate provisions from the legislative history to the 1986 Act that clinical testing of a pharmaceutical product prior to its commercial production in the United States is not treated as occurring after the beginning of commercial production even if the product is commercially available in other countries, and that additional clinical testing of a pharmaceutical product after a product has been approved for a specific therapeutic use by the Food and Drug Administration and is ready for commercial production and sale are not treated as occurring after the beginning of commercial production if such clinical tests are undertaken to establish new functional uses, characteristics, indications, combinations, dosages, or delivery forms for the product.

VIII. Adaptation

Several commentators suggested alternate formulations of the adaptation exclusion. Because such formulations effectively would render the adaptation exclusion inapplicable to activities that satisfy the other requirements for qualified research, thereby reading the exclusion out of the Internal Revenue Code, the final regulations do not adopt the suggestions.

Two new examples clarify that the adaptation exclusion may also apply to contract research expenses paid by the customer to the vendor or to in-house research expenses incurred by the customer itself to adapt an existing business component to that customer's requirement or need.

IX. Internal-use Software

As noted above, the 1997 proposed regulations describe when software that is developed by (or for the benefit of) a taxpayer primarily for the taxpayer's internal use can qualify for the credit. The final regulations incorporate these special provi-

sions for internal-use software. A number of changes have been made to the 1997 proposed regulations to address commentator concerns, and to coordinate the internal-use provisions with the other provisions of the final regulations.

Under the proposed regulations, research with respect to software developed primarily for a taxpayer's internal use is qualified research only if it satisfies both the general requirements for credit eligibility under section 41 *and* an additional condition for eligibility. Except for certain software developed for use in conducting qualified research or for use in a production process, and for certain software created as part of a package of hardware and software developed concurrently, the additional condition for eligibility is a requirement that the taxpayer satisfy a three-part test (requiring that the internal-use software be innovative, that its development involve significant economic risk, and that it not be commercially available).

Most of the comments received focused on two issues — (1) the determination of when software is developed primarily for internal use, and (2) the application of the three-part test to internal-use software. On the first issue, several commentators urged that internal-use software be defined to exclude any software used to deliver a service to customers or any software that includes an interface with customers or the public. After careful analysis of the legislative history to the 1986 Act and the 1999 Act, however, IRS and Treasury concluded that such a broad exclusion would be inconsistent with the statutory mandate, because the exclusion would extend to some software that Congress clearly intended to treat as internal-use software. At the same time, IRS and Treasury share the commentators' belief that the goals of the research credit may be advanced by removing additional conditions for credit-eligibility in the case of certain internal-use software used to provide new features to services offered to customers that are not otherwise available to them. Accordingly, as described in more detail below, the final regulations retain the definition of internal-use software contained in the proposed regulations, but provide a new exception (pursuant to the regulatory authority under section 41(d)(4)(E)) under which the development of certain internal-use software used to deliver noncomputer services to

customers with features that are not yet offered by a taxpayer's competitors is not subject to the three-part test.

Consistent with a statement in the Conference Report to the 1999 Act that software research undertaken to support the provision of a service should not be deemed internal-use software "solely because the business component involves the provision of a service," the final regulations clarify that the determination of whether software is internal-use software depends on the nature of the service provided by the taxpayer. Software that is intended to be used to provide noncomputer services to customers is internal-use software, while software that is to be used to provide computer services is not developed primarily for internal use. Computer services are services offered by a taxpayer to customers who do business with the taxpayer primarily for the use of the taxpayer's computer or software technology. Noncomputer services are services offered by a taxpayer to customers who do business with the taxpayer primarily to obtain a service other than a computer service, even if such other service is enabled, supported, or facilitated by computer or software technology.

The conclusion that software used to provide noncomputer services is internal-use software is consistent with the legislative history to the 1986 Act, which defined internal-use software as software used in general administrative functions *and software used in providing noncomputer services (such as accounting, consulting, or banking services)*. See H.R. Conf. Rep. No. 841, at II-73 (emphasis added).

As noted above, the final regulations contain a new exception under which a taxpayer is not required to establish that internal-use software used to provide noncomputer services containing features or improvements that are not yet offered by a taxpayer's competitors satisfies the three-part test. Software that is intended to be used to provide noncomputer services is described within the exception if the software is designed to provide customers a new feature with respect to a noncomputer service; the taxpayer reasonably anticipated that customers would choose to obtain the noncomputer service from the taxpayer (rather than from the taxpayer's competitors) because of those features of the service that will be provided by the software;

and those features are not available (at the time the research is undertaken) from any of the taxpayer's competitors.

No inference should be drawn that software described within the foregoing exception is not internal-use software or that internal-use software not described within the exception would fail the three-part test. Rather, the exception reflects a determination by IRS and Treasury that it is appropriate to exercise the regulatory authority in section 41(d)(4)(E) to exempt certain internal-use software from having to fulfil additional conditions for credit eligibility. This exercise of regulatory authority is based on a determination that the development of software containing features or improvements that are not available from a taxpayer's competitors and that provide a demonstrable competitive advantage is more likely to increase the innovative qualities and efficiency of the U.S. economy (by generating knowledge that can be used by other service providers) than is the development of software used to provide noncomputer services containing features or improvements that are already offered by others. IRS and Treasury believe that drawing such a line is an appropriate way to administer the credit with a view to identifying and facilitating the credit availability for software with the greatest potential for benefitting the U.S. economy, an important rationale for the research credit.

The final regulations also make a number of changes with respect to the three-part high threshold of innovation test, which continues to apply to certain software not described within the new exception. For example, commentators had questioned whether the 1997 proposed regulations impose a separate high threshold of innovation requirement that serves as an additional condition for credit eligibility, even where taxpayers otherwise satisfy the three-part test. The final regulations clarify that the three-part test is the high threshold of innovation test, and not a separate requirement. Similarly, commentators had objected to a sentence in the 1997 proposed regulations that could be read to suggest that certain internal-use software could never qualify for the credit. The final regulations clarify that research with respect to internal-use software that satisfies both the general conditions for credit eligibility and the three-part test is eligible for the credit.

Consistent with the application of the discovery requirement, the final regulations adopt the suggestion of several commentators that the three-part test should be applied without regard to whether the taxpayer succeeds in achieving the results described in that test.

Commentators questioned whether the “as where” clauses used to elaborate on the three requirements of the high threshold of innovation test in the 1997 proposed regulations were intended as mandatory requirements or merely as illustrations of ways in which taxpayers could satisfy the tests. By replacing the “as where” clauses with “in that” clauses, the final regulations confirm that a taxpayer must satisfy the provisions, as elaborated. Consistent with this clarification, the final regulations provide that the innovative prong of the three-part test may be satisfied with respect to any intended improvement, not just reductions in cost or improvements in speed.

Under the final regulations, all qualified research, including research with respect to internal-use software, must satisfy the discovery requirement (that is, must be intended to exceed, expand, or refine the common knowledge of skilled professionals in the particular field of science or engineering). The final regulations clarify how the three-part high threshold of innovation test supplements the discovery requirement. Specifically, the final regulations provide that several aspects of the three-part test (the determination of whether the software is intended to result in an improvement that is substantial and economically significant and the extent of uncertainty and technical risk) also must be applied with respect to the common knowledge of skilled professionals. In essence, the common knowledge of skilled professionals rather than the knowledge base of the taxpayer’s employees is treated as the baseline with respect to which the intended software must satisfy the innovative prong and other prongs of the three-part test. Stated differently, research with respect to internal-use software is credit eligible only if it is intended to exceed, expand, or refine the common knowledge of skilled professionals (as defined in §1.41-4(a)(3)(ii)) to a degree that is substantial and economically significant. See *Norwest* 110 T.C. at 499-500 (stating that “...the extent of the improvements required by Congress with respect to internal use software is much greater than

that required in other fields” and that “...the significant economic risk test requires a higher threshold of technological advancement in the development of internal use software than in other fields”).

Reference to the common knowledge of skilled professionals as the baseline is necessary to give proper meaning to the statutory three-part test. For example, if the innovative requirement was applied simply with respect to the prior state of the taxpayer’s own business, then ordinary inventory software installed by a taxpayer who previously tracked its inventory manually could be deemed to satisfy the innovative requirement merely because the taxpayer had achieved a substantial and economically significant improvement in speed over its prior non-automated operations.

Although the final regulations related to internal use software generally are effective for taxable years beginning after December 31, 1985, the provisions relating to software developed for use in providing computer and noncomputer services to customers and the provisions clarifying the interaction of the three-part test with the discovery requirement, like other provisions concerning the discovery requirement, are effective only prospectively; however, taxpayers may rely on these rules for expenditures paid or incurred prior to January 3, 2001.

X. Alternative Incremental Credit

Certain commentators suggested that taxpayers be permitted to elect the alternative incremental credit on an amended return. However, IRS and Treasury believe that the intended incentive effects of the credit would not be advanced by permitting taxpayers to make retroactive elections to alter the computation of (and presumably increase) the credit for prior years. Similarly, the availability of a retroactive election would undermine the application of section 41(c)(4)(B). Thus, the final regulations retain the requirement contained in the proposed regulations that the election to apply the provisions of the alternative incremental credit must be made on the taxpayer’s timely filed original return.

Effective Dates

In general, the regulations are applicable for expenditures paid or incurred on or after January 3, 2001. However, the regu-

lations addressing the base amount are applicable for taxable years beginning on or after January 3, 2001. The regulations addressing internal-use software are applicable for taxable years beginning after December 31, 1985. However, § 1.41-4(c)(6)(ii)(C)(4), §1.41-4(c)(6)(iv)(A) and (B), §1.41-4(c)(6)(v), the second and third sentences of §1.41-4(c)(6)(vii), and §1.41-4(c)(6)(viii) *Example 2* are applicable for expenditures paid or incurred on or after January 3, 2001. The special documentation requirements of §1.41-4(d) are applicable with respect to research projects that begin on or after March 4, 2001. The regulations providing for the election and revocation of the alternative incremental credit are applicable for taxable years ending on or after January 3, 2001. No inference should be drawn from the applicability date concerning the application of section 41 to expenditures paid or incurred or the computation of the base amount before the applicability date.

Special Analyses

It has been determined that these regulations are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations.

It is hereby certified that the collection of information contained in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that the rules of this section impact only taxpayers who engage in qualified research. Moreover, in those instances where the rules of this section impact small entities, the economic impact is not likely to be significant because it merely requires taxpayers to (1) prepare (before or during the early stages of a research project) and retain written documentation describing the principal questions to be answered and the information the taxpayer seeks to obtain that satisfies the requirements of §1.41-4(a)(3) of these regulations; (2) elect on Form 6765, “*Credit for Increasing Research Activities*,” to use the alternative incremental credit if the entity desires to use that method; and (3) obtain permission

to revoke the alternative incremental credit election, if so desired. Further, the economic impact of electing the alternative incremental credit on Form 6765 also would not be significant because the election is made on the same form and is based on the same information that is used to claim the research credit. Accordingly, a regulatory flexibility analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required.

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

Drafting Information

The principal authors of these regulations are Lisa J. Shuman and Leslie H. Finlow of the Office of the Associate Chief Counsel (Passthroughs and Special Industries), IRS. However, personnel from other offices of the IRS and the Treasury Department participated in their development.

Adoption of Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Par. 2. Revise the undesignated center-heading immediately before §1.30-1 to read as follows:

CREDITS ALLOWABLE UNDER SECTIONS 30 THROUGH 44B

Par. 3. Remove the undesignated center-heading immediately before §1.41-0.

Par. 4. Section 1.41-0 is revised to read as follows:

§1.41-0 Table of contents.

This section lists the paragraphs contained in

§§1.41-1 through 1.41-8 as follows:

§1.41-1 Credit for increasing research activities.

(a) Amount of credit.

(b) Introduction to regulations under section 41.

§1.41-2 Qualified research expenses.

- (a) Trade or business requirement.
 - (1) In general.
 - (2) New business.
 - (3) Research performed for others.
 - (i) Taxpayer not entitled to results.
 - (ii) Taxpayer entitled to results.
 - (4) Partnerships.
 - (i) In general.
 - (ii) Special rule for certain partnerships and joint ventures.
- (b) Supplies and personal property used in the conduct of qualified research.
 - (1) In general.
 - (2) Certain utility charges.
 - (i) In general.
 - (ii) Extraordinary expenditures.
 - (3) Right to use personal property.
 - (4) Use of personal property in taxable years beginning after December 31, 1985.
- (c) Qualified services.
 - (1) Engaging in qualified research.
 - (2) Direct supervision.
 - (3) Direct support.
 - (4) Wages paid for qualified services.
 - (1) In general.
 - (2) "Substantially all."
 - (5) Contract research expenses.
 - (1) In general.
 - (2) Performance of qualified research.
 - (3) "On behalf of."
 - (4) Prepaid amounts.
 - (5) Examples.

§1.41-3 Base amount for taxable years beginning on or after January 3, 2001.

- (a) New taxpayers.
- (b) Special rules for short taxable years.
 - (1) Short credit year.
 - (2) Short taxable year preceding credit year.
 - (3) Short taxable year in determining fixed-base percentage.
- (c) Definition of gross receipts.
 - (1) In general.
 - (2) Amounts excluded.
 - (3) Foreign corporations.
 - (4) Consistency requirement.
 - (1) In general.
 - (2) Illustrations.
 - (5) Effective date.

§1.41-4 Qualified research for expenditures paid or incurred on or after January 3, 2001.

- (a) Qualified research.
 - (1) General rule.
 - (2) Requirements of section 41(d)(1).
 - (3) Undertaken for the purpose of discovering information.
 - (i) In general.
 - (ii) Common knowledge.
 - (iii) Means of discovery.
 - (iv) Patent safe harbor.
 - (v) Rebuttable presumption.
 - (4) Technological in nature.
 - (5) Process of experimentation.
 - (6) Substantially all requirement.
 - (7) Use of computers and information technology.
 - (8) Illustrations.
- (b) Application of requirements for qualified research.
 - (1) In general.
 - (2) Shrinking-back rule.
 - (3) Illustration.
 - (c) Excluded activities.
 - (1) In general.
 - (2) Research after commercial production.
 - (i) In general.
 - (ii) Certain additional activities related to the business component.
 - (iii) Activities related to production process or technique.
 - (iv) Clinical testing.
 - (3) Adaptation of existing business components.
 - (4) Duplication of existing business component.
 - (5) Surveys, studies, research relating to management functions, etc.
 - (6) Internal-use computer software.
 - (i) General rule.
 - (ii) Requirements.
 - (iii) Primarily for internal use.
 - (iv) Software used in the provision of services.
 - (A) Computer services.
 - (B) Noncomputer services.
 - (v) Exception for certain software used in providing noncomputer services.
 - (vi) High threshold of innovation test.
 - (vii) Application of high threshold of innovation test.
 - (viii) Illustrations.
 - (ix) Effective dates.
 - (7) Activities outside the United States, Puerto Rico, and other possessions.
 - (i) In general.
 - (ii) Apportionment of in-house research expenses.
 - (iii) Apportionment of contract research expenses.

- (8) Research in the social sciences, etc.
- (9) Research funded by any grant, contract, or otherwise.
- (10) Illustrations.
- (d) Documentation.
- (e) Effective dates.

§1.41-5 Basic research for taxable years beginning after December 31, 1986. [Reserved]

§1.41-6 Aggregation of expenditures.

- (a) Controlled group of corporations; trades or businesses under common control.
 - (1) In general.
 - (2) Definition of trade or business.
 - (3) Determination of common control.
 - (4) Examples.
- (b) Minimum base period research expenses.
- (c) Tax accounting periods used.
 - (1) In general.
 - (2) Special rule where timing of research is manipulated.
 - (d) Membership during taxable year in more than one group.
 - (e) Intra-group transactions.
 - (1) In general.
 - (2) In-house research expenses.

- (3) Contract research expenses.
- (4) Lease payments.
- (5) Payment for supplies.

§1.41-7 Special rules.

- (a) Allocations.
 - (1) Corporation making an election under subchapter S.
 - (i) Pass-through, for taxable years beginning after December 31, 1982, in the case of an S corporation.
 - (ii) Pass-through, for taxable years beginning before January 1, 1983, in the case of a subchapter S corporation.
 - (2) Pass-through in the case of an estate or trust.
 - (3) Pass-through in the case of a partnership.
 - (i) In general.
 - (ii) Certain expenditures by joint ventures.
 - (4) Year in which taken into account.
 - (5) Credit allowed subject to limitation.
 - (b) Adjustments for certain acquisitions and dispositions—Meaning of terms.
 - (c) Special rule for pass-through of credit.
 - (d) Carryback and carryover of unused credits.

§1.41-8 Special rules for taxable years ending on or after January 3, 2001.

- (a) Alternative incremental credit.
- (b) Election.
 - (1) In general.
 - (2) Time and manner of election.
 - (3) Revocation.
 - (4) Effective date.

Par. 5. Section 1.41-1 is revised to read as follows:

§1.41-1 Credit for increasing research activities.

(a) *Amount of credit.* The amount of a taxpayer's credit is determined under section 41(a). For taxable years beginning after June 30, 1996, and at the election of the taxpayer, the portion of the credit determined under section 41(a)(1) may be calculated using the alternative incremental credit set forth in section 41(c)(4).

(b) *Introduction to regulations under section 41.* (1) Sections 1.41-2 through 1.41-8 and 1.41-3A through 1.41-5A address only certain provisions of section 41. The following table identifies the provisions of section 41 that are addressed, and lists each provision with the section of the regulations in which it is covered.

Section of the regulation	Section of the Internal Revenue Code
§1.41-2	41(b)
§1.41-3	41(c)
§1.41-4	41(d)
§1.41-5	41(e)
§1.41-6	41(f)
§1.41-7	41(f) 41(g)
§1.41-8	41(c)
§1.41-3A	41(c) (taxable years beginning before January 1, 1990)
§1.41-4A	41(d) (taxable years beginning before January 1, 1986)
§1.41-5A	41(e) (taxable years beginning before January 1, 1987)

(2) Section 1.41-3A also addresses the special rule in section 221(d)(2) of the Economic Recovery Tax Act of 1981 relating to taxable years overlapping the effective dates of section 41. Section 41 was formerly designated as sections 30

and 44F. Sections 1.41-0 through 1.41-8 and 1.41-0A through 1.41-5A refer to these sections as section 41 for conformity purposes. Whether section 41, former section 30, or former section 44F applies to a particular expenditure depends upon

when the expenditure was paid or incurred.

§1.41-2 [Amended]

Par. 6. Section 1.41-2 is amended as follows:

1. The last sentence of paragraph (a)(3)(i) is amended by removing the language “§1.41-5(d)(2)” and adding “§1.41-4A(d)(2)” in its place.

2. The last sentence of paragraph (a)(3)(ii) is amended by removing the language “§1.41-5(d)(3)” and adding “§1.41-4A(d)(3)” in its place.

3. The last sentence of paragraph (a)(4)(ii)(F) is amended by removing the language “§1.41-9(a)(3)(ii)” and adding “§1.41-7(a)(3)(ii)” in its place.

4. Paragraph (e)(1)(i) is amended by removing the language “§1.41-5” and adding “§1.41-4 or 1.41-4A, whichever is applicable” in its place.

§§1.41-0A through 1.41-8A
[Removed]

Par. 6A. Sections 1.41-0A through 1.41-8A and the undesignated centerheading preceding these sections are removed.

Par. 7. An undesignated centerheading is added immediately following §1.44B-1 to read as follows:

RESEARCH CREDIT—FOR
TAXABLE YEARS BEGINNING
BEFORE JANUARY 1, 1990

§1.41-3 [Redesignated as §1.41-3A]

Par. 8. Section 1.41-3 is redesignated as §1.41-3A and added under the new undesignated centerheading “RESEARCH CREDIT—FOR TAXABLE YEARS BEGINNING BEFORE JANUARY 1, 1990.”

Par. 9. New §1.41-3 is added to read as follows:

§1.41-3 Base amount for taxable years beginning on or after January 3, 2001.

(a) *New taxpayers.* If, with respect to any credit year, the taxpayer has not been in existence for any previous taxable year, the average annual gross receipts of the taxpayer for the four taxable years preceding the credit year shall be zero. If, with respect to any credit year, the taxpayer has been in existence for at least one previous taxable year, but has not been in existence for four taxable years preceding the taxable year, then the average annual gross receipts of the taxpayer for the four taxable years preceding the credit year shall be the average annual gross receipts

for the number of taxable years preceding the credit year for which the taxpayer has been in existence.

(b) *Special rules for short taxable years—(1) Short credit year.* If a credit year is a short taxable year, then the base amount determined under section 41(c)(1) (but not section 41(c)(2)) shall be modified by multiplying that amount by the number of months in the short taxable year and dividing the result by 12.

(2) *Short taxable year preceding credit year.* If one or more of the four taxable years preceding the credit year is a short taxable year, then the gross receipts for such year are deemed to be equal to the gross receipts actually derived in that year multiplied by 12 and divided by the number of months in that year.

(3) *Short taxable year in determining fixed-base percentage.* No adjustment shall be made on account of a short taxable year to the computation of a taxpayer’s fixed-base percentage.

(c) *Definition of gross receipts—(1) In general.* For purposes of section 41, gross receipts means the total amount, as determined under the taxpayer’s method of accounting, derived by the taxpayer from all its activities and from all sources (e.g., revenues derived from the sale of inventory before reduction for cost of goods sold).

(2) *Amounts excluded.* For purposes of this paragraph (c), gross receipts do not include amounts representing—

- (i) Returns or allowances;
- (ii) Receipts from the sale or exchange of capital assets, as defined in section 1221;
- (iii) Repayments of loans or similar instruments (e.g., a repayment of the principal amount of a loan held by a commercial lender);

(iv) Receipts from a sale or exchange not in the ordinary course of business, such as the sale of an entire trade or business or the sale of property used in a trade or business as defined under section 1221(2);

(v) Amounts received with respect to sales tax or other similar state and local taxes if, under the applicable state or local law, the tax is legally imposed on the purchaser of the good or service, and the taxpayer merely collects and remits the tax to the taxing authority; and

(vi) Amounts received by a taxpayer in a taxable year that precedes the first tax-

able year in which the taxpayer derives more than \$25,000 in gross receipts other than investment income. For purposes of this paragraph (c)(2)(vi), investment income is interest or distributions with respect to stock (other than the stock of a 20-percent owned corporation as defined in section 243(c)(2)).

(3) *Foreign corporations.* For purposes of section 41, in the case of a foreign corporation, gross receipts include only gross receipts that are effectively connected with the conduct of a trade or business within the United States, the Commonwealth of Puerto Rico, or other possessions of the United States. See section 864(c) and applicable regulations thereunder for the definition of effectively connected income.

(d) *Consistency requirement—(1) In general.* In computing the credit for increasing research activities for taxable years beginning after December 31, 1989, qualified research expenses and gross receipts taken into account in computing a taxpayer’s fixed-base percentage and a taxpayer’s base amount must be determined on a basis consistent with the definition of qualified research expenses and gross receipts for the credit year, without regard to the law in effect for the taxable years taken into account in computing the fixed-base percentage or the base amount. This consistency requirement applies even if the period for filing a claim for credit or refund has expired for any taxable year taken into account in computing the fixed-base percentage or the base amount.

(2) *Illustrations.* The following examples illustrate the application of the consistency rule of paragraph (d)(1) of this section:

Example 1. (i) X, an accrual method taxpayer using the calendar year as its taxable year, incurs qualified research expenses in 2001. X wants to compute its research credit under section 41 for the tax year ending December 31, 2001. As part of the computation, X must determine its fixed-base percentage, which depends in part on X’s qualified research expenses incurred during the fixed-base period, the taxable years beginning after December 31, 1983, and before January 1, 1989.

(ii) During the fixed-base period, X reported the following amounts as qualified research expenses on its Form 6765:

1984	.....	\$ 100x
1985	.....	120x
1986	.....	150x
1987	.....	180x
1988	.....	<u>170x</u>
Total	.....	\$ 720x

(iii) For the taxable years ending December 31, 1984, and December 31, 1985, X based the amounts reported as qualified research expenses on the definition of qualified research in effect for those taxable years. The definition of qualified research changed for taxable years beginning after December 31, 1985. If X used the definition of qualified research applicable to its taxable year ending December 31, 2001, the credit year, its qualified research expenses for the taxable years ending December 31, 1984, and December 31, 1985, would be reduced to \$ 80x and \$ 100x, respectively. Under the consistency rule in section 41(c)(5) and paragraph (d)(1) of this section, to compute the research credit for the tax year ending December 31, 2001, X must reduce its qualified research expenses for 1984 and 1985 to reflect the change in the definition of qualified research for taxable years beginning after December 31, 1985. Thus, X's total qualified research expenses for the fixed-base period (1984-1988) to be used in computing the fixed-base percentage is \$ 80 + 100 + 150 + 180 + 170 = \$ 680x.

Example 2. The facts are the same as in *Example 1*, except that, in computing its qualified research expenses for the taxable year ending December 31, 2001, X claimed that a certain type of expenditure incurred in 2001 was a qualified research expense. X's claim reflected a change in X's position, because X had not previously claimed that similar expenditures were qualified research expenses. The consistency rule requires X to adjust its qualified research expenses in computing the fixed-base percentage to include any similar expenditures not treated as qualified research expenses during the fixed-base period, regardless of whether the period for filing a claim for credit or refund has expired for any year taken into account in computing the fixed-base percentage.

(e) *Effective date.* The rules in paragraphs (c) and (d) of this section are applicable for taxable years beginning on or after the date final regulations are published in the **Federal Register**.

Par. 10. Section 1.41-4 is revised to read as follows:

§1.41-4 Qualified research for expenditures paid or incurred on or after January 3, 2001.

(a) *Qualified research*—(1) *General rule.* Research activities related to the development or improvement of a business component constitute qualified research only if the research activities meet all of the requirements of section 41(d)(1) and this section, and are not otherwise excluded under section 41(d)(3)(B) or (d)(4), or this section.

(2) *Requirements of section 41(d)(1).* Research constitutes qualified research only if it is research—

(i) With respect to which expenditures may be treated as expenses under section 174, see §1.174-2;

(ii) That is undertaken for the purpose of discovering information that is technological in nature, and the application of

which is intended to be useful in the development of a new or improved business component of the taxpayer; and

(iii) Substantially all of the activities of which constitute elements of a process of experimentation that relates to a new or improved function, performance, reliability or quality.

For certain recordkeeping requirements, see paragraph (d) of this section.

(3) *Undertaken for the purpose of discovering information*—(i) *In general.* For purposes of section 41(d) and this section, research is undertaken for the purpose of discovering information only if it is undertaken to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science or engineering. A determination that research is undertaken for the purpose of discovering information does not require that the taxpayer succeed in obtaining the knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science or engineering, nor does it require that the advance sought be more than evolutionary. However, research is not undertaken for the purpose of discovering information merely because an expenditure may be treated as an expense under section 174.

(ii) *Common knowledge.* Common knowledge of skilled professionals in a particular field of science or engineering means information that should be known to skilled professionals had they performed, before the research in question is undertaken, a reasonable investigation of the existing level of information in the particular field of science or engineering. Thus, knowledge may, in certain circumstances, exceed, expand, or refine the common knowledge of skilled professionals in a particular field of science or engineering even though such knowledge has previously been obtained by other persons. For example, trade secrets generally are not within the common knowledge of skilled professionals in a particular field of science or engineering because they are not reasonably available to skilled professionals not employed, hired, or licensed by the owner of such trade secrets.

(iii) *Means of discovery.* In seeking to obtain knowledge that exceeds, expands, or refines the common knowledge of

skilled professionals in a particular field of science or engineering, a taxpayer may employ existing technologies in a particular field and may rely on existing principles of science or engineering.

(iv) *Patent safe harbor.* For purposes of section 41(d) and paragraph (a)(3)(i) of this section, the issuance of a patent by the Patent and Trademark Office under the provisions of section 151 of title 35, United States Code (other than a patent for design issued under the provisions of section 171 of title 35, United States Code) is conclusive evidence that a taxpayer has obtained knowledge that exceeds, expands, or refines the common knowledge of skilled professionals. However, the issuance of such a patent is not a precondition for credit availability.

(v) *Rebuttable presumption.* If a taxpayer demonstrates with credible evidence that research activities were undertaken to obtain the information described in the taxpayer's contemporaneous documentation required under paragraph (d)(1) of this section, and if that documentation also sets forth the basis for the taxpayer's belief that obtaining this information would exceed, expand, or refine the common knowledge of skilled professionals in the particular field of science or engineering, the research activities are presumed to satisfy the requirements of this paragraph (a)(3). However, the presumption applies only if the taxpayer cooperates with reasonable requests by the Commissioner for witnesses, information, documents, meetings, and interviews. Furthermore, the Commissioner may overcome the presumption in this paragraph if the Commissioner demonstrates that the information described in the taxpayer's documentation was within the common knowledge of skilled professionals (as described in paragraph (a)(3)(ii) of this section), or that the research activities were not undertaken to obtain the information described in the taxpayer's documentation.

(4) *Technological in nature.* For purposes of section 41(d) and this section, information is technological in nature if the process of experimentation used to discover such information fundamentally relies on principles of the physical or biological sciences, engineering, or computer science.

(5) *Process of experimentation.* For purposes of section 41(d) and this section,

a process of experimentation is a process to evaluate more than one alternative designed to achieve a result where the capability or method of achieving that result is uncertain at the outset. A process of experimentation does not include the evaluation of alternatives to establish the appropriate design of a business component, if the capability and method for developing or improving the business component are not uncertain. A process of experimentation in the physical or biological sciences, engineering, or computer science may involve—

(i) Developing one or more hypotheses designed to achieve the intended result;

(ii) Designing an experiment (that, where appropriate to the particular field of research, is intended to be replicable with an established experimental control) to test and analyze those hypotheses (through, for example, modeling, simulation, or a systematic trial and error methodology);

(iii) Conducting the experiment; and

(iv) Refining or discarding the hypotheses as part of a sequential design process to develop or improve the business component.

(6) *Substantially all requirement.* The substantially all requirement of section 41(d)(1)(C) and paragraph (a)(2)(iii) of this section is satisfied only if 80 percent or more of the research activities, measured on a cost or other consistently applied reasonable basis (and without regard to §1.41-2(d)(2)), constitute elements of a process of experimentation for a purpose described in section 41(d)(3). The substantially all requirement is applied separately to each business component.

(7) *Use of computers and information technology.* The employment of computers or information technology, or the reliance on principles of computer science or information technology to store, collect, manipulate, translate, disseminate, produce, distribute, or process data or information, and similar uses of computers and information technology does not itself establish that qualified research has been undertaken.

(8) *Illustrations.* The following examples illustrate the application of this paragraph (a):

Example 1. (i) Facts. X and other manufacturing companies have previously designed and manufactured a particular kind of machine using Material S. Material T is less expensive than Material S. X wishes to design a new machine that appears and

functions exactly the same as its existing machines, but that is made of Material T instead of Material S. The capability and method necessary to achieve this objective should not have been known to skilled professionals had they conducted a reasonable investigation of the existing information in the relevant field of science or engineering at the time the research was undertaken.

(ii) *Conclusion.* X's activities to design the new machine using Material T may be qualified research within the meaning of section 41(d)(1) and this paragraph (a). In seeking to design the machine, X undertook to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in the relevant field of science or engineering.

Example 2. (i) Facts. X is engaged in the business of developing and manufacturing widgets. X wants to manufacture an improved widget made out of a material that X has not previously used. Although X is uncertain how to use the material to manufacture an improved widget, the capability and method of using the material to manufacture such widgets should have been known to skilled professionals had they conducted a reasonable investigation of the existing level of information in the particular field of science or engineering at the time the research was undertaken.

(ii) *Conclusion.* Even though X's expenditures for the activities to resolve the uncertainty in manufacturing the improved widget may be treated as expenses for research activities under section 174 and §1.174-2, X's activities to resolve the uncertainty in manufacturing the improved widget are not qualified research within the meaning of section 41(d) and this paragraph (a). Although X's activities were intended to eliminate uncertainty, the activities were not undertaken to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in the relevant field of science or engineering.

Example 3. (i) Facts. X desires to build a bridge that can sustain greater traffic flow without deterioration than can existing bridges. The capability and method used to build such a bridge should not have been known to skilled professionals had they conducted a reasonable investigation of the existing level of information in the particular field of science or engineering at the time the research was undertaken. X eventually abandons the project after attempts to develop the technology prove unsuccessful.

(ii) *Conclusion.* X's activities to develop the technology to build the bridge may be qualified research within the meaning of section 41(d)(1) and this paragraph (a), regardless of the fact that X did not actually succeed in developing that technology. In seeking to develop the technology, X undertook to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in the relevant field of science or engineering.

Example 4. (i) Facts. The facts are the same as in *Example 3*, except that Y successfully builds a bridge that can sustain the greater traffic flow. Thereafter, Z seeks to build a bridge that can also sustain such greater traffic flow. The method Y used to build its bridge is a closely guarded trade secret that is not known to Z and should not have been known to skilled professionals had they conducted a reasonable investigation of the existing level of

information in the particular field of science or engineering at the time the research was undertaken.

(ii) *Conclusion.* Z's activities to develop the technology to build the bridge may be qualified research within the meaning of section 41(d)(1) and this paragraph (a), even if it so happens that the technology Z used to build its bridge is similar or identical to the technology Y used. In developing the technology, Z undertook to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in the relevant field of science or engineering.

Example 5. (i) Facts. X, a widget manufacturer, seeks to develop a new widget and initiates Project A. Before or during the early stages of Project A, X's employees prepare contemporaneous documentation that describes the principal questions to be answered by Project A and the information that X seeks to obtain to exceed, expand, or refine the common knowledge of skilled professionals in the relevant field of science or engineering. The documentation includes a statement from one of X's skilled professionals setting forth the basis for that professional's belief that the information is beyond the common knowledge of skilled professionals in the relevant field. Upon examination by the Commissioner, X presents credible evidence that the research activities were undertaken to obtain the information described in the contemporaneous documentation. X cooperates with all requests by the IRS for witnesses, information, documents, meetings, and interviews.

(ii) *Conclusion.* X's research activities with respect to Project A are presumed to be undertaken for the purpose of obtaining knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in the relevant field of science or engineering. The Commissioner may overcome this presumption by demonstrating that the information X sought to obtain was within the common knowledge of skilled professionals in the relevant field of science or engineering (*i.e.*, by demonstrating that, at the time Project A began, the information should have been known to skilled professionals had they performed a reasonable investigation of the existing level of knowledge in the relevant field).

(b) *Application of requirements for qualified research—(1) In general.* The requirements for qualified research in section 41(d)(1) and paragraph (a) of this section, must be applied separately to each business component, as defined in section 41(d)(2)(B). In cases involving development of both a product and a manufacturing or other commercial production process for the product, research activities relating to development of the process are not qualified research unless the requirements of section 41(d) and this section are met for the research activities relating to the process without taking into account the research activities relating to development of the product. Similarly, research activities relating to development of the product are not qualified research unless the requirements of section 41(d)

and this section are met for the research activities relating to the product without taking into account the research activities relating to development of the manufacturing or other commercial production process.

(2) *Shrinking-back rule.* The requirements of section 41(d) and paragraph (a) of this section are to be applied first at the level of the discrete business component, that is, the product, process, computer software, technique, formula, or invention to be held for sale, lease, or license, or used by the taxpayer in a trade or business of the taxpayer. If the requirements for credit eligibility are met at that first level, then some or all of the taxpayer's research expenses are eligible for the credit. A special shrinking-back rule applies in the case where a taxpayer incurs some research expenses with respect to that discrete business component that would constitute qualified research expenses with respect to that business component but for the fact that less than substantially all of the research activities with respect to that component constitute elements of a process of experimentation that relates to a new or improved function, performance, reliability or quality. In such a case, the requirements for the credit are to be applied at the next most significant subset of elements of the business component. The shrinking-back of the applicable business component continues until a subset or series of subsets of elements of the business component satisfies the substantially all requirement of section 41(d)(1)(C) and paragraph (a)(2)(iii) of this section (treating that subset of elements as a business component) or the most basic element fails to satisfy the requirements. This shrinking-back rule is applied only if a taxpayer does not satisfy the requirements of section 41(d)(1)(C) and paragraph (a)(2)(iii) of this section with respect to the overall business component. The shrinking-back rule is not itself applied as a reason to exclude research activities from credit eligibility.

(3) *Illustration.* The following example illustrates the application of this paragraph (b):

(i) *Facts.* X, a widget manufacturer, develops a widget that is improved in several respects. Among the various improvements to the widget is an improvement to the widget's cooling mechanism. Although the capability and method of making the other improvements to the widget would have been known to skilled professionals had they conducted a reason-

able investigation of the existing level of information in the particular field of science or engineering, the method of developing the improved cooling mechanism and of incorporating the improved mechanism into the widget would not have been known to skilled professionals had they conducted a reasonable investigation of the existing level of information in the particular field of science or engineering. Substantially all of X's research activities in improving the widget constitute elements of a process of experimentation for purposes of improving the performance of the widget. None of X's research activities in improving the widget are described in section 41(d)(4) or paragraph (c) of this section.

(ii) *Conclusion.* Some, but not all, of X's research activities in developing the improved widget are qualified research within the meaning of section 41(d)(1) and paragraph (a) of this section. In seeking to improve the widget, some of X's activities (related to improving the cooling mechanism and incorporating the improved cooling mechanism into the widget) were undertaken to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in the relevant field of science or engineering. However, other activities (related to the other improvements) were not undertaken to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in the relevant field of science or engineering, and thus are not qualified research and are not eligible for the credit. Not all of X's research activities relating to the widget are eligible for the credit because some of the activities are not qualified research as defined in section 41(d) and paragraph (a) of this section, even though the widget qualifies as a business component with respect to which qualified research that satisfies the requirements of section 41(d) and paragraph (a) of this section is undertaken.

(c) *Excluded activities—(1) In general.* Qualified research does not include any activity described in section 41(d)(4) and paragraph (c) of this section.

(2) *Research after commercial production—(i) In general.* Activities conducted after the beginning of commercial production of a business component are not qualified research. Activities are conducted after the beginning of commercial production of a business component if such activities are conducted after the component is developed to the point where it is ready for commercial sale or use, or meets the basic functional and economic requirements of the taxpayer for the component's sale or use.

(ii) *Certain additional activities related to the business component.* The following activities are deemed to occur after the beginning of commercial production of a business component—

- (A) Preproduction planning for a finished business component;
- (B) Tooling-up for production;
- (C) Trial production runs;

(D) Trouble shooting involving detecting faults in production equipment or processes;

(E) Accumulating data relating to production processes; and

(F) Debugging flaws in a business component.

(iii) *Activities related to production process or technique.* In cases involving development of both a product and a manufacturing or other commercial production process for the product, the exclusion described in section 41(d)(4)(A) and paragraphs (c)(2)(i) and (ii) of this section applies separately for the activities relating to the development of the product and the activities relating to the development of the process. For example, even after a product meets the taxpayer's basic functional and economic requirements, activities relating to the development of the manufacturing process still may constitute qualified research, provided that the development of the process itself separately satisfies the requirements of section 41(d) and this section, and the activities are conducted before the process meets the taxpayer's basic functional and economic requirements or is ready for commercial use.

(iv) *Clinical testing.* Clinical testing of a pharmaceutical product prior to its commercial production in the United States is not treated as occurring after the beginning of commercial production even if the product is commercially available in other countries. Additional clinical testing of a pharmaceutical product after a product has been approved for a specific therapeutic use by the Food and Drug Administration and is ready for commercial production and sale are not treated as occurring after the beginning of commercial production if such clinical tests are undertaken to establish new functional uses, characteristics, indications, combinations, dosages, or delivery forms for the product. A functional use, characteristic, indication, combination, dosage or delivery form shall be considered new only if such functional use, characteristic, indication, combination, dosage or delivery form must be approved by the Food and Drug Administration.

(3) *Adaptation of existing business components.* Activities relating to adapting an existing business component to a particular customer's requirement or need are not qualified research. This exclusion does not apply merely because a business component is intended for a specific customer.

(4) *Duplication of existing business component.* Activities relating to reproducing an existing business component (in whole or in part) from a physical examination of the business component itself or from plans, blueprints, detailed specifications, or publicly available information about the business component are not qualified research. This exclusion does not apply merely because the taxpayer inspects an existing business component in the course of developing its own business component.

(5) *Surveys, studies, research relating to management functions, etc.* Qualified research does not include activities relating to—

(i) Efficiency surveys;

(ii) Management functions or techniques, including such items as preparation of financial data and analysis, development of employee training programs and management organization plans, and management-based changes in production processes (such as rearranging work stations on an assembly line);

(iii) Market research, testing, or development (including advertising or promotions);

(iv) Routine data collections; or

(v) Routine or ordinary testing or inspections for quality control.

(6) *Internal-use computer software—*

(i) *General rule.* Research with respect to computer software that is developed by (or for the benefit of) the taxpayer primarily for the taxpayer's internal use is eligible for the research credit only if the software satisfies the requirements of paragraph (c)(6)(ii) of this section.

(ii) *Requirements.* The requirements of this paragraph (c)(6)(ii) are—

(A) The research satisfies the requirements of section 41(d)(1);

(B) The research is not otherwise excluded under section 41(d)(4) (other than section 41(d)(4)(E)); and

(C) One of the following conditions is met—

(1) The taxpayer develops the software for use in an activity that constitutes qualified research (other than the development of the internal-use software itself);

(2) The taxpayer develops the software for use in a production process that meets the requirements of section 41(d)(1);

(3) The taxpayer develops a new or improved package of computer software

and hardware together as a single product, of which the software is an integral part, that is used directly by the taxpayer in providing technological services in its trade or business to customers. In these cases, eligibility for the research credit is to be determined by examining the combined hardware-software product as a single product;

(4) The taxpayer develops the software for use in providing computer services to customers; or

(5) The software satisfies the high threshold of innovation test of paragraph (c)(6)(vi) of this section.

(iii) *Primarily for internal use.* Software is developed primarily for the taxpayer's internal use if the software is to be used internally, for example, in general administrative functions of the taxpayer (such as payroll, bookkeeping, or personnel management) or in providing noncomputer services (such as accounting, consulting or banking services). If computer software is developed primarily for the taxpayer's internal use, the requirements of paragraph (c)(6) apply even though the taxpayer intends to, or subsequently does, sell, lease, or license the computer software.

(iv) *Software used in the provision of services—*(A) *Computer services.* For purposes of this section, a computer service is a service offered by a taxpayer to customers who conduct business with the taxpayer primarily for the use of the taxpayer's computer or software technology. A taxpayer does not provide a computer service merely because customers interact with the taxpayer's software.

(B) *Noncomputer services.* For purposes of this section, a noncomputer service is a service offered by a taxpayer to customers who conduct business with the taxpayer primarily to obtain a service other than a computer service, even if such other service is enabled, supported, or facilitated by computer or software technology.

(v) *Exception for certain software used in providing noncomputer services.* The requirements of paragraph (c)(6)(ii)(C) of this section are deemed satisfied for research with respect to computer software if, at the time the research was undertaken—

(A) The software is designed to provide customers a new feature with respect to a noncomputer service;

(B) The taxpayer reasonably anticipated that customers would choose to obtain the noncomputer service from the taxpayer (rather than from the taxpayer's competitors) because of those new features provided by the software; and

(C) Those new features were not available from any of the taxpayer's competitors.

(vi) *High threshold of innovation test.* Computer software satisfies the high threshold of innovation test of this paragraph (c)(6)(vi) only if the taxpayer can establish that—

(A) The software is innovative in that the software is intended to result in a reduction in cost, improvement in speed, or other improvement, that is substantial and economically significant;

(B) The software development involves significant economic risk in that the taxpayer commits substantial resources to the development and there is a substantial uncertainty, because of technical risk, that such resources would be recovered within a reasonable period; and

(C) The software is not commercially available for use by the taxpayer in that the software cannot be purchased, leased, or licensed and used for the intended purpose without modifications that would satisfy the requirements of paragraphs (c)(6)(vi)(A) and (B) of this section.

(vii) *Application of high threshold of innovation test.* In determining if the high threshold of innovation test of paragraph (c)(6)(vi) of this section is satisfied, all of the facts and circumstances are considered. The determination of whether the software is intended to result in an improvement or cost reduction that is substantial and economically significant is based on a comparison of the intended result with software that is within the common knowledge of skilled professionals in the relevant field of science or engineering, see §1.41-4(a)(3)(ii). Similarly, the extent of uncertainty and technical risk is determined with respect to the common knowledge of skilled professionals in the relevant field of science or engineering. Further, in determining if the high threshold of innovation test of paragraph (c)(6)(vi) of this section is satisfied, the activities to develop the new or improved software are considered independent of the effect of any modifications to related hardware or other software.

(viii) *Illustrations.* The following examples illustrate the application of this paragraph (c)(6):

Example 1. (i) Facts. X is engaged in the business of manufacturing and selling widgets to wholesalers. X has experienced strong growth and at the same time has expanded its product offerings. X also has increased significantly the size of its business by expanding into new territories. The increase in the size and scope of its business has strained X's existing financial management systems such that management can no longer obtain timely comprehensive financial data. Accordingly, X undertakes the development of a financial management computer software system that is more appropriate to its newly expanded operations.

(ii) *Conclusion.* X's new computer software system is developed by X primarily for X's internal use. X's activities to develop the new computer software system may be eligible for the research credit only if the computer software development activities satisfy the requirements of paragraph (c)(6)(ii) of this section.

Example 2. (i) Facts. X is engaged in the business of designing, manufacturing, and selling widgets. X delivers its widgets in the same manner and time as its competitors. In keeping with X's corporate commitment to provide customers with top quality service, X undertakes a project to develop for X's internal use a computer software system to facilitate the tracking of the manufacturing and delivery of widgets which will enable X's customers to monitor the progress of their orders and know precisely when their widgets will be delivered. X's computer software activities include research activities that satisfy the discovery requirement in section 41(d)(1) and paragraph (a)(3) of this section. At the time the research is undertaken, X reasonably anticipates that if it is successful, X will increase its market share as compared to X's competitors, none of which has such a tracking feature for its delivery system.

(ii) *Conclusion.* Although X's computer software system is developed primarily for X's internal use, X's activities are excepted from the high threshold of innovation test of paragraph (c)(6)(vi) of this section because, at the time the research is undertaken, X's software is designed to provide improved tracking features, X reasonably anticipates that customers will purchase widgets from X because these improved tracking features, and because comparable tracking features are not available from any of X's competitors.

(ix) *Effective dates.* This paragraph (c)(6) is applicable for taxable years beginning after December 31, 1985, except paragraphs (c)(6)(ii)(C)(4), (c)(6)(iv)(A) and (B), (c)(6)(v), the second and third sentences of paragraph (c)(6)(vii), and paragraph (c)(6)(viii) *Example 2* of this section apply to expenditures paid or incurred on or after January 3, 2001.

(7) *Activities outside the United States, Puerto Rico, and other possessions—(i) In general.* Research conducted outside the United States, as defined in section

7701(a)(9), the Commonwealth of Puerto Rico and other possessions of the United States does not constitute qualified research.

(ii) *Apportionment of in-house research expenses.* In-house research expenses paid or incurred for qualified services performed both (A) in the United States, the Commonwealth of Puerto Rico and other possessions of the United States and (B) outside the United States, the Commonwealth of Puerto Rico and other possessions of the United States must be apportioned between the services performed in the United States, the Commonwealth of Puerto Rico and other possessions of the United States and the services performed outside the United States, the Commonwealth of Puerto Rico and other possessions of the United States. Only those in-house research expenses apportioned to the services performed within the United States, the Commonwealth of Puerto Rico and other possessions of the United States are eligible to be treated as qualified research expenses, unless the in-house research expenses are wages and the 80 percent rule of § 1.41-2(d)(2) applies.

(iii) *Apportionment of contract research expenses.* If contract research is performed partly in the United States, the Commonwealth of Puerto Rico and other possessions of the United States and partly outside the United States, the Commonwealth of Puerto Rico and other possessions of the United States, only 65 percent (or 75 percent in the case of amounts paid to qualified research consortia) of the portion of the contract amount that is attributable to the research activity performed in the United States, the Commonwealth of Puerto Rico and other possessions of the United States may qualify as a contract research expense (even if 80 percent or more of the contract amount is for research performed in the United States, the Commonwealth of Puerto Rico and other possessions of the United States).

(8) *Research in the social sciences, etc.* Qualified research does not include research in the social sciences (including economics, business management, and behavioral sciences), arts, or humanities.

(9) *Research funded by any grant, contract, or otherwise.* Qualified research does not include any research to the extent

funded by any grant, contract, or otherwise by another person (or governmental entity). To determine the extent to which research is so funded, § 1.41-4A(d) applies.

(10) *Illustrations.* The following examples illustrate provisions contained in paragraphs (c)(1) through (9) of this section. No inference should be drawn from these examples concerning the application of section 41(d)(1) and paragraph (a) of this section to these facts. The examples are as follows:

Example 1. (i) Facts. X, a tire manufacturer, seeks to build a tire that will not deteriorate as rapidly under certain conditions of high speed and temperature as do existing tires. X commences laboratory research on January 1. On April 1, X determines in the laboratory that a certain combination of materials and additives can withstand higher rotational speeds and temperatures than the combination of materials and additives used in existing tires. On the basis of this determination, X undertakes further research activities to determine how to design a tire using those materials and additives, and to determine whether such a tire functions outside the laboratory as intended under various actual road conditions. By September 1, X's research has progressed to the point where the new tire meets X's basic functional and economic requirements.

(ii) *Conclusion.* Any research activities conducted by X after September 1 with respect to the design of the tire are not qualified research within the meaning of section 41(d)(1) and paragraph (a) of this section because they are undertaken after the beginning of commercial production of the tire. Whether any activities X engaged in to develop a process for manufacturing the new tire constitute qualified research depends on if the development of the process itself separately satisfies the requirements of section 41(d) and paragraph (c)(2) of this section, and also depends on if the activities occur before the point in time when the process meets the taxpayer's basic functional and economic requirements or is ready for commercial use.

Example 2. (i) Facts. For several years, X has manufactured and sold a particular kind of widget. X initiates a new research project to develop an improved widget.

(ii) *Conclusion.* X's activities to develop an improved widget are not excluded from the definition of qualified research under section 41(d)(4)(A) and paragraph (c)(2) of this section until the beginning of commercial production of the improved widget. The fact that X's activities relating to the improved widget are undertaken after the beginning of commercial production of the unimproved widget does not bar the activities from credit eligibility because those activities constitute a new research project to develop a new business component, an improved widget.

Example 3. (i) Facts. X, a computer software development firm, owns all substantial rights in a general ledger accounting software core program that X markets and licenses to customers. X incurs expenditures in adapting the core software program to the requirements of C, one of X's customers.

(ii) *Conclusion.* Because X's activities represent activities to adapt an existing software program to a particular customer's requirement, X's activities are excluded from the definition of qualified research under section 41(d)(4)(B) and paragraph (c)(3) of this section.

Example 4. (i) *Facts.* The facts are the same as in *Example 3*, except that C pays X to adapt the core software program to C's requirements.

(ii) *Conclusion.* Because X's activities are excluded from the definition of qualified research under section 41(d)(4)(B) and paragraph (c)(3) of this section, C's payments to X do not constitute contract research expenses under section 41(b)(3)(A).

Example 5. (i) *Facts.* The facts are the same as in *Example 3*, except that C's own employees adapt the core software program to C's requirements.

(ii) *Conclusion.* Because C's employees' activities are excluded from the definition of qualified research under section 41(d)(4)(B) and paragraph (c)(3) of this section, the wages C paid to its employees do not constitute in-house research expenses under section 41(b)(2)(A).

Example 6. (i) *Facts.* An existing gasoline additive is manufactured by Y using three ingredients, A, B, and C. X seeks to develop and manufacture its own gasoline additive that appears and functions in a manner similar to Y's additive. To develop its own additive, X first inspects the composition of Y's additive, and uses knowledge gained from the inspection to reproduce A and B in the laboratory. Any differences between ingredients A and B that are used in Y's additive and those reproduced by X are insignificant and are not material to the viability, effectiveness, or cost of A and B. X desires to use with A and B an ingredient that has a materially lower cost than ingredient C. Accordingly, X engages in a process of experimentation to discover potential alternative formulations of the additive (i.e., the development and use of various ingredients other than C to use with A and B).

(ii) *Conclusion.* X's activities in analyzing and reproducing ingredients A and B involve duplication of existing business components and are excluded from qualified research under section 41(d)(4)(C) and paragraph (c)(4) of this section. X's experimentation activities to discover potential alternative formulations of the additive do not involve duplication of an existing business component and are not excluded from qualified research under section 41(d)(4)(C) and paragraph (c)(4) of this section.

Example 7. (i) *Facts.* X, an insurance company, develops a new life insurance product. In the course of developing the product, X engages in research with respect to the effect of pricing and tax consequences on demand for the product, the expected volatility of interest rates, and the expected mortality rates (based on published data and prior insurance claims).

(ii) *Conclusion.* X's activities related to the new product represent research in the social sciences, and are thus excluded from qualified research under section 41(d)(4)(G) and paragraph (c)(8) of this section.

(d) *Documentation.* No credit shall be allowed under section 41 with regard to an expenditure relating to a research project unless the taxpayer—

(1) Prepares documentation before or during the early stages of the research project, that describes the principal questions to be answered and the information the taxpayer seeks to obtain to satisfy the requirements of paragraph (a)(3) of this section, and retains that documentation on paper or electronically in the manner prescribed in applicable regulations, revenue rulings, revenue procedures, or other appropriate guidance until such time as taxes may no longer be assessed (except under section 6501(c)(1), (2), or (3)) for any year in which the taxpayer claims to have qualified research expenditures in connection with the research project; and

(2) Satisfies section 6001 and the regulations thereunder.

(e) *Effective dates.* In general, the rules of this section are applicable for expenditures paid or incurred on or after January 3, 2001. The rules of paragraph (d), however, apply to research projects that begin on or after March 4, 2001.

§1.41-5 [Redesignated as §1.41-4A, and Amended]

Par. 11. Section 1.41-5 is redesignated as §1.41-4A, and the last sentence of paragraph (d)(1) is amended by removing the language “§1.41-8(e)” and adding “§1.41-6(e)” in its place.

§1.41-6 [Redesignated as §1.41-5, and Amended]

Par. 12. Section 1.41-6 is redesignated as §1.41-5 and the section heading is amended by removing the language “December 31, 1985” and adding “December 31, 1986” in its place.

§1.41-7 [Redesignated as §1.41-5A, and Amended]

Par. 13. Section 1.41-7 is redesignated as §1.41-5A, and amended as follows:

1. The section heading is amended by removing the language “January 1, 1986” and adding “January 1, 1987” in its place.

2. Paragraph (e)(2) is amended by removing the language “§1.41-5(c)” and adding “1.41-4A(c)” in its place.

§1.41-8 [Redesignated as §1.41-6, and Amended]

Par. 14. Section 1.41-8 is redesignated as §1.41-6, and the last sentence of paragraph (c) is amended by removing the lan-

guage “§1.41-3, except that §1.41-3(c)(2)” and adding “§1.41-3A, except that §1.41-3A(c)(2)” in its place.

§1.41-9 [Redesignated as §1.41-7]

Par. 15. Section 1.41-9 is redesignated as §1.41-7.

Par. 16. New §1.41-8 is added to read as follows:

§1.41-8 Special rules for taxable years ending on or after January 3, 2001.

(a) *Alternative incremental credit.* At the election of the taxpayer, the credit determined under section 41(a)(1) equals the amount determined under section 41(c)(4).

(b) *Election—(1) In general.* A taxpayer may elect to apply the provisions of the alternative incremental credit in section 41(c)(4) for any taxable year of the taxpayer beginning after June 30, 1996. If a taxpayer makes an election under section 41(c)(4), the election applies to the taxable year for which made and all subsequent taxable years.

(2) *Time and manner of election.* An election under section 41(c)(4) is made by completing the portion of Form 6765, “*Credit for Increasing Research Activities*,” relating to the election of the alternative incremental credit, and attaching the completed form to the taxpayer's timely filed original return (including extensions) for the taxable year to which the election applies.

(3) *Revocation.* An election under this section may not be revoked except with the consent of the Commissioner. A taxpayer must attach the Commissioner's consent to revoke an election under section 41(c)(4) to the taxpayer's timely filed original return (including extensions) for the taxable year of the revocation.

(4) *Effective date.* Paragraphs (b)(2) and (3) of this section are applicable for taxable years ending on or after January 3, 2001.

Par. 17. Section 1.41-0A is added under the new undesignated centerheading “RESEARCH CREDIT—FOR TAXABLE YEARS BEGINNING BEFORE JANUARY 1, 1990” to read as follows:

§1.41-0A Table of contents.

This section lists the paragraphs contained in §§1.41-0A, 1.41-3A, 1.41-4A and 1.41-5A.

§1.41-0A Table of contents.

§1.41-3A Base period research expense.

- (a) Number of years in base period.
- (b) New taxpayers.
- (c) Definition of base period research expenses.
- (d) Special rules for short taxable years.
 - (1) Short determination year.
 - (2) Short base period year.
 - (3) Years overlapping the effective dates of section 41 (section 44F).
- (i) Determination years.
- (ii) Base period years.
- (4) Number of months in a short taxable year.
- (e) Examples.

§1.41-4A Qualified research for taxable years beginning before January 1, 1986.

- (a) General rule.
- (b) Activities outside the United States.
 - (1) In-house research.
 - (2) Contract research.
- (c) Social sciences or humanities.
- (d) Research funded by any grant, contract, or otherwise.
 - (1) In general.
 - (2) Research in which taxpayer retains no rights.

- (3) Research in which the taxpayer retains substantial rights.
 - (i) In general.
 - (ii) Pro rata allocation.
 - (iii) Project-by-project determination.
- (4) Independent research and development under the Federal Acquisition Regulations System and similar provisions.
- (5) Funding determinable only in subsequent taxable year.
- (6) Examples.

§1.41-5A Basic research for taxable years beginning before January 1, 1987.

- (a) In general.
- (b) Trade or business requirement.
- (c) Prepaid amounts.
 - (1) In general.
 - (2) Transfers of property.
 - (d) Written research agreement.
 - (1) In general.
 - (2) Agreement between a corporation and a qualified organization after June 30, 1983.
 - (i) In general.
 - (ii) Transfers of property.
 - (3) Agreement between a qualified fund and a qualified educational organization after June 30, 1983.
 - (e) Exclusions.

- (1) Research conducted outside the United States.
- (2) Research in the social sciences or humanities.
- (f) Procedure for making an election to be treated as a qualified fund.

§1.218-0 [Removed]

Par. 18. Section 1.218-0 is removed.

§1.482-7 [Amended]

Par. 19. In §1.482-7, the sixth sentence of paragraph (h)(1) is amended by removing the language “§1.41-8(e)” and adding “§1.41-6(e)” in its place.

PART 602-OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT.

Par. 20. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 21. In §602.101, paragraph (b) is amended by adding an entry to the table in numerical order to read as follows:

§602.101 OMB Control numbers.

- * * * * *
- (b) * * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.41-4(d)	1545-1625
* * * * *	
1.41-8(b)	1545-1625
* * * * *	

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

Approved December 22, 2000.

Joanthan Talisman,
*Acting Assistant Secretary
of the Treasury.*

(Filed by the Office of the Federal Register on December 27, 2000, 12:33 p.m., and published in the issue of the Federal Register for January 3, 2001, 66 F.R. 280)

For what purposes are Indian tribal governments treated as states? See Rev. Proc. 2001-15, page 465.

Section 105(e).—Amounts Received Under Accident and Health Plans

For what purposes are Indian tribal governments treated as states? See Rev. Proc. 2001-15, page 465.

Section 117(b)(2)(A).—Qualified Scholarships

For what purposes are Indian tribal governments

treated as states? See Rev. Proc. 2001-15, page 465.

Section 164.—Deductions-Taxes

For what purposes are Indian tribal governments treated as states? See Rev. Proc. 2001-15, page 465.

Section 170.—Deductions-Charitable, etc., Contributions and Gifts

For what purposes are Indian tribal governments treated as states? See Rev. Proc. 2001-15, page 465.

Section 103(c).—Definition. Interest on State and Local Bonds

**Section 403(b)(1)(A)(ii).—
Taxation of Employee Annuities-
Taxability of Beneficiary Under
Annuity Purchased by Section
501(c)(3) Organization or Public
School**

For what purposes are Indian tribal governments treated as states? See Rev. Proc. 2001-15, page 465.

**Section 454(b)(2).—Obligations
Issued at Discount—Short-Term
Obligations Issued on Discount
Basis**

For what purposes are Indian tribal governments treated as states? See Rev. Proc. 2001-15, page 465.

**Section 472.—Last-in, First-out
Inventories**

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

LIFO; price indexes; department stores. The November 2000 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, 2000.

Rev. Rul. 2001-5

The following Department Store Inventory Price Indexes for November 2000 were issued by the Bureau of Labor Statistics. 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, 2000.

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, food, 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. 1999	Nov. 2000	Percent Change from Nov. 1999 to Nov. 2000 ¹
1. Piece Goods	514.3	499.6	-2.9
2. Domestics and Draperies	622.0	610.2	-1.9
3. Women's and Children's Shoes	651.4	664.0	1.9
4. Men's Shoes	875.1	911.2	4.1
5. Infants' Wear	647.6	648.0	0.1
6. Women's Underwear	571.9	577.3	0.9
7. Women's Hosiery	328.9	347.0	5.5
8. Women's and Girls' Accessories	539.6	555.4	2.9
9. Women's Outerwear and Girls' Wear	410.3	402.0	-2.0
10. Men's Clothing	617.4	598.8	-3.0
11. Men's Furnishings	627.6	639.2	1.8
12. Boys' Clothing and Furnishings	510.2	501.3	-1.7
13. Jewelry	950.5	936.0	-1.5
14. Notions	764.6	798.0	4.4
15. Toilet Articles and Drugs	983.6	973.8	-1.0
16. Furniture and Bedding	689.7	696.6	1.0
17. Floor Coverings	602.1	625.6	3.9
18. Housewares	789.3	775.6	-1.7
19. Major Appliances	235.5	227.9	-3.2
20. Radio and Television	63.5	57.5	-9.4
21. Recreation and Education ²	96.1	92.3	-4.0
22. Home Improvements ²	129.2	129.2	0.0
23. Auto Accessories ²	107.6	107.6	0.0
Groups 1 - 15: Soft Goods	606.9	604.6	-0.4
Groups 16 - 20: Durable Goods	446.9	435.6	-2.5
Groups 21 - 23: Misc. Goods ²	102.7	100.1	-2.5
Store Total ³	547.2	541.4	-1.1

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

² Indexes on a January 1986=100 base.

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

DRAFTING INFORMATION

The principal author of this revenue ruling is Alan J. Tomsic of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Mr. Tomsic at (202) 622-4970 (not a toll-free call).

Section 511(a)(2)(B).—Imposition of Tax on Unrelated Business Income of Charitable, etc., Organizations—Organizations Subject to Tax

For what purposes are Indian tribal governments treated as states? See Rev. Proc. 2001-15, page 465.

Section 2055.—Transfers for Public, Charitable, and Religious Uses

For what purposes are Indian tribal governments treated as states? See Rev. Proc. 2001-15, page 465.

Section 2106(a)(2).—Taxable Estate—Transfer for Public, Charitable, and Religious Uses

For what purposes are Indian tribal governments treated as states? See Rev. Proc. 2001-15, page 465.

Section 2522.—Charitable and Similar Gifts

For what purposes are Indian tribal governments treated as states? See Rev. Proc. 2001-15, page 465.

Section 2601.—Tax Imposed

26 CFR 26.2601-1: Effective dates.

T.D. 8912

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 26

Generation-Skipping Transfer Issues

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the application of the effective date rules of the generation-skipping transfer (GST) tax imposed under chapter 13 of the Internal Revenue Code (Code). These regulations provide guidance with respect to the type of trust modifications that will not affect the exempt status of a trust. In addition, these regulations clarify the application of the effective date rules in the case of property transferred pursuant to the exercise of a general power of appointment. These regulations are necessary to provide guidance to taxpayers so that they may properly determine if chapter 13 of the Code is applicable to a particular trust.

DATES: These regulations are effective December 20, 2000.

SUPPLEMENTARY INFORMATION:

Background

On November 18, 1999, the Treasury Department and the IRS published in the **Federal Register** (64 F.R. 62997) a notice of proposed rulemaking (REG-103841-99, 1999-2 C.B. 639) relating to the application of the GST tax provisions where the terms of a trust that was irrevocable before the effective date of the statute are changed or modified after that date. The IRS received comments on the notice of proposed rulemaking. In addition, a public hearing was held on March 15, 2000. This document adopts final regulations with respect to the notice of proposed rulemaking. A summary of the principle comments received is provided below.

1. *The Regulatory Approach*

In general, under the effective date rules accompanying the GST statutory provisions, a trust that was irrevocable on September 25, 1985, is not subject to the GST tax provisions, unless a GST transfer is made out of corpus added to the trust after that date. Section 1433(b)(2)(A) of the Tax Reform Act of 1986 (TRA), Public Law 99-514 (100 Stat. 2085, 2731), 1986-3 (Vol. 1) C.B. 1, 634. Such trusts are hereinafter referred to as exempt trusts for GST tax purposes. The proposed regulations provide a number of safe harbors with respect to changes that can be made to the terms of an exempt

trust that will not result in the loss of exempt status.

Commentators argued that the approach set forth in the proposed regulations is inconsistent with the statutory effective date provisions. They contend that, under the TRA, with the exception of additions to principal, modifications or other actions with respect to a trust should not affect the trust's exempt status. Rather, any change should have GST tax consequences only if the change subjects the trust principal to a current gift tax. In that case, the individual making the gift will be treated, to the extent of the gift, as the transferor of the trust for GST tax purposes and the trust, to the extent of the gift, will be subject to the GST tax regime.

This approach was not adopted. The statutory effective date provision protects generation-skipping trusts that were irrevocable before the GST tax was enacted and presumably could not be changed to avoid the imposition of the tax. The Treasury Department and the IRS believe that the approach adopted in the regulations is consistent with Congressional intent to protect these trusts and that most of the modifications that will not affect the exempt status of a trust will be covered by the safe harbors in the final regulations.

2. *Trustee Discretionary Actions*

Under the proposed regulations, where there is a distribution of trust principal from an exempt trust to a new trust, the new trust will be an exempt trust if the terms of the governing instrument of the old trust authorize the trustee to make distributions to the new trust without the consent or approval of any beneficiary or court and the terms of the new trust do not extend the time for vesting of any beneficial interest in the trust beyond the applicable perpetuities period.

In response to comments, the final regulations clarify that the retention of property in a continuing trust, as well as the distribution of property to a new trust, will not cause loss of exempt status, assuming the requirements of the regulations are satisfied.

In response to comments, the final regulations provide that distribution to a new trust or retention in a continuing trust will not cause the loss of exempt status, even if

the governing instrument does not specifically authorize the action, if state law, at the time the exempt trust became irrevocable, permitted such distribution or retention in a continuing trust.

One comment suggested that the final regulations provide that a discretionary distribution that otherwise satisfies the regulatory requirements should not cause the trust to lose exempt status if the trustee, although not required to do so, seeks approval of a court or the trust beneficiaries before taking action. This change was deemed unnecessary. An action that satisfies the requirements of the regulations will not cause loss of exempt status even if, for whatever reason, the trustee seeks a court's or a beneficiary's approval of such action.

Comments suggested that the period for measuring the appropriate perpetuities period for the new trust should be the date the original trust became irrevocable under local law. The comments noted that the perpetuities period is properly measured from the date the trust becomes irrevocable, which is not always the date the trust was created (the date referenced in the proposed regulations). The regulations have been revised accordingly.

3. Settlements and Judicial Constructions

Under the proposed regulations, a court-approved settlement of a *bona fide* issue regarding the administration of the trust or the construction of terms of the trust will not cause the trust to lose exempt status if the settlement is the product of arm's length negotiations, and the settlement is within the range of reasonable outcomes under the governing instrument and applicable state law. A judicial construction of a governing instrument resolving an ambiguity in the terms of the instrument or correcting a scrivener's error will not cause loss of exempt status if the judicial action involves a *bona fide* issue, and the construction is consistent with applicable state law that would be applied by the highest court of the state.

One comment suggested that the standard applicable for recognition of settlement agreements should also apply for court decrees, such that one standard would govern both actions. Thus, the commentator suggested that a settlement agreement or court decree should be

binding on the Service (and not cause loss of exempt status) if the result is within the range of reasonable outcomes and the agreement or court decision is the product of adversarial proceedings. The suggestion was not adopted. The standard applied in the regulations for court decrees was enunciated by the Supreme Court in *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967), and has been continuously and repeatedly applied by the IRS and the courts. The adoption of a different standard at this time is not appropriate.

Another comment addressing the rule for settlements stated that the requirement that the settlement fall within the range of reasonable outcomes under the governing instrument and state law could be read to deny protection to a settlement that reaches a result that a court could not reach. However, the purpose of this rule is not to restrict safe harbor protection to only those settlements that reach the result a court could reach if the issue was litigated. Rather, the rule is intended to afford the parties a greater degree of latitude to settle a case than would be available if a court had to decide the issue. Thus, a settlement "within the range of reasonable outcomes" would include a compromise that reflects the parties' assessment of their relative rights and the strengths and weaknesses of their respective positions. The settlement need not (and it is anticipated that in most cases it would not) resolve the issue in the same manner as a court decision on the merits. Language has been added to the final regulations emphasizing this point. On the other hand, as illustrated in the preamble to the proposed regulations, a settlement that, for example, creates beneficial interests that did not exist under a reasonable interpretation of the instrument will not satisfy the regulations.

One comment suggested that the scope of the judicial construction rule should be expanded to cover not only ambiguities and scrivener's error, but any request for court instructions or any similar proceedings such as requests to modernize the trust instrument, or adapt the instrument to unforeseen changed circumstances. This suggestion was not adopted. The Treasury Department and the IRS believe that these and similar actions are properly

addressed under the safe-harbor "shift in beneficial interest" rule provided in the regulations, and a separate category to address these items is not needed.

4. Other Changes

Under the proposed regulations, a modification that does not satisfy the regulatory rules for trustee distributions, settlements, and constructions will not cause a trust to lose exempt status, if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

Comments suggested that the regulations should provide additional guidance on when a modification shifts a beneficial interest in a trust. In response to these comments, the final regulations provide that a modification to an exempt trust will result in a shift in beneficial interest to a lower generation beneficiary if the modification can result in an increase in a GST transfer or create a new GST transfer. To determine whether a modification of an irrevocable trust will shift a beneficial interest in a trust to a beneficiary who occupies a lower generation, the effect of the instrument on the date of the modification is measured against the effect of the instrument in existence immediately before the modification. If the effect of the modification cannot be immediately determined, it is deemed to shift a beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification.

In conjunction with this change, the final regulations remove *Example 7* contained in §26.2601-1(b)(2)(vii)(B). This example had illustrated the transition rule contained in §26.2601-1(b)(2) for generation-skipping transfers under wills or revocable trusts executed before October 22, 1986. Under this rule, the GST tax does not apply to transfers made under a will or revocable trust executed before October 22, 1986, if the decedent dies before January 1, 1987, and the instru-

ment is not amended after October 21, 1986, in any respect that results in the creation of, or increase in the amount of, a generation-skipping transfer. In *Example 7*, trust income is to be distributed equally, for life, to A, B, and C who are skip persons assigned to the same generation. The trust is amended to increase A's share of the income. The example concludes that the trust is subject to GST tax because the amendment increases the amount of the generation-skipping transfers to be made to A. The amendment to the trust, however, does not increase the amount of a generation-skipping transfer when viewed in the aggregate. The amendment merely shifts an interest from one beneficiary to another beneficiary assigned to the same generation. *Example 7* in §26.2601-1(b)(4)(i)(E) considers a substantially similar fact pattern involving a trust that is irrevocable on or before September 25, 1985, and concludes that the modification will not result in an increase in a generation-skipping transfer.

The standard contained in §26.2601-1(b)(2) (relating to wills and revocable trusts executed before October 22, 1986) is similar to the standard contained in §26.2602-1(b)(4)(i)(D) (relating to a modification to a trust that was irrevocable on September 25, 1985). The Treasury Department and the IRS believe that the two provisions should be applied in a consistent manner. Therefore, *Example 7* in §26.2601-1(b)(2)(vii)(B) has been eliminated.

In response to comments, the final regulations specify that changes that are administrative in nature (such as a change in the number of trustees) will not cause the trust to lose its exempt status. An example has been added illustrating this point.

Several comments indicated that many states have adopted, or are considering adopting, section 104 of the Revised Uniform Principal and Income Act. Unif. Principal and Income Act § 104, 7B U.L.A. 141 (1997) (Act). The Act allows a trustee to adjust between principal and income to the extent necessary to produce an equitable result, if the trustee invests and manages trust assets pursuant to the state's prudent investor statute and the trustee is unable to administer the trust fairly and reasonably under the gen-

eral statutory rules governing the allocation of income and principal. In addition, the comments noted that some state legislatures are contemplating revising their state principal and income act to define trust *income* as a unitrust amount (a fixed percentage of the trust principal determined annually). The comments suggested that the regulations provide additional safe harbors to the effect that the administration of an exempt trust pursuant to a state statute adopting the Act, or the conversion of an income interest to a unitrust interest pursuant to a court order or a state statute redefining trust income, would not cause the trust to lose exempt status.

A guidance project considering the tax consequences of these state law changes in a broader context is currently under consideration. Accordingly, these regulations do not specifically address this issue. However, two examples have been added to the regulations illustrating circumstances under which a trust will not lose exempt status where an income interest is converted to an interest that pays the greater of trust income or a unitrust amount, and a trust is modified to allow allocation of capital gain to income.

In response to a comment, the facts presented in §26.2601-1(b)(4)(i)(E) *Example 5*, have been changed to clarify that after the trusts are partitioned, if either beneficiary should die without descendants surviving, the principal of their partitioned trust will pass to the other partitioned trust.

5. *Effective Dates and Other Matters*

Comments requested clarification regarding the status of exempt trusts that were modified or subject to other actions (for example, judicial constructions or settlements) prior to the effective date of these regulations, December 20, 2000. The IRS will not challenge the exempt status of a trust that was, prior to December 20, 2000, subject to any trustee action, judicial construction, settlement agreement, modification, or other action, if the action satisfies the requirements of the regulations.

Finally, with respect to the deletion of §26.2601-1(b)(2)(vii)(B) *Example 7*, discussed above, the IRS will not follow that

example when applying the rule in §26.2601-1(b)(2).

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) 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 James F. Hogan, Office of the Chief Counsel, IRS. Other personnel from the IRS and the Treasury Department participated in their development.

* * * * *

PART 26—GENERATION-SKIPPING TRANSFER TAX REGULATIONS UNDER THE TAX REFORM ACT OF 1986

Par. 1. The authority citation for part 26 continues to read in part as follows:

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

Par. 2. In §26.2600-1, the table is amended under §26.2601-1 by revising the entry for paragraph (b)(4) and adding an entry for paragraph (b)(5) to read as follows:

§26.2600-1 *Table of contents.*

* * * * *

§26.2601-1. Effective dates.

* * * * *

(b) * * *

* * * * *

(4) Retention of trust's exempt status in the case of modifications, etc.

(5) Exceptions to additions rule.

* * * * *

Par. 3. Section 26.2601-1 is amended as follows:

1. Adding four sentences to the end of paragraph (b)(1)(i).

2. Paragraph (b)(2)(vii)(B) is amended by revising the heading, removing *Example 7*, and redesignating *Examples 8* and *9* as *Examples 7* and *8*, respectively.

2. Redesignating paragraph (b)(4) as paragraph (b)(5).

3. Adding a new paragraph (b)(4).

4. Paragraph (c) is amended by adding a new sentence to the end of the paragraph.

The additions read as follows:

§26.2601-1 *Effective dates.*

* * * * *

(b) * * *(1) * * *(i) * * * Further, the rule in the first sentence of this paragraph (b)(1)(i) does not apply to a transfer of property pursuant to the exercise, release, or lapse of a general power of appointment that is treated as a taxable transfer under chapter 11 or chapter 12. The transfer is made by the person holding the power at the time the exercise, release, or lapse of the power becomes effective, and is not considered a transfer under a trust that was irrevocable on September 25, 1985. See paragraph (b)(1)(v)(B) of this section regarding the treatment of the release, exercise, or lapse of a power of appointment that will result in a constructive addition to a trust. See §26.2652-1(a) for the definition of a transferor.

* * * * *

(2)* * *

(vii)* * *

(B) *Facts applicable to Examples 6 through 8.*

* * * * *

(4) *Retention of trust's exempt status in the case of modifications, etc.*—(i) *In general.* This paragraph (b)(4) provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust that is exempt from the generation-skipping transfer tax under paragraph (b)(1), (2), or (3) of this section (hereinafter referred to as an exempt trust) will not cause the trust to lose its exempt status. The rules contained in this paragraph (b)(4) are applicable only for purposes of determining whether an exempt trust retains its exempt status for generation-skipping transfer tax purposes. The rules do not apply in determining, for example, whether the transaction results in a gift subject to gift tax, or may cause the trust to be included in the gross estate of a ben-

eficiary, or may result in the realization of capital gain for purposes of section 1001.

(A) *Discretionary powers.* The distribution of trust principal from an exempt trust to a new trust or retention of trust principal in a continuing trust will not cause the new or continuing trust to be subject to the provisions of chapter 13, if—

(1) Either—

(i) The terms of the governing instrument of the exempt trust authorize distributions to the new trust or the retention of trust principal in a continuing trust, without the consent or approval of any beneficiary or court; or

(ii) at the time the exempt trust became irrevocable, state law authorized distributions to the new trust or retention of principal in the continuing trust, without the consent or approval of any beneficiary or court; and

(2) The terms of the governing instrument of the new or continuing trust do not extend the time for vesting of any beneficial interest in the trust in a manner that may postpone or suspend the vesting, absolute ownership, or power of alienation of an interest in property for a period, measured from the date the original trust became irrevocable, extending beyond any life in being at the date the original trust became irrevocable plus a period of 21 years, plus if necessary, a reasonable period of gestation. For purposes of this paragraph (b)(4)(i)(A), the exercise of a trustee's distributive power that validly postpones or suspends the vesting, absolute ownership, or power of alienation of an interest in property for a term of years that will not exceed 90 years (measured from the date the original trust became irrevocable) will not be considered an exercise that postpones or suspends vesting, absolute ownership, or the power of alienation beyond the perpetuities period. If a distributive power is exercised by creating another power, it is deemed to be exercised to whatever extent the second power may be exercised.

(B) *Settlement.* A court-approved settlement of a *bona fide* issue regarding the administration of the trust or the construction of terms of the governing instrument will not cause an exempt trust to be subject to the provisions of chapter 13, if—

(1) The settlement is the product of arm's length negotiations; and

(2) The settlement is within the range of reasonable outcomes under the governing instrument and applicable state law addressing the issues resolved by the settlement. A settlement that results in a compromise between the positions of the litigating parties and reflects the parties' assessments of the relative strengths of their positions is a settlement that is within the range of reasonable outcomes.

(C) *Judicial construction.* A judicial construction of a governing instrument to resolve an ambiguity in the terms of the instrument or to correct a scrivener's error will not cause an exempt trust to be subject to the provisions of chapter 13, if—

(1) The judicial action involves a *bona fide* issue; and

(2) The construction is consistent with applicable state law that would be applied by the highest court of the state.

(D) *Other changes.* (1) A modification of the governing instrument of an exempt trust (including a trustee distribution, settlement, or construction that does not satisfy paragraph (b)(4)(i)(A), (B), or (C) of this section) by judicial reformation, or nonjudicial reformation that is valid under applicable state law, will not cause an exempt trust to be subject to the provisions of chapter 13, if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

(2) For purposes of this section, a modification of an exempt trust will result in a shift in beneficial interest to a lower generation beneficiary if the modification can result in either an increase in the amount of a GST transfer or the creation of a new GST transfer. To determine whether a modification of an irrevocable trust will shift a beneficial interest in a trust to a beneficiary who occupies a lower generation, the effect of the instrument on the date of the modification is measured against the effect of the instrument in existence immediately before the modification. If the effect of the modification cannot be immediately determined, it is deemed to shift a beneficial interest in the trust to a beneficiary who occupies a

lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification. A modification that is administrative in nature that only indirectly increases the amount transferred (for example, by lowering administrative costs or income taxes) will not be considered to shift a beneficial interest in the trust.

(E) *Examples.* The following examples illustrate the application of this paragraph (b)(4). In each example, assume that the trust established in 1980 was irrevocable for purposes of paragraph (b)(1)(ii) of this section and that there have been no additions to any trust after September 25, 1985. The examples are as follows:

Example 1. Trustee's power to distribute principal authorized under trust instrument. In 1980, Grantor established an irrevocable trust (Trust) for the benefit of Grantor's child, A, A's spouse, and A's issue. At the time Trust was established, A had two children, B and C. A corporate fiduciary was designated as trustee. Under the terms of Trust, the trustee has the discretion to distribute all or part of the trust income to one or more of the group consisting of A, A's spouse or A's issue. The trustee is also authorized to distribute all or part of the trust principal to one or more trusts for the benefit of A, A's spouse, or A's issue under terms specified by the trustee in the trustee's discretion. Any trust established under Trust, however, must terminate 21 years after the death of the last child of A to die who was alive at the time Trust was executed. Trust will terminate on the death of A, at which time the remaining principal will be distributed to A's issue, per stirpes. In 2002, the trustee distributes part of Trust's principal to a new trust for the benefit of B and C and their issue. The new trust will terminate 21 years after the death of the survivor of B and C, at which time the trust principal will be distributed to the issue of B and C, per stirpes. The terms of the governing instrument of Trust authorize the trustee to make the distribution to a new trust without the consent or approval of any beneficiary or court. In addition, the terms of the governing instrument of the new trust do not extend the time for vesting of any beneficial interest in a manner that may postpone or suspend the vesting, absolute ownership or power of alienation of an interest in property for a period, measured from the date of creation of Trust, extending beyond any life in being at the date of creation of Trust plus a period of 21 years, plus if necessary, a reasonable period of gestation. Therefore, neither Trust nor the new trust will be subject to the provisions of chapter 13 of the Internal Revenue Code.

Example 2. Trustee's power to distribute principal pursuant to state statute. In 1980, Grantor established an irrevocable trust (Trust) for the benefit of Grantor's child, A, A's spouse, and A's issue. At the time Trust was established, A had two children, B and C. A corporate fiduciary was designated as trustee. Under the terms of Trust, the trustee has the discretion to distribute all or part of the trust income or principal to one or more of the group consisting of A, A's spouse or A's issue. Trust will terminate on the death of A, at which time, the trust principal will

be distributed to A's issue, per stirpes. Under a state statute enacted after 1980 that is applicable to Trust, a trustee who has the absolute discretion under the terms of a testamentary instrument or irrevocable inter vivos trust agreement to invade the principal of a trust for the benefit of the income beneficiaries of the trust, may exercise the discretion by appointing so much or all of the principal of the trust in favor of a trustee of a trust under an instrument other than that under which the power to invade is created, or under the same instrument. The trustee may take the action either with consent of all the persons interested in the trust but without prior court approval, or with court approval, upon notice to all of the parties. The exercise of the discretion, however, must not reduce any fixed income interest of any income beneficiary of the trust and must be in favor of the beneficiaries of the trust. Under state law prior to the enactment of the state statute, the trustee did not have the authority to make distributions in trust. In 2002, the trustee distributes one-half of Trust's principal to a new trust that provides for the payment of trust income to A for life and further provides that, at A's death, one-half of the trust remainder will pass to B or B's issue and one-half of the trust will pass to C or C's issue. Because the state statute was enacted after Trust was created and requires the consent of all of the parties, the transaction constitutes a modification of Trust. However, the modification does not shift any beneficial interest in Trust to a beneficiary or beneficiaries who occupy a lower generation than the person or persons who held the beneficial interest prior to the modification. In addition, the modification does not extend the time for vesting of any beneficial interest in Trust beyond the period provided for in the original trust. The new trust will terminate at the same date provided under Trust. Therefore, neither Trust nor the new trust will be subject to the provisions of chapter 13 of the Internal Revenue Code.

Example 3. Construction of an ambiguous term in the instrument. In 1980, Grantor established an irrevocable trust for the benefit of Grantor's children, A and B, and their issue. The trust is to terminate on the death of the last to die of A and B, at which time the principal is to be distributed to their issue. However, the provision governing the termination of the trust is ambiguous regarding whether the trust principal is to be distributed per stirpes, only to the children of A and B, or per capita among the children, grandchildren, and more remote issue of A and B. In 2002, the trustee files a construction suit with the appropriate local court to resolve the ambiguity. The court issues an order construing the instrument to provide for per capita distributions to the children, grandchildren, and more remote issue of A and B living at the time the trust terminates. The court's construction resolves a *bona fide* issue regarding the proper interpretation of the instrument and is consistent with applicable state law as it would be interpreted by the highest court of the state. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code.

Example 4. Change in trust situs. In 1980, Grantor, who was domiciled in State X, executed an irrevocable trust for the benefit of Grantor's issue, naming a State X bank as trustee. Under the terms of the trust, the trust is to terminate, in all events, no later than 21 years after the death of the last to die of certain designated individuals living at the time the

trust was executed. The provisions of the trust do not specify that any particular state law is to govern the administration and construction of the trust. In State X, the common law rule against perpetuities applies to trusts. In 2002, a State Y bank is named as sole trustee. The effect of changing trustees is that the situs of the trust changes to State Y, and the laws of State Y govern the administration and construction of the trust. State Y law contains no rule against perpetuities. In this case, however, in view of the terms of the trust instrument, the trust will terminate at the same time before and after the change in situs. Accordingly, the change in situs does not shift any beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the transfer. Furthermore, the change in situs does not extend the time for vesting of any beneficial interest in the trust beyond that provided for in the original trust. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code. If, in this example, as a result of the change in situs, State Y law governed such that the time for vesting was extended beyond the period prescribed under the terms of the original trust instrument, the trust would not retain exempt status.

Example 5. Division of a trust. In 1980, Grantor established an irrevocable trust for the benefit of his two children, A and B, and their issue. Under the terms of the trust, the trustee has the discretion to distribute income and principal to A, B, and their issue in such amounts as the trustee deems appropriate. On the death of the last to die of A and B, the trust principal is to be distributed to the living issue of A and B, per stirpes. In 2002, the appropriate local court approved the division of the trust into two equal trusts, one for the benefit of A and A's issue and one for the benefit of B and B's issue. The trust for A and A's issue provides that the trustee has the discretion to distribute trust income and principal to A and A's issue in such amounts as the trustee deems appropriate. On A's death, the trust principal is to be distributed equally to A's issue, per stirpes. If A dies with no living descendants, the principal will be added to the trust for B and B's issue. The trust for B and B's issue is identical (except for the beneficiaries), and terminates at B's death at which time the trust principal is to be distributed equally to B's issue, per stirpes. If B dies with no living descendants, principal will be added to the trust for A and A's issue. The division of the trust into two trusts does not shift any beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the division. In addition, the division does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Therefore, the two partitioned trusts resulting from the division will not be subject to the provisions of chapter 13 of the Internal Revenue Code.

Example 6. Merger of two trusts. In 1980, Grantor established an irrevocable trust for Grantor's child and the child's issue. In 1983, Grantor's spouse also established a separate irrevocable trust for the benefit of the same child and issue. The terms of the spouse's trust and Grantor's trust are identical. In 2002, the appropriate local court approved the merger of the two trusts into one trust

to save administrative costs and enhance the management of the investments. The merger of the two trusts does not shift any beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the merger. In addition, the merger does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Therefore, the trust that resulted from the merger will not be subject to the provisions of chapter 13 of the Internal Revenue Code.

Example 7. Modification that does not shift an interest to a lower generation. In 1980, Grantor established an irrevocable trust for the benefit of Grantor's grandchildren, A, B, and C. The trust provides that income is to be paid to A, B, and C, in equal shares for life. The trust further provides that, upon the death of the first grandchild to die, one-third of the principal is to be distributed to that grandchild's issue, per stirpes. Upon the death of the second grandchild to die, one-half of the remaining trust principal is to be distributed to that grandchild's issue, per stirpes, and upon the death of the last grandchild to die, the remaining principal is to be distributed to that grandchild's issue, per stirpes. In 2002, A became disabled. Subsequently, the trustee, with the consent of B and C, petitioned the appropriate local court and the court approved a modification of the trust that increased A's share of trust income. The modification does not shift a beneficial interest to a lower generation beneficiary because the modification does not increase the amount of a GST transfer under the original trust or create the possibility that new GST transfers not contemplated in the original trust may be made. In this case, the modification will increase the amount payable to A who is a member of the same generation as B and C. In addition, the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Therefore, the trust as modified will not be subject to the provisions of chapter 13 of the Internal Revenue Code. However, the modification increasing A's share of trust income is a transfer by B and C to A for Federal gift tax purposes.

Example 8. Conversion of income interest into unitrust interest. In 1980, Grantor established an irrevocable trust under the terms of which trust income is payable to A for life and, upon A's death, the remainder is to pass to A's issue, per stirpes. In 2002, the appropriate local court approves a modification to the trust that converts A's income interest into the right to receive the greater of the entire income of the trust or a fixed percentage of the trust assets valued annually (unitrust interest) to be paid each year to A for life. The modification does not result in a shift in beneficial interest to a beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification. In this case, the modification can only operate to increase the amount distributable to A and decrease the amount distributable to A's issue. In addition, the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Therefore, the trust will not be subject to the

provisions of chapter 13 of the Internal Revenue Code.

Example 9. Allocation of capital gain to income. In 1980, Grantor established an irrevocable trust under the terms of which trust income is payable to Grantor's child, A, for life, and upon A's death, the remainder is to pass to the A's issue, per stirpes. Under applicable state law, unless the governing instrument provides otherwise, capital gain is allocated to principal. In 2002, the trust is modified to allow the trustee to allocate capital gain to the income. The modification does not shift any beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification. In this case, the modification can only have the effect of increasing the amount distributable to A, and decreasing the amount distributable to A's issue. In addition, the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code.

Example 10. Administrative change to terms of a trust. In 1980, Grantor executed an irrevocable trust for the benefit of Grantor's issue, naming a bank and five other individuals as trustees. In 2002, the appropriate local court approves a modification of the trust that decreases the number of trustees which results in lower administrative costs. The modification pertains to the administration of the trust and does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification. In addition, the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code.

(ii) *Effective date.* The rules in this paragraph (b)(4) are applicable on and after December 20, 2000.

* * * *

(c) * * * The last four sentences in paragraph (b)(1)(i) of this section are applicable on and after November 18, 1999.

Robert E. Wenzel,
Deputy Commissioner
of Internal Revenue.

Approved December 7, 2000.

Jonathan Talisman,
Acting Assistant Secretary
of the Treasury.

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Section 4041(g).—Retail Excise Taxes—Special Fuels—Other Exemptions

For what purposes are Indian tribal governments treated as states? See Rev. Proc. 2001–15, page 465.

Section 4216.—Manufacturers Excise Taxes—Special Provisions Applicable to Manufacturers Tax

For what purposes are Indian tribal governments treated as states? See Rev. Proc. 2001–15, page 465.

Section 4253(i).—Facilities and Services—Communications—State and Local Government Exemption

For what purposes are Indian tribal governments treated as states? See Rev. Proc. 2001–15, page 465.

Section 4483(a).—Certain Other Excise Taxes—Tax on Use of Certain Vehicles—Exemptions

For what purposes are Indian tribal governments treated as states? See Rev. Proc. 2001–15, page 465.

Section 4911.—Tax on Excess Expenditures to Influence Legislation

For what purposes are Indian tribal governments treated as states? See Rev. Proc. 2001–15, page 465.

Section 4940(c).—Excise Tax Based on Investment Income—Net Investment Income Defined

For what purposes are Indian tribal governments treated as states? See Rev. Proc. 2001–15, page 465.

Section 4941(d).—Taxes on Self-Dealing

For what purposes are Indian tribal governments treated as states? See Rev. Proc. 2001–15, page 465.

Section 4942(f).—Taxes on Failure to Distribute Income—Adjusted Net Income

For what purposes are Indian tribal governments treated as states? See Rev. Proc. 2001–15, page 465.

Section 4945(f).—Taxes on Taxable Expenditures—Nonpartisan Activities Carried on by Certain Organizations

For what purposes are Indian tribal governments treated as states? See Rev. Proc. 2001–15, page 465.

Section 4946(c).—Definitions and Special Rules—Government Official

For what purposes are Indian tribal governments treated as states? See Rev. Proc. 2001–15, page 465.

Part III. Administrative, Procedural, and Miscellaneous

Split-Dollar Life Insurance Arrangements

Notice 2001-10

I. PURPOSE

The Treasury Department and Internal Revenue Service (IRS) are reviewing the Federal income tax treatment of so-called “split-dollar” arrangements for the purchase of life insurance contracts. This notice clarifies prior rulings issued by the IRS regarding the taxation of split-dollar arrangements, provides taxpayers with interim guidance on the tax treatment of split-dollar arrangements pending publication of further guidance, and requests taxpayer comments on the interim guidance and a number of unresolved issues.

This notice primarily addresses split-dollar arrangements between employers and employees. However, Treasury and the IRS believe the same principles generally govern the Federal tax treatment of split-dollar arrangements in other contexts, including arrangements that provide compensation to non-employees and economic benefits to corporate shareholders and arrangements involving gifts.

II. BACKGROUND

Rev. Rul. 64-328, 1964-2 C.B. 11, and Rev. Rul. 66-110, 1966-1 C.B. 12, addressed the Federal income tax treatment of split-dollar arrangements under which an employer and employee join in the purchase of a life insurance contract on the life of the employee subject to a contractual allocation of policy benefits between the employer and employee. The rulings described two contractual forms: (1) the endorsement method, under which the employer is formally designated as the owner of the contract, and the employer endorses the contract to specify the portion of the proceeds payable to the employee's beneficiary; and (2) the collateral assignment method, under which the employee is formally designated as the owner of the contract, the employer's premium payments are characterized as loans from the employer to the employee, and the employer's interest in the proceeds of the contract is designated as collateral security for its loans.

These rulings conclude that all economic benefits conferred on an employee under such an arrangement, excluding economic benefits attributable to the employee's own premium payments, constitute gross income to the employee. See also *Commissioner v. LoBue*, 351 U.S. 243 (1956); *Commissioner v. Smith*, 324 U.S. 177 (1945). Under the rationale of these rulings, the determination of an employee's gross income is unaffected by whether the endorsement method or the collateral assignment method is used.

Under the specific split-dollar arrangement addressed in Rev. Rul. 64-328, all amounts credited to the cash surrender value of the life insurance contract inured to the benefit of the employer. Thus, the only economic benefit inuring to the employee was the value of the insurance protection attributable to the portion of the contract's death benefit payable to the employee's beneficiary. Rev. Rul. 64-328 holds that, in such a case, the employee's gross income in any year includes the value of the life insurance protection provided to the employee in that year, less any amount actually paid by the employee.

Rev. Rul. 66-110 amplified Rev. Rul. 64-328 by holding that the value of any economic benefits in addition to current insurance protection that are provided to an employee under a split-dollar arrangement are also includible in the employee's gross income. More specifically, Rev. Rul. 66-110 held that an employee has additional gross income equal to the amount of any policyholder dividends distributed to the employee or applied to provide additional insurance for the exclusive benefit of the employee. Thus, where the employer has no interest in the dividend applied to provide paid-up additional insurance, the taxable economic benefit is the dividend itself, not the value of the insurance protection resulting from the dividend.

Rev. Rul. 64-328 and Rev. Rul. 66-110 each addressed a situation in which the employer possessed all beneficial interest in the cash surrender value of the life insurance contract (exclusive of any separate cash surrender value of paid-up additions attributable to dividends¹), and the employee was entitled only to certain

other economic benefits generated by the employer's investment in the contract, specifically, current insurance protection or dividends. Consistent with that, Rev. Rul. 64-328 revoked Rev. Rul. 55-713, 1955-2 C.B. 23, which had treated a split-dollar arrangement similar to that addressed in Rev. Rul. 64-328 as a secured loan from the employer to the employee. In rejecting the loan characterization, Rev. Rul. 64-328 stated that the substance of the split-dollar arrangement differed from that of a loan because the employee was not expected to make repayment except out of the cash surrender value or proceeds of the life insurance contract. But see *Commissioner v. Tufts*, 461 U.S. 300, 307 (1983) (“we read [*Crane v. Commissioner*, 331 U.S. 1 (1947)] to have approved the Commissioner's decision to treat a nonrecourse loan in this context as a true loan.”).

Rev. Rul. 64-328 held that the table of one-year premium rates set forth in Rev. Rul. 55-747, 1955-2 C.B. 228, commonly referred to as the “P.S. 58” rates, may be used to determine the value of the current life insurance protection provided to an employee under a split-dollar arrangement. Rev. Rul. 66-110 amplified Rev. Rul. 64-328 in this respect by holding that the insurer's published premium rates for one-year term insurance may be used to measure the value of the current insurance protection if those rates are lower than the P.S. 58 rates and available to all standard risks. Rev. Rul. 67-154, 1967-1 C.B. 11, modified Rev. Rul. 66-110 by holding that an insurer's published term rates must be available for initial issue insurance (as distinguished from rates for dividend options) in order to be substituted for the P.S. 58 rates set forth in Rev. Rul. 55-747.

Similarly, the IRS has ruled that the economic benefit inuring to a third-party donee under an employer-employee split-dollar arrangement or to a shareholder under a corporation-shareholder split-dol-

¹ Under the type of life insurance contract involved in Rev. Rul. 66-110, the cash surrender value of paid-up additions purchased with dividends was separate and distinct from the cash surrender value of the life insurance contract under which the dividends were paid.

lar arrangement is to be determined under the principles and valuation methods set forth in Rev. Rul. 64-328, as amplified by Rev. Rul. 66-110. See Rev. Rul. 78-420, 1978-2 C.B. 67; Rev. Rul. 79-50, 1979-1 C.B. 138. Also, the same premium rate alternatives may be relied upon to measure the value of current life insurance protection provided to an employee under a qualified retirement plan. See Rev. Rul. 55-747, *supra*.

III. NEED FOR UPDATED GUIDANCE

A. Equity Split-Dollar

None of the published rulings relating to split-dollar life insurance has directly addressed the forms of equity split-dollar arrangements that have been widely used in recent years. In contrast with the split-dollar arrangements described in Rev. Rul. 64-328 and Rev. Rul. 66-110, an employee's economic interest in a life insurance contract purchased under an equity split-dollar arrangement includes an agreed upon portion of the cash surrender value. Under the most common form of equity split-dollar arrangement, the employer's interest in the cash surrender value of the contract is limited to the aggregate amount of its premium payments, exclusive of any earnings component. In such cases, the employee derives the entire economic benefit of any positive return on the employer's investment in the life insurance contract.

Under such an equity split-dollar arrangement, the employee derives a valuable economic benefit from the employer's premium payments beyond the current life insurance protection addressed in Rev. Rul. 64-328. As held in Rev. Rul. 66-110, an employee who receives economic benefits beyond the value of current life insurance protection is taxable on the value of those additional benefits. Therefore, under the general principles followed in Rev. Rul. 64-328 and Rev. Rul. 66-110, it is necessary to account for the employee's rights in the cash surrender value under an equity split-dollar arrangement in a manner consistent with the substance of the parties' contractual positions.

Under section 83, which was enacted in 1969 and generally governs the income tax treatment of property transferred in connection with the performance of ser-

vices, a life insurance contract is considered to be property to the extent of its cash surrender value. See § 1.83-3(e) of the Income Tax Regulations. Therefore, if the substance of an equity split-dollar arrangement involves the transfer of a beneficial interest in the cash surrender value of a life insurance contract from an employer to an employee, that economic benefit is properly includible in the employee's gross income under section 83. For purposes of section 83, a split-dollar arrangement could, depending on the facts, involve a series of property transfers or a single transfer of property.²

However, whether an equity split-dollar arrangement involves a transfer of property within the meaning of section 83 depends on the substance of the arrangement. See § 1.83-3(a) of the regulations. If the employee is the beneficial owner of the life insurance contract from the inception of the arrangement, there is no transfer of property under section 83. For example, assuming there is a reasonable and *bona fide* expectation that the employer will receive repayment of its share of the premiums at a fixed or determinable future date, then the arrangement may in certain circumstances be properly treated as an acquisition of a life insurance contract by the employee with the proceeds of a loan or series of loans from the employer to the employee secured by the life insurance contract, rather than as an arrangement whereby the employer acquires ownership of the life insurance contract and provides economic benefits to the employee thereunder.

Section 7872 of the Code, which was enacted in 1984, sets forth rules for determining the tax treatment of certain direct and indirect below-market loans. In general, section 7872 recharacterizes a below-market loan (a loan in which the interest rate charged is less than the applicable Federal rate, or "AFR") as an arm's-length transaction in which the lender makes a loan to the borrower at the AFR, coupled with a payment or payments to the borrower sufficient to fund

all or part of the interest that the borrower is treated as paying on that loan. The amount, timing, and characterization of the imputed payments to the borrower under a below-market loan depend on the relationship between the borrower and the lender and whether the loan is characterized as a demand loan or a term loan. In the case of a compensation-related below-market loan within the meaning of section 7872(c)(1)(B), the imputed payments to the borrower are treated as compensation income.

The legislative history of section 7872 states that the term "loan" is to be interpreted broadly for purposes of section 7872, potentially encompassing "any transfer of money that provides the transferor with a right to repayment." H.R. Rep. 98-861, 98th Cong., 2d Sess. 1018 (1984). Treasury and the IRS believe that Congress generally intended that section 7872 would govern the determination of compensation income resulting from an arrangement the substance of which is a loan from an employer to an employee, and that there was no congressional intent to make section 7872 inapplicable to split-dollar arrangements if such arrangements are, in substance, loans.

B. Value of Current Life Insurance Protection

The P.S. 58 rates set forth in Rev. Rul. 55-747, which are based on mortality tables originally published in 1946, no longer bear an appropriate relationship to the fair market value of current life insurance protection. Since the published split-dollar rulings merely state that the P.S. 58 rates "may" be used to value the economic benefit that an employee receives in the form of current life insurance protection and allow that economic benefit to instead be valued using the insurer's lower published one-year term rates, the P.S. 58 rates have come to function more as an upper limit on the valuation of current life insurance protection for Federal income tax purposes than as the presumptive measure of the fair market value of that economic benefit. Nonetheless, because the P.S. 58 rates represent the only valuation standard sanctioned by existing published guidance other than the insurer's published term rates, some taxpayers (and plan administrators in the case of life insurance held for participants in qualified

² For income or gift tax purposes outside of the compensation context, transfers of beneficial interests in the cash surrender value of life insurance contracts may similarly be treated as transfers of property interests in accordance with general tax principles.

plans) continue to use the P.S. 58 rates to value current life insurance protection and thereby report more gross income than is warranted under current conditions.

Treasury and the IRS are also concerned that the P.S. 58 rates have been used to understate the economic benefits provided to employees and other taxpayers under certain split-dollar arrangements. In particular, some taxpayers have used the P.S. 58 rates to determine the employer's share of the premiums under so-called "reverse" split-dollar arrangements, where the employer's interest in the life insurance contract is limited to a specified portion of the death benefit. The use of P.S. 58 rates in this manner significantly overstates the value of the policy benefits allocated to the employer, such that the employee's share of the premiums is significantly lower than the employee's actual share of the policy benefits. No published guidance has authorized reliance on the P.S. 58 rates for this purpose.

In addition, Treasury and the IRS question whether insurers' published term rates provide an appropriate alternative measure of the fair market value of current life insurance protection. Treasury and the IRS understand that, in some instances, the published premium rates used for this purpose may not be realistically available to all standard risks who apply for term insurance, as required by Rev. Rul. 66-110 and the other published authorities that have sanctioned that alternative valuation standard. Moreover, taxpayers and the IRS ordinarily have no practical means to confirm that the same premium rates are available to all standard risks who apply for one-year term insurance from the same life insurance company. It is also questionable whether the life insurance protection provided to a particular insured should be valued differently for Federal tax purposes from that provided to a similarly situated insured solely because of differences in the published premium rates of their respective insurers.

There are a number of variables other than age that affect the cost and value of current life insurance protection, including assumed mortality rates, the sex and health of the insured, and the extent of sales and other expense charges included or assumed to be included in premiums. However, valuation standards that allow

some or all of such variables to be taken into account on an individual basis may not be administrable or provide taxpayers with sufficient certainty. Therefore, to ease administrative burdens, minimize disputes, and provide greater assurance that similarly situated taxpayers are treated the same, Treasury and the IRS believe it may be preferable, at least as a general rule, for the value of current life insurance protection provided under split-dollar arrangements and qualified retirement plans to be determined under one or more premium rate tables prescribed for those purposes.

IV. INTERIM GUIDANCE

A. Characterization of Split-Dollar Arrangements

In light of the rationale set forth in Rev. Rul. 64-328 and the fact that no published guidance has addressed the potential applicability of section 7872 to split-dollar arrangements, Treasury and the IRS recognize that taxpayers have not generally treated employer payments under equity split-dollar arrangements as loans, and that the below-market loan rules of section 7872 have not generally been applied to impute compensation income to employees from such arrangements. It is also recognized that, without further guidance, it may be difficult for taxpayers to determine whether an employer's payments under a split-dollar arrangement are properly characterized as loans for Federal tax purposes or whether the employer should instead be treated as having acquired a beneficial ownership interest in the life insurance contract through its premium payments and having provided economic benefits to the employee thereunder. Accordingly, pending consideration of public comments and the publication of further guidance, the characterization and income tax treatment of equity and other split-dollar arrangements will generally be determined under the following guidelines:

1. The IRS will generally accept the parties' characterization of the employer's payments under a split-dollar arrangement, provided that (i) such characterization is not clearly inconsistent with the substance of the arrangement, (ii) such characterization has been consistently followed by the parties from the inception of

the arrangement, and (iii) the parties fully account for all economic benefits conferred on the employee in a manner consistent with that characterization.

2. The IRS will permit an employer's payments under a split-dollar arrangement to be characterized as loans for tax purposes, provided that all of the conditions set forth in paragraph 1 are satisfied. In such cases, the tax consequences of the payments treated as loans will be determined under section 7872, the employee will not have additional compensation income for the value of the insurance protection provided under the life insurance contract, and the cash surrender value of the contract will not represent property that has been transferred to the employee for purposes of section 83. However, the employee ordinarily would have additional gross income if the employer's advances were not repaid in accordance with the terms of the arrangement. Moreover, the employee could have gross income under section 72 for distributions actually received under the life insurance contract.

3. In any case in which an employer's payments under a split-dollar arrangement have not been consistently treated as loans in accordance with paragraph 1, the parties will be treated as having adopted a non-loan characterization of the arrangement, and the parties must fully account for all of the economic benefits that the employee derives from the arrangement in a manner consistent with that characterization and with Rev. Rul. 64-328, Rev. Rul. 66-110, and the general tax principles upon which those rulings are based. In general, this means that (i) the employer will be treated as having acquired beneficial ownership of the life insurance contract through its share of the premium payments, (ii) the employee will have compensation income under section 61 equal to the value of the life insurance protection provided to the employee each year that the arrangement remains in effect, reduced by any payments made by the employer for such life insurance protection, (iii) the employee will have compensation income under section 61 equal to any dividends or similar distributions made to the employee under the life insurance contract (including any dividends described in Rev. Rul. 66-110 applied to provide additional policy benefits), and

(iv) the employee will have compensation income under section 83(a) to the extent that the employee acquires a substantially vested interest in the cash surrender value of the life insurance contract, reduced under section 83(a)(2) by any consideration paid by the employee for such interest in the cash surrender value.

4. Pending the publication of further guidance, the IRS will not treat an employer as having made a transfer of a portion of the cash surrender value of a life insurance contract to an employee for purposes of section 83 solely because the interest or other earnings credited to the cash surrender value of the contract cause the cash surrender value to exceed the portion thereof payable to the employer on termination of the split-dollar arrangement. If future guidance provides that such earnings increments are to be treated as transfers of property for purposes of section 83, it will apply prospectively.

5. In any case in which the employer's payments under a split-dollar arrangement have not been consistently treated as loans, then for so long as the arrangement remains in effect, the IRS will treat the employee as continuing to have gross income under section 61 for any current life insurance protection provided to the employee under the arrangement, except to the extent allocable to premium payments made by the employee (or included in the employee's gross income under paragraph 6) or to any portion of the cash surrender value of the contract that has been treated as a substantially vested transfer of property to the employee under section 83. When such an allocation is required, the IRS will accept a *pro rata* or other reasonable method for determining that portion of the death benefit allocable to cash surrender value beneficially owned by the employer and that portion allocable to cash surrender value transferred to or purchased by the employee.

6. If an employer makes a premium or other payment for the benefit of an employee under a split-dollar arrangement, and the employer neither acquires a beneficial ownership interest in the life insurance contract through such payment nor has a reasonable expectation of receiving repayment of that amount through policy proceeds or otherwise, such payment will be treated as compensation income to the employee under sec-

tion 61. See Reg. § 1.61-2(d)(2)(ii)(a); *Frost v. Commissioner*, 52 T.C. 89 (1969).

In sum, therefore, any payment made by an employer under a split-dollar arrangement must be accounted for as a loan (see paragraph 2), as an investment in the contract for the employer's own account (see paragraph 3), or as a payment of compensation (see paragraph 6).

B. Revised Standards for Valuing Current Life Insurance Protection

Pending the consideration of comments and publication of further guidance, the following interim guidance is provided on the valuation of current life insurance protection:

1. Rev. Rul. 55-747 is hereby revoked, and the IRS will no longer treat or accept the P.S. 58 rates set forth therein as a proper measure of the value of current life insurance protection for Federal tax purposes. Nonetheless, for taxable years ending on or before December 31, 2001, taxpayers may continue to use the P.S. 58 rates set forth in Rev. Rul. 55-747 for purposes of determining the value of current life insurance protection provided to an employee under a split-dollar arrangement or a qualified retirement plan.

2. Taxpayers may use the premium rate table set forth at the end of this notice, captioned as Table 2001, to determine the value of current life insurance protection on a single life provided under a split-dollar arrangement or qualified retirement plan for taxable years ending after the date of issuance of this notice. Table 2001 is based on the mortality experience reflected in the table of uniform premiums promulgated under section 79(c) of the Code (see § 1.79-3(d)(2) of the regulations), with extensions for ages below 25 and above 70, and the elimination of the five-year age brackets.³ With the revocation of Rev. Rul. 55-747, the rates set forth in Table 2001 are provided as an interim substitute for the P.S. 58 rates that taxpayers may rely upon pending further consideration of how the value of current life insurance protection should be determined for these Federal tax purposes in the future. The premium rates set forth in Table 2001 are materially lower than the P.S. 58 rates at all ages.

3. Taxpayers may continue to determine the value of current life insurance

protection by using the insurer's lower published premium rates that are available to all standard risks for initial issue one-year term insurance as set forth in Rev. Rul. 66-110, subject to the following additional limitations. First, for periods after December 31, 2003, the IRS will not consider an insurer's published premium rates to be available to all standard risks who apply for term insurance unless (i) the insurer generally makes the availability of such rates known to persons who apply for term insurance coverage from the insurer, (ii) the insurer regularly sells term insurance at such rates to individuals who apply for term insurance coverage through the insurer's normal distribution channels, and (iii) the insurer does not more commonly sell term insurance at higher premium rates to individuals that the insurer classifies as standard risks under the definition of standard risk most commonly used by that insurer for the issuance of term insurance. Second, with respect to a life insurance contract (or individual certificate) issued after February 28, 2001, no assurance is provided that such published premium rates may be used to determine the value of life insurance protection for periods after the later of December 31, 2003, or December 31 of the year in which further guidance relating to the valuation of current life insurance protection is published.

V. EFFECT ON OTHER DOCUMENTS

Rev. Rul. 55-747 is revoked. Rev. Rul. 64-328 and Rev. Rul. 66-110 are modified to the extent that those rulings indicate that an employer's premium payments under a split-dollar arrangement should not be treated as loans where an employee is not expected to make repayment except out of the cash surrender value or proceeds of the life insurance contract.

VI. REQUEST FOR COMMENTS

Comments are requested on the issues discussed in this notice and on any other issues for which further guidance relating to the Federal tax treatment of split-dollar arrangements is needed. In particular, Treasury and the IRS request comments on (i) the circumstances in which employer payments under a split-dollar arrangement should be treated as loans; (ii) in cases where employer payments under a

³ The table is limited to insureds below age 100.

split-dollar arrangement are not treated as loans, the circumstances in which interests in the cash surrender value of a life insurance contract should be treated as transfers of property to the employee for purposes of section 83, including whether earnings credited to the cash surrender value of a life insurance contract should be treated as transfers of property for purposes of section 83 when such earnings cause the cash surrender value to exceed the portion thereof payable to the employer (or other transferor); and (iii) whether additional guidance is needed on the treatment of split-dollar arrangements for Federal gift tax purposes.

Comments are also invited on the standards that should be used to value life insurance protection. Comments are specifically invited on (i) whether one or more premium rate tables should be prescribed as the exclusive basis for valuing current life insurance protection for Federal tax purposes; (ii) if one or more premium rate tables are prescribed for

these purposes, what assumptions should be used in constructing such table or tables; (iii) if one or more premium rate tables are prescribed for these purposes, whether the value of life insurance protection for a given insured should take account of variables other than the age of the insured; (iv) whether one or more premium rate tables should be prescribed for purposes of determining the value of current life insurance protection under a second-to-die policy and, if so, what assumptions should be used in constructing such table or tables; (v) whether there are reasonable and workable means to incorporate premium rates actually charged by life insurance companies into the valuation standards used for Federal tax purposes; and (vi) whether there are reasonable and workable means to allow the value of life insurance protection for a given insured to be determined by reference to the cost structure of the life insurance contract covering that insured.

Written comments are requested to be submitted no later than April 30, 2001, to CC:FIP (Notice 2001-10), room 4300, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Comments may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:FIP (Notice 2001-10), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. All comments will be available for public inspection and copying.

DRAFTING INFORMATION

The principal authors of this notice are David B. Silber of the Office of Associate Chief Counsel (Financial Institutions and Products) and Erin Madden of the Office of Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this notice, contact Mr. Silber at (202) 622-3930 or Ms. Madden at (202) 622-6060 (Not toll-free calls).

TABLE 2001
INTERIM TABLE OF ONE-YEAR TERM PREMIUMS
FOR \$1,000 OF LIFE INSURANCE PROTECTION

Attained Age	Section 79 Extended and Interpolated Annual Rates	Attained Age	Section 79 Extended and Interpolated Annual Rates	Attained Age	Section 79 Extended and Interpolated Annual Rates
0	\$0.70	35	\$0.99	70	\$20.62
1	\$0.41	36	\$1.01	71	\$22.72
2	\$0.27	37	\$1.04	72	\$25.07
3	\$0.19	38	\$1.06	73	\$27.57
4	\$0.13	39	\$1.07	74	\$30.18
5	\$0.13	40	\$1.10	75	\$33.05
6	\$0.14	41	\$1.13	76	\$36.33
7	\$0.15	42	\$1.20	77	\$40.17
8	\$0.16	43	\$1.29	78	\$44.33
9	\$0.16	44	\$1.40	79	\$49.23
10	\$0.16	45	\$1.53	80	\$54.56
11	\$0.19	46	\$1.67	81	\$60.51
12	\$0.24	47	\$1.83	82	\$66.74
13	\$0.28	48	\$1.98	83	\$73.07
14	\$0.33	49	\$2.13	84	\$80.35
15	\$0.38	50	\$2.30	85	\$88.76
16	\$0.52	51	\$2.52	86	\$99.16
17	\$0.57	52	\$2.81	87	\$110.40
18	\$0.59	53	\$3.20	88	\$121.85
19	\$0.61	54	\$3.65	89	\$133.40
20	\$0.62	55	\$4.15	90	\$144.30
21	\$0.62	56	\$4.68	91	\$155.80
22	\$0.64	57	\$5.20	92	\$168.75
23	\$0.66	58	\$5.66	93	\$186.44

TABLE 2001—Continued
INTERIM TABLE OF ONE-YEAR TERM PREMIUMS
FOR \$1,000 OF LIFE INSURANCE PROTECTION

Attained Age	Section 79 Extended and Interpolated Annual Rates	Attained Age	Section 79 Extended and Interpolated Annual Rates	Attained Age	Section 79 Extended and Interpolated Annual Rates
24	\$0.68	59	\$6.06	94	\$206.70
25	\$0.71	60	\$6.51	95	\$228.35
26	\$0.73	61	\$7.11	96	\$250.01
27	\$0.76	62	\$7.96	97	\$265.09
28	\$0.80	63	\$9.08	98	\$270.11
29	\$0.83	64	\$10.41	99	\$281.05
30	\$0.87	65	\$11.90		
31	\$0.90	66	\$13.51		
32	\$0.93	67	\$15.20		
33	\$0.96	68	\$16.92		
34	\$0.98	69	\$18.70		

Withholding and Information Reporting on Payments to Financial Institutions in U.S. Possessions

Notice 2001-11

Corporations and partnerships that are organized under the laws of a possession of the United States are generally treated as foreign persons for purposes of section 1441 and the regulations thereunder (relating to the withholding of tax on payments to foreign persons). See section 881(b)(1) for exceptions to this general rule. Financial institutions organized under the laws of a U.S. possession (“possessions financial institutions”) have noted that, to the extent they act as intermediaries (that is, as agents for others), the regulations under section 1441, as in effect on January 1, 2001 (the “new withholding regulations”), will require them to function as nonqualified intermediaries. Payments of U.S. source income made to nonqualified intermediaries are generally subject to 30-percent withholding (or 31-percent withholding in the case of deposit interest and certain payments on short-term obligations) unless the nonqualified intermediary provides documentation from, and other information relating to, customers on whose behalf the nonqualified intermediary acts that supports a

reduced rate of withholding. See section 1.1441-1(b)(1) and 1.1441-1(e)(3)(iii) and (iv). Possessions financial institutions have commented that the requirement to provide a withholding agent with information relating to the possessions financial institution’s customers should not apply to them because they are subject to all of the withholding and information reporting requirements that apply to U.S. withholding agents under Chapters 3 and 61 and section 3406 of the Internal Revenue Code and because they are subject to direct audit supervision by the Internal Revenue Service.

Treasury and IRS agree that, for the reasons described above, possessions financial institutions should not be required to act as nonqualified intermediaries under the new withholding regulations. Accordingly, until further notice, any possessions financial institution will be treated as a U.S. branch under section 1.1441-1(b)(2)(iv) of the new withholding regulations. As such, it may agree with a withholding agent from which it is receiving payments to be treated as a U.S. person. See section 1.1441-1(b)(2)(iv)(A) and (E). Under the general rule of section 1.1441-1(b)(1), payments of U.S. source income to a possessions financial institution that agrees to be treated as a U.S. person will be treated as made to a U.S. payee and therefore not subject to with-

holding under section 1441. The possessions financial institution shall be subject to all of the withholding and reporting obligations of a U.S. withholding agent under chapters 3 and 61 of the Code and section 3406. For purposes of this notice, the term financial institution has the same meaning as in section 1.1441-1(c)(5).

A possessions financial institution that agrees to be treated as a U.S. person must provide a withholding agent with a properly completed Form W-8IMY on which it evidences its agreement to be treated as a U.S. person. The possessions financial institution should not provide a Form W-9. See section 1.1441-1(b)(2)(iv). In addition, a withholding agent making a payment to a possessions financial institution that agrees to be treated as a U.S. person must report payments made to the institution on Form 1042-S. See section 1.1441-1(b)(2)(iv) and 1.1461-1(c)(4)(i)(C)(I).

Contact Information

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26 CFR 601.201: Rulings and determination letters. (Also sections 103(c), 105(e), 117(b)(2)(A), 164, 170, 403(b)(1)(A)(ii), 454(b)(2), 511(a)(2)(B), 2055, 2106(a)(2), 2522, 4041(g), 4216, 4253(i), 4483(a), 4911, 4940(c), 4941(d), 4942(f), 4945(f), 4946(c).)

Rev. Proc. 2001-15

SECTION 1. GENERAL

01. *PURPOSE* The purpose of this revenue procedure is to provide a modified and supplemented list of Indian tribal governments that are to be treated similarly to states for specified purposes under the Internal Revenue Code.

02. *BACKGROUND* The Indian Tribal Governmental Tax Status Act of 1982 (Title II of Pub. L. No. 97-473, 1983-1 C.B. 510, 511, as amended by Pub. L. No. 98-21, 1983-2 C.B. 309, 315) added certain provisions to the Code that pertain to the status of Indian tribal governments. Section 7871(a) of the Internal Revenue Code and Section 305.7871-1 of the Income Tax Regulations provide that Indian tribal governments (or subdivisions thereof) will be treated as states for certain enumerated federal tax purposes. For example, charitable contributions to or for the use of a tribal government may be deductible under the federal income, gift, and estate tax laws; a tribal government is entitled to exemption from certain excise taxes; taxes imposed by a tribe may be deductible; and public activity bonds may be tax exempt obligations. Section 1065 of the Tax Reform Act of 1984, 1984-3 (Vol. 1) C.B. 556, made permanent the rules treating Indian tribal governments (or subdivisions thereof) as states (or political subdivisions thereof).

03. *DEFINITIONS* The term "Indian tribal government" is defined under section 7701(a)(40) of the Code, as amended, to mean the governing body of any tribe, band, community, village or group of Indians, or (if applicable) Alaska Natives that is determined by the Secretary of Treasury, after consultation with the Secretary of the Interior, to exercise governmental functions. Section 7871(d) of the Code states that, for purposes of section 7871(a), a subdivision of an Indian tribal government shall be treated as a political subdivision of a state if (and only if) the Secretary of the Treasury determines (after consultation with the Secretary of the Interior) that such subdivision has been delegated the right to exercise one or more

of the substantial governmental functions of the Indian tribal government.

SECTION 2. APPLICATION

01. *QUALIFICATIONS* The following modified and supplemented list of Indian tribal entities, including Indian tribes, bands, communities, villages, and groups of Indians, as well as Alaska Natives, represents Indian tribal governments and is subject to these qualifications:

(1) The list does not include Indian tribal subdivisions because the determination of which entities qualify as subdivisions is discussed in Rev. Proc. 84-36, 1984-1 C.B. 510, as modified by Rev. Proc. 86-17, 1986-1 C.B. 550.

(2) Temporary Regulation section 305.7701-1(a) defines what constitutes "governmental functions" for purposes of defining an Indian tribal government or political subdivision thereof. Tribal entities not appearing on this list may apply for a ruling on whether they qualify pursuant to all applicable procedural rules set forth in the Statement of Procedural Rules (26 CFR Part 601), and guidelines set forth in Rev. Proc. 84-37, 1984-1 C.B. 513, as modified by Rev. Proc. 86-17, 1986-1 C.B. 550, and Rev. Proc. 2001-1, IRB 2001-1.

(3) Inclusion on a published list does not necessarily establish that a tribe qualifies for a particular tax benefit. For example, when a tribal entity seeks exemption from excise taxes, the entity must be able to demonstrate that the underlying transaction involves the exercise of an essential governmental function of the Indian tribal government.

SECTION 3. LIST

01. INDIAN TRIBAL ENTITIES THAT EXERCISE GOVERNMENTAL FUNCTIONS FOR PURPOSES OF TITLE II OF PUB. L. NO. 97-473.

Absentee-Shawnee Tribe of Indians of Oklahoma

Agua Caliente Band of Cahuilla Indians of the Agua Caliente Indian Reservation, California

Ak Chin Indian Community of the Maricopa (Ak Chin) Indian Reservation, Arizona

Alabama-Coushatta Tribes of Texas

Alabama-Quassarte Tribal Town, Oklahoma

Alturas Indian Rancheria, California

Apache Tribe of Oklahoma

Arapahoe Tribe of the Wind River Reservation, Wyoming

Aroostook Band of Micmac Indians of Maine

Assiniboine and Sioux Tribes of the Fort Peck Indian Reservation, Montana

Augustine Band of Cahuilla Mission Indians of the Augustine Reservation, California

Bad River Band of the Lake Superior Tribe of Chippewa Indians of the Bad River Reservation, Wisconsin

Barona Group of Capitan Grande Band of Mission Indians of the Barona Reservation, California

Bay Mills Indian Community of the Sault Ste. Marie Band of Chippewa Indians, Bay Mills Reservation, Michigan

Bear River Band of the Rohnerville Rancheria, California

Berry Creek Rancheria of Maidu Indians of California

Big Lagoon Rancheria, California

Big Pine Band of Owens Valley Paiute Shoshone Indians of the Big Pine Reservation, California

Big Sandy Rancheria of Mono Indians of California

Big Valley Band of Pomo Indians of the Big Valley Rancheria, California

Blackfeet Tribe of the Blackfeet Indian Reservation of Montana

Blue Lake Rancheria, California

Bridgeport Paiute Indian Colony of California

Buena Vista Rancheria of Me-Wuk Indians of California

Burns Paiute Tribe of the Burns Paiute Indian Colony of Oregon

Cabazon Band of Cahuilla Mission Indians of the Cabazon Reservation, California	Comanche Indian Tribe, Oklahoma	Eastern Band of Cherokee Indians of North Carolina
Cachil DeHe Band of Wintun Indians of the Colusa Indian Community of the Colusa Rancheria, California	Confederated Salish & Kootenai Tribes of the Flathead Reservation, Montana	Eastern Shawnee Tribe of Oklahoma
Caddo Indian Tribe of Oklahoma	Confederated Tribes of the Chehalis Reservation, Washington	Elem Indian Colony of Pomo Indians of the Sulphur Bank Rancheria, California
Cahuilla Band of Mission Indians of the Cahuilla Reservation, California	Confederated Tribes of the Colville Reservation, Washington	Elk Valley Rancheria, California
Cahto Indian Tribe of the Laytonville Rancheria, California	Confederated Tribes of the Coos, Lower Umpqua and Siuslaw Indians of Oregon	Ely Shoshone Tribe of Nevada
Campo Band of Diegueno Mission Indians of the Campo Indian Reservation, California	Confederated Tribes of the Goshute Reservation, Nevada and Utah	Enterprise Rancheria of Maidu Indians of California
Capitan Grande Band of Diegueno Mission Indians of California	Confederated Tribes of the Grande Ronde Community of Oregon	Flandreau Santee Sioux Tribe of South Dakota
Catawba Indian Nation (aka Catawba Tribe of South Carolina)	Confederated Tribes of the Siletz Reservation, Oregon	Forest County Potawatomi Community of Wisconsin Potawatomi Indians, Wisconsin
Cayuga Nation of New York	Confederated Tribes of the Umatilla Reservation, Oregon	Fort Belknap Indian Community of the Fort Belknap Reservation of Montana
Cedarville Rancheria, California	Confederated Tribes of the Warm Springs Reservation of Oregon	Fort Bidwell Indian Community of the Fort Bidwell Reservation of California
Chemehuevi Indian Tribe of the Chemehuevi Reservation, California	Confederated Tribes and Bands of the Yakima Indian Nation of the Yakima Reservation, Washington	Fort Independence Indian Community of Paiute Indians of the Fort Independence Reservation, California
Cher-Ae Heights Indian Community of the Trinidad Rancheria, California	Coquille Tribe of Oregon	Fort McDermitt Paiute and Shoshone Tribes of the Fort McDermitt Indian Reservation, Nevada and Oregon
Cherokee Nation, Oklahoma	Cortina Indian Rancheria of Wintun Indians of California	Fort McDowell Mohave-Apache Community of the Fort McDowell Indian Reservation, Arizona
Cheyenne-Arapaho Tribes of Oklahoma	Coushatta Tribe of Louisiana	Fort Mojave Indian Tribe of Arizona, California and Nevada
Cheyenne River Sioux Tribe of the Cheyenne River Reservation, South Dakota	Cow Creek Band of Umpqua Indians of Oregon	Fort Sill Apache Tribe of Oklahoma
Chickasaw Nation, Oklahoma	Coyote Valley Band of Pomo Indians of California	Gila River Indian Community of the Gila River Indian Reservation, Arizona
Chicken Ranch Rancheria of Me-Wuk Indians of California	Crow Tribe of Montana	Grand Traverse Band of Ottawa and Chippewa Indians of Michigan
Chippewa-Cree Indians of the Rocky Boy's Reservation, Montana	Crow Creek Sioux Tribe of the Crow Creek Reservation, South Dakota	Graton Rancheria, California
Chitimacha Tribe of Louisiana	Cuyapaipe Community of Diegueno Mission Indians of the Cuyapaipe Reservation, California	Greenville Rancheria of Maidu Indians of California
Choctaw Nation of Oklahoma	Death Valley Timba-Sha Shoshone Band of California	Grindstone Indian Rancheria of Wintun-Wailaki Indians of California
Citizen Potawatomi Nation, Oklahoma	Delaware Nation, Oklahoma (formerly Delaware Tribe of Western Oklahoma)	Guidiville Rancheria of California
Cloverdale Rancheria of Pomo Indians of California	Delaware Tribe of Indians, Oklahoma	Hannahville Indian Community of Wisconsin Potawatomi Indians of Michigan
Cocopah Tribe of Arizona	Dry Creek Rancheria of Pomo Indians of California	Havasupai Tribe of the Havasupai Reservation, Arizona
Coeur D'Alene Tribe of the Coeur D'Alene Reservation, Idaho	Duckwater Shoshone Tribe of the Duckwater Reservation, Nevada	Ho-Chunk Nation of Wisconsin (formerly known as the Wisconsin Winnebago Tribe)

Hoh Indian Tribe of the Hoh Indian Reservation, Washington	Kootenai Tribe of Idaho	Match-e-be-nash-she-wish Band of Potawatomi Indians of Michigan
Hoop Valley Tribe, California	La Jolla Band of Luiseno Mission Indians of the La Jolla Reservation, California	Mechoopda Indian Tribe of Chico Rancheria, California
Hopi Tribe of Arizona	La Posta Band of Diegueno Mission Indians of the La Posta Indian Reservation, California	Menominee Indian Tribe of Wisconsin
Hopland Band of Pomo Indians of the Hopland Rancheria, California	Lac Courte Oreilles Band of Lake Superior Chippewa Indians of the Lac Courte Oreilles Reservation of Wisconsin	Mesa Grande Band of Diegueno Mission Indians of the Mesa Grande Reservation, California
Houlton Band of Maliseet Indians of Maine	Lac du Flambeau Band of Lake Superior Chippewa Indians of the Lac du Flambeau Reservation of Wisconsin, Wisconsin	Mescalero Apache Tribe of the Mescalero Reservation, New Mexico
Hualapai Tribe of the Hualapai Indian Reservation, Arizona	Lac Vieu Desert Band of Lake Superior Chippewa Indians of Michigan	Miami Tribe of Oklahoma
Huron Potawatomi, Inc., Michigan	Las Vegas Tribe of Paiute Indians of the Las Vegas Indian Colony, Nevada	Miccosukee Tribe of Indians of Florida
Inaja Band of Diegueno Mission Indians of the Inaja and Cosmit Reservation, California	Little River Band of Ottawa Indians of Michigan	Middletown Rancheria of Pomo Indians of California
Ione Band of Miwok Indians of California	Little Traverse Bay Bands of Odawa Indians of Michigan	Minnesota Chippewa Tribe, Minnesota (Six Component reservations: Bois Forte Band (Nett Lake); Fond du Lac Band; Grand Portage Band; Leech Lake Band; Mille Lacs Band; White Earth Band)
Iowa Tribe of Kansas and Nebraska	Los Coyotes Band of Cahuilla Mission Indians of the Los Coyotes Reservation, California	Mississippi Band of Choctaw Indians, Mississippi
Iowa Tribe of Oklahoma	Lovelock Paiute Tribe of the Lovelock Indian Colony, Nevada	Moapa Band of Paiute Indians of the Moapa River Indian Reservation, Nevada
Jackson Rancheria of Me-Wuk Indians of California	Lower Brule Sioux Tribe of the Lower Brule Reservation, South Dakota	Modoc Tribe of Oklahoma
Jamestown S'Klallam Tribe of Washington	Lower Elwha Tribal Community of the Lower Elwha Reservation, Washington	Mohegan Indian Tribe of Connecticut
Jamul Indian Village of California	Lower Lake Rancheria, California	Mooretown Rancheria of Maidu Indians of California
Jena Band of Choctaw Indians, Louisiana	Lower Sioux Indian Community of Minnesota Mdewakanton Sioux Indians of the Lower Sioux Reservation in Minnesota	Morongo Band of Cahuilla Mission Indians of the Morongo Reservation, California
Jicarilla Apache Tribe of the Jicarilla Apache Indian Reservation, New Mexico	Lummi Tribe of the Lummi Reservation, Washington	Muckleshoot Indian Tribe of the Muckleshoot Reservation, Washington
Kaibab Band of Paiute Indians of the Kaibab Indian Reservation, Arizona	Lytton Rancheria of California	Muscogee (Creek) Nation, Oklahoma
Kalispel Indian Community of the Kalispel Reservation, Washington	Makah Indian Tribe of the Makah Indian Reservation, Washington	Narragansett Indian Tribe of Rhode Island
Karok Tribe of California	Manchester Band of Pomo Indians of the Manchester-Point Arena Rancheria, California	Navajo Nation, Arizona, New Mexico and Utah
Kashia Band of Pomo Indians of the Stewarts Point Rancheria, California	Manzanita Band of Diegueno Mission Indians of the Manzanita Reservation, California	Nez Perce Tribe of Idaho
Kaw Nation, Oklahoma	Mashantucket Pequot Tribe of Connecticut	Nisqually Indian Tribe of the Nisqually Reservation, Washington
Keweenaw Bay Indian Community of L'Anse and Ontonagon Bands of Chippewa Indians of the L'Anse Reservation, Michigan		Nooksack Indian Tribe of Washington
Kialegee Tribal Town, Oklahoma		Northern Cheyenne Tribe of the Northern Cheyenne Indian Reservation, Montana
Kickapoo Tribe of Indians of the Kickapoo Reservation in Kansas		Northfork Rancheria of Mono Indians of California
Kickapoo Tribe of Oklahoma		
Kickapoo Traditional Tribe of Texas		
Kiowa Indian Tribe of Oklahoma		
Klamath Indian Tribe of Oregon		

Northwestern Band of Shoshoni Nation of Utah (Washakie)	Pokagon Band of Potawatomi Indians of Michigan	Quinault Tribe of the Quinault Reservation, Washington
Oglala Sioux Tribe of the Pine Ridge Reservation, South Dakota	Ponca Tribe of Indians of Oklahoma	Ramona Band or Village of Cahuilla Mission Indians of California
Omaha Tribe of Nebraska	Ponca Tribe of Nebraska	Red Cliff Band of Lake Superior Chippewa Indians of Wisconsin
Oneida Nation of New York	Port Gamble Indian Community of the Port Gamble Reservation, Washington	Red Lake Band of Chippewa Indians of the Red Lake Reservation, Minnesota
Oneida Tribe of Wisconsin	Potter Valley Rancheria of Pomo Indians of California	Redding Rancheria, California
Onondaga Nation of New York	Prairie Band of Potawatomi Indians, Kansas	Redwood Valley Rancheria of Pomo Indians of California
Osage Tribe, Oklahoma	Prairie Island Indian Community of Minnesota Mdewakanton Sioux Indians of the Prairie Island Reservation, Minnesota	Reno-Sparks Indian Colony, Nevada
Ottawa Tribe of Oklahoma	Pueblo of Acoma, New Mexico	Resighini Rancheria, California (formerly known as the Coast Indian Community of Yurok Indians of the Resighini Rancheria)
Otoe-Missouria Tribe of Indians, Oklahoma	Pueblo of Cochiti, New Mexico	Rincon Band of Luiseno Mission Indians of the Rincon Reservation, California
Paiute Indian Tribe of Utah	Pueblo of Jemez, New Mexico	Robinson Rancheria of Pomo Indians of California
Paiute-Shoshone Indians of the Bishop Community of the Bishop Colony, California	Pueblo of Isleta, New Mexico	Rosebud Sioux Tribe of the Rosebud Indian Reservation, South Dakota
Paiute-Shoshone Tribe of the Fallon Reservation and Colony, Nevada	Pueblo of Laguna, New Mexico	Round Valley Indian Tribes of the Round Valley Reservation, California (formerly known as the Covelo Indian Community)
Paiute-Shoshone Indians of the Lone Pine Community of the Lone Pine Reservation, California	Pueblo of Nambe, New Mexico	Rumsey Indian Rancheria of Wintun Indians of California
Pala Band of Luiseno Mission Indians of the Pala Reservation, California	Pueblo of Picuris, New Mexico	Sac and Fox Tribe of the Mississippi in Iowa
Pascua Yaqui Tribe of Arizona	Pueblo of Pojoaque, New Mexico	Sac and Fox Nation of Missouri in Kansas and Nebraska
Paskenta Band of Nomlaki Indians of California	Pueblo of San Felipe, New Mexico	Sac and Fox Nation, Oklahoma
Passamaquoddy Tribe of Maine	Pueblo of San Juan, New Mexico	Saginaw Chippewa Indian Tribe of Michigan, Isabella Reservation
Pauma Band of Luiseno Mission Indians of the Pauma and Yuima Reservation, California	Pueblo of San Ildefonso, New Mexico	Salt River Pima-Maricopa Indian Community of the Salt River Reservation, Arizona
Pawnee Nation of Oklahoma	Pueblo of Sandia, New Mexico	Samish Indian Tribe, Washington
Pechanga Band of Luiseno Mission Indians of the Pechanga Reservation, California	Pueblo of Santa Ana, New Mexico	San Carlos Apache Tribe of the San Carlos Reservation, Arizona
Penobscot Tribe of Maine	Pueblo of Santa Clara, New Mexico	San Juan Southern Paiute Tribe of Arizona
Peoria Tribe of Indians of Oklahoma	Pueblo of Santo Domingo, New Mexico	San Manual Band of Serrano Mission Indians of the San Manual Reservation, California
Picayune Rancheria of Chukchansi Indians of California	Pueblo of Taos, New Mexico	San Pasqual Band of Diegueno Mission Indians of California
Pinoleville Rancheria of Pomo Indians of California	Pueblo of Tesuque, New Mexico	
Pit River Tribe, California (includes Big Bend, Lookout, Montgomery Creek and Roaring Creek Rancherias, and XL Ranch)	Pueblo of Zia, New Mexico	
Poarch Band of Creek Indians of Alabama	Puyallup Tribe of the Puyallup Reservation, Washington	
	Pyramid Lake Paiute Tribe of the Pyramid Lake Reservation, Nevada	
	Quapaw Tribe of Indians, Oklahoma	
	Quartz Valley Indian Community of the Quartz Valley Reservation of California	
	Quechan Tribe of the Fort Yuma Indian Reservation, California and Arizona	
	Quileute Tribe of the Quileute Reservation, Washington	

Santa Rosa Indian Community of the Santa Rosa Rancheria, California	Skull Valley Band of Goshute Indians of Utah	Tohono O'odham Nation of Arizona (formerly Papago Tribal Council)
Santa Rosa Band of Cahuilla Mission Indians of the Santa Rosa Reservation, California	Smith River Rancheria, California	Tonawanda Band of Seneca Indians of New York
Santa Ynez Band of Chumash Mission Indians of the Santa Ynez Reservation, California	Snoqualmie Tribe, Washington	Tonkawa Tribe of Indians of Oklahoma
Santa Ysabel Band of Diegueno Mission Indians of the Santa Ysabel Reservation, California	Soboba Band of Luiseno Mission Indians of the Soboba Reservation, California	Tonto Apache Tribe of Arizona
Santee Sioux Tribe of the Santee Reservation of Nebraska	Sokaogon Chippewa Community of the Mole Lake Band of Chippewa Indians, Wisconsin	Torres-Martinez Band of Cahuilla Mission Indians of California
Sauk-Suiattle Indian Tribe of Washington	Southern Ute Indian Tribe of the Southern Ute Reservation, Colorado	Tule River Indian Tribe of the Tule River Indian Reservation, California
Sault Ste. Marie Tribe of Chippewa Indians of Michigan	Spirit Lake Tribe, North Dakota (formerly known as the Devils Lake Sioux Tribe)	Tulalip Tribes of the Tulalip Reservation, Washington
Scotts Valley Band of Pomo Indians of California	Spokane Tribe of the Spokane Reservation, Washington	Tunica-Biloxi Indian Tribe of Louisiana
Seminole Nation of Oklahoma	Squaxin Island Tribe of the Squaxin Island Reservation, Washington	Tuolumne Band of Me-Wuk Indians of the Tuolumne Rancheria of California
Seminole Tribe of Florida, Dania, Big Cypress, Brighton, Hollywood and Tampa Reservations	St. Croix Chippewa Indians of Wisconsin, St. Croix Reservation	Turtle Mountain Band of Chippewa Indians of North Dakota
Seneca Nation of New York	St. Regis Band of Mohawk Indians of New York	Tuscarora Nation of New York
Seneca-Cayuga Tribe of Oklahoma	Standing Rock Sioux Tribe of North and South Dakota	Twenty-Nine Palms Band of Luiseno Mission Indians of California
Shakopee Mdewakanton Sioux Community of Minnesota (Prior Lake)	Stockbridge-Munsee Community of Mohican Indians of Wisconsin	United Auburn Indian Community of the Auburn Rancheria of California
Shawnee Tribe, Oklahoma	Stillaguamish Tribe of Washington	United Keetoowah Band of Cherokee Indians of Oklahoma
Sheep Ranch Rancheria of Me-Wuk Indians of California	Summit Lake Paiute Tribe of Nevada	Upper Lake Band of Pomo Indians of Upper Lake Rancheria of California
Sherwood Valley Rancheria of Pomo Indians of California	Suquamish Indian Tribe of the Port Madison Reservation, Washington	Upper Sioux Indian Community of the Upper Sioux Reservation, Minnesota
Shingle Springs Band of Miwok Indians, Shingle Springs Rancheria (Verona Tract), California	Susanville Indian Rancheria, California	Upper Skagit Indian Tribe of Washington
Shoalwater Bay Tribe of the Shoalwater Bay Indian Reservation, Washington	Swinomish Indians of the Swinomish Reservation, Washington	Ute Indian Tribe of the Uintah and Ouray Reservation, Utah
Shoshone Tribe of the Wind River Reservation, Wyoming	Sycuan Band of Diegueno Mission Indians of California	Ute Mountain Tribe of the Ute Mountain Reservation, Colorado, New Mexico and Utah
Shoshone-Bannock Tribes of the Fort Hall Reservation of Idaho	Table Bluff Reservation-Wiyot Tribe, California	Utu Utu Gwaitu Paiute Tribe of the Benton Paiute Reservation, California
Shoshone-Paiute Tribes of the Duck Valley Reservation, Nevada	Table Mountain Rancheria of California	Viejas (Baron Long) Group of Capitan Grande Band of Mission Indians of the Viejas Reservation, California
Sisseton-Wahpeton Sioux Tribe of the Lake Traverse Reservation, South Dakota	Te-Moak Tribes of Western Shoshone Indians of Nevada (Four constituent bands: Battle Mountain Band; Elko Band; South Fork Band; and Wells Band)	Walker River Paiute Tribe of the Walker River Reservation, Nevada
Skokomish Indian Tribe of the Skokomish Reservation, Washington	Thlopthlocco Tribal Town, Oklahoma	Wampanoag Tribe of Gay Head (Aquinnah) of Massachusetts
	Three Affiliated Tribes of the Fort Berthold Reservation, North Dakota	

Washoe Tribe of Nevada and California (Carson Colony; Dresslerville Colony; Woodfords Community; Stewart Community; and Washoe Ranches)	Angoon Community Association	Circle Native Community
White Mountain Apache Tribe of the Fort Apache Reservation, Arizona	Aniak, Village of Aniak	Clark's Point, Village of Clark's Point
Wichita and Affiliated Tribes (Wichita, Keechi, Waco and Twakonie), Oklahoma	Anvik Village	Council, Native Village of Council
Winnebago Tribe of Nebraska	Arctic Village (See Venetie, Native Village of Venetie Tribal Government)	Craig Community Association
Winnemucca Indian Colony of Nevada	Asa'carsarmiut Tribe (formerly Native Village of Mountain Village)	Crooked Creek, Village of Crooked Creek
Wyandotte Tribe of Oklahoma	Atka, Native Village of Atka	Curyung Tribal Council (formerly Native Village of Dillingham)
Yankton Sioux Tribe of South Dakota	Atqasuk Village (Atkasook)	Deering, Native Village of Deering
Yavapai-Apache Nation of the Camp Verde Indian Reservation, Arizona	Atmauthluak, Village of Atmauthluak	Diomede, Native Village of Diomede (aka Inalik)
Yavapai-Prescott Tribe of the Yavapai Reservation, Arizona	Barrow, Native Village of Barrow Inupiat Traditional Government (formerly Native Village of Barrow)	Dot Lake, Village of Dot Lake
Yerington Paiute Tribe of the Yerington Colony and Campbell Ranch, Nevada	Beaver Village	Douglas Indian Association
Yomba Shoshone Tribe of the Yomba Reservation, Nevada	Belkofski, Native Village of Belkofski	Eagle, Native Village of Eagle
Ysleta Del Sur Pueblo of Texas	Bill Moore's Slough, Village of Bill Moore's Slough	Eek, Native Village of Eek
Yurok Tribe of the Yurok Reservation, California	Birch Creek Tribe (formerly listed as Birch Creek Village)	Egegik Village
Zuni Tribe of the Zuni Reservation, New Mexico	Brevig Mission, Native Village of Brevig Mission	Eklutna Native Village
ALASKA NATIVE ENTITIES	Buckland, Native Village of Buckland	Ekuk, Native Village of Ekuk
Afognak, Village of Afognak	Cantwell, Native Village of Cantwell	Ekwok Village
Agdaagux Tribe of King Cove	Chalkyitsik Village	Elim, Native Village of Elim
Akhiok, Native Village of Akhiok	Chanega (aka Chenega), Native Village of Chanega	Emmonak Village
Akiachak, Native Village of Akiachak	Chefornak, Village of Chefornak	Evansville Village (aka Bettles Field)
Akiak Native Community	Chevak Native Village	Eyak, Native Village of Eyak (Cordova)
Akutan, Native Village of Akutan	Chickaloon Native Village	False Pass, Native Village of False Pass
Alakanak, Village of Alakanak	Chignik, Native Village of Chignik	Fort Yukon, Native Village of Fort Yukon
Alatna Village	Chignik Lagoon, Native Village of Chignik Lagoon	Gakona, Native Village of Gakona
Alegnagik, Native Village of Alegnagik	Chignik Lake Village	Galena Village (aka Loudon Village)
Algaaciq, Native Village of Algaaciq (St. Mary's)	Chilkat Indian Village (Klukwan)	Gambell, Native Village of Gambell
Allakaket Village	Chilkoot Indian Association (Haines)	Georgetown, Native Village of Georgetown
Ambler, Native Village of Ambler	Chinik Eskimo Community (Golovin)	Goodnews Bay, Native Village of Goodnews Bay
Anaktuvuk Pass, Village of Anaktuvuk Pass	Chistochina, Native Village of Chistochina	Grayling, Organized Village of Grayling (aka Holikachuk)
Andreafski, Yupit of Andreafski	Chitina, Native Village of Chitina	Gulkana Village
	Chuathbaluk, Native Village of Chuathbaluk (Russian Mission, Kuskokwim)	Hamilton, Native Village of Hamilton
	Chuloonawick Native Village	Healy Lake Village
		Holy Cross Village
		Hoonah Indian Association
		Hooper Bay, Native Village of Hooper Bay

Hughes Village	Kwinhagak, Native Village of Kwinhagak (aka Quinhagak)	Noorvik Native Community
Huslia Village		Northway Village
Hydaburg Cooperative Association	Larsen Bay, Native Village of Larsen Bay	Nuiqsut, Native Village of Nuiqsut (aka Nookisut)
Igiugig Village	Levelock Village	Nulato Village (Nulato Village Council)
Iliamna, Village of Iliamna	Lesnoi Village (aka Woody Island)	Nunakauyarmiut Tribe (formerly Native Village of Toksook Bay)
Inupiat Community of the Arctic Slope	Lime Village	Nunapitchuk, Native Village of Nunapitchuk
Iqurmuit Traditional Council (formerly Native Village of Russian Mission)	Lower Kalskag, Village of Lower Kalskag	Ohogamiut, Village of Ohogamiut
Ivanoff Bay Village	Manley Hot Springs Village	Old Harbor, Village of Old Harbor
Kaguyak Village	Manokotak Village	Orutsararmiut Native Village (aka Bethel)
Kake, Organized Village of Kake	Marshall, Native Village of Marshall (aka Fortuna Ledge)	Oscarville Traditional Village
Kaktovik Village (aka Barter Island)	Mary's Igloo, Native Village of Mary's Igloo	Ouzinkie, Native Village of Ouzinkie
Kalskag, Village of Kalskag	McGrath Native Village	Paimiut, Native Village of Paimiut
Kaltag, Village of Kaltag	Mekoryuk, Native Village of Mekoryuk	Pauloff Harbor Village
Kanatak, Native Village of Kanatak	Mentasta Traditional Council (formerly Mentasta Lake Village)	Pedro Bay Village
Karluk, Native Village of Karluk	Metlakatla Indian Community, Annette Island Reserve	Perryville, Native Village of Perryville
Kasaan, Organized Village of Kasaan	Minto, Native Village of Minto	Petersburg Indian Association
Kasigluk, Native Village of Kasigluk	Naknek Native Village	Pilot Point, Native Village of Pilot Point
Kenaitze Indian Tribe	Nanwalek, Native Village of Nanwalek (aka English Bay)	Pilot Station Traditional Village
Ketchikan Indian Corporation	Napaimute, Native Village of Napaimute	Pitka's Point, Native Village of Pitka's Point
Kiana, Village of Kiana	Napakiak, Native Village of Napakiak	Platinum Traditional Village
King Island Native Community	Napaskiak, Native Village of Napaskiak	Point Hope, Native Village of Port Hope
King Salmon Tribe	Nelson Lagoon, Native Village of Nelson Lagoon	Point Lay, Native Village of Point Lay
Kipnuk, Native Village of Kipnuk	Nenana Native Association	Port Graham, Native Village of Port Graham
Kivalina, Native Village of Kivalina	New Koliganek Village Council (formerly Koliganek Village)	Port Heiden, Native Village of Port Heiden
Klawock Cooperative Association	Newhalen Village	Port Lions, Native Village of Port Lions
Kluti Kaah, Native Village of Kluti Kaah (aka Copper Center)	New Stuyahok Village	Portage Creek Village (aka Ohgsenakale)
Knik Tribe	Newtok Village	Pribilof Islands Aleut Communities of St. Paul and St. George Islands
Kobuk, Native Village of Kobuk	Nightmute, Native Village of Nightmute	Qagan Tayagungin Tribe of Sand Point Village
Kokhanok Village	Nikolai Village	Qawalangin Tribe of Unalaska
Kongiganak, Native Village of Kongiganak	Nikolski, Native Village of Nikolski	Rampart Village
Kotlik, Village of Kotlik	Ninilchik Village	Red Devil, Village of Red Devil
Kotzebue, Native Village of Kotzebue	Noatak, Native Village of Noatak	Ruby, Native Village of Ruby
Koyuk, Native Village of Koyuk	Nome Eskimo Community	Saint George Island (See Pribilof Islands)
Koyukuk Native Village	Nondalton Village	
Kwethluk, Organized Village of Kwethluk		
Kwigillingok, Native Village of Kwigillingok		

Aleut Communities of St. Paul and St. George Islands)
Saint Michael, Native Village of Saint Michael
Saint Paul Island (See Pribilof Islands Aleut Communities of St. Paul and St. George Islands)
Salamatoff, Village of Salamatoff
Savoonga, Native Village of Savoonga
Saxman, Organized Village of Saxman
Scammon Bay, Native Village of Scammon Bay
Selawik, Native Village of Selawik
Seldovia Village Tribe
Shageluk Native Village
Shaktoolik, Native Village of Shaktoolik
Sheldon's Point, Native Village of Sheldon's Point
Shishmaref, Native Village of Shishmaref
Shoonaq' Tribe of Kodiak
Shungnak, Native Village of Shungnak
Sitka Tribe of Alaska
Skagway Village
Sleetmute, Village of Sleetmute
Solomon, Village of Solomon
South Naknek Village
Stebbins Community Association
Stevens, Native Village of Stevens
Stony River, Village of Stony River

Takotna Village
Tanacross, Native Village of Tanacross
Tanana, Native Village of Tanana
Tatitlek, Native Village of Tatitlek
Tazlina, Native Village of Tazlina
Telida Village
Teller, Native Village of Teller
Tetlin, Native Village of Tetlin
Tlingit and Haida, Central Council of Tlingit and Haida Indian Tribes
Togiak, Traditional Village of Togiak
Tuluksak Native Community
Tuntutuliak, Native Village of Tuntutuliak
Tununak, Native Village of Tununak
Twin Hills Village
Tyonek, Native Village of Tyonek
Ugashik Village
Umkumiute Native Village
Unalakleet, Native Village of Unalakleet
Unga, Native Village of Unga
Venetie, Native Village of Venetie Tribal Government (Arctic Village and Village of Venetie)
Wainwright, Village of Wainwright
Wales, Native Village of Wales
White Mountain, Native Village of White Mountain.

Wrangell Cooperative Association
Yakutat Tlingit Tribe

SECTION 4. EFFECT ON OTHER DOCUMENTS

01. Rev. Proc. 83-87, 1983-2 C.B. 606 is superseded. Rev. Proc. 92-19, 1992-1 C.B. 685 is also superseded. Letter rulings received by Indian tribal governments prior to the effective date below are not affected by this revenue procedure.

SECTION 5. EFFECTIVE DATE

01. This revenue procedure is effective as of January 29, 2001.

SECTION 6. DRAFTING INFORMATION

The principal author of this revenue procedure is Barbara E. Beckman of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For more information concerning this revenue procedure, contact Ms. Beckman at (202) 622-6010 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking and Notice of Public Hearing

Election to Treat Trust as Part of an Estate

REG-106542-98

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations that relate to an election to have certain revocable trusts treated and taxed as part of an estate. This document provides the procedures and requirements for making the election, rules regarding the tax treatment of the trust and the estate while the election is in effect, and rules regarding the termination of the election. This document also provides clarification of the reporting rules for a trust, or portion of a trust, that 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, for the taxable year ending with the death of the grantor or other person. In addition, this document provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by March 19, 2001. Requests to speak (with outlines of oral comments) at a public hearing scheduled for February 21, 2001, at 10 a.m., must be submitted by January 31, 2001.

ADDRESSES: Send submissions to: CC:M&SP:RU (REG-106542-98), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may also be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:M&SP:RU (REG-106542-98), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.gov/tax_reg/reglist.html

(the IRS Internet site). The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Faith Colson, (202) 622-3060; concerning submission of comments, the hearing, and/or to be placed on the building access list to attend the hearing, LaNita VanDyke, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information in this notice of proposed rulemaking 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 1545-1578.

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

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

Background

This document contains proposed regulations under section 645 relating to certain revocable trusts for which an election is made to be treated and taxed as part of an estate. This document also contains proposed amendments to the Income Tax Regulations under section 671 relating to reporting for a trust, or portion of a trust, for the taxable year ending with the death of the grantor or other person treated as the owner of the trust, or portion of the trust.

Explanation of Provisions

A. Overview of Section 645

Both estates and trusts can function to settle the affairs of a decedent and distribute

assets to heirs. In the case of a revocable inter vivos trust, the grantor transfers property to a trust that the grantor may revoke during the grantor's lifetime. When the grantor dies, the power to revoke ceases, and the trustee performs the settlement functions typically performed by an estate executor. See H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. at 711 (1997).

Section 1305 of the TRA 1997 added section 646 to the Internal Revenue Code. Section 646 was redesignated section 645 by section 6013(a) of the Internal Revenue Service Restructuring and Reform Act of 1998, Public Law 105-206 (112 Stat. 685)(1998). Section 645 provides that an election may be made to have certain revocable trusts treated and taxed as part of an estate.

Under section 645, if both the executor (if any) of an estate and the trustee of a qualified revocable trust (QRT) elect the treatment provided in section 645, the trust shall be treated and taxed for income tax purposes as part of the estate (and not as a separate trust) during the election period.

A QRT is any trust (or portion thereof) that on the date of death of the decedent was treated as owned by the decedent under section 676 by reason of a power held by the decedent (determined without regard to section 672(e)). In accordance with the legislative history accompanying section 645, the proposed regulations provide that a trust that was treated as owned by the decedent under section 676 solely by reason of a power held by a nonadverse party is not a QRT. See H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. at 711 (1997). In addition, a trust that was treated as owned by the decedent under section 676 by reason of a power held by the decedent that was exercisable by the decedent only with the approval or consent of another person is not a QRT. Further, a QRT must be a domestic trust under section 7701(a)(30)(E). A section 645 election for a QRT must result in a domestic estate under section 7701(a)(30)(D). A section 645 election may be made with respect to more than one QRT.

B. The Election

The section 645 election may be made whether or not a personal representative is

appointed for the decedent's estate. Under the proposed regulations, if a personal representative is appointed for the decedent's estate, the personal representative and the trustee of the QRT make the section 645 election by attaching a statement to the Form 1041, "U.S. Income Tax Return for Estates and Trusts," filed for the first taxable year of the decedent's estate (related estate). If a personal representative is not appointed for the decedent's estate, the trustee makes a section 645 election for the QRT by attaching a statement to the Form 1041 filed for the first taxable year of the trust treating the trust as an estate.

Rev. Proc. 98-13 (1998-1 C.B. 370) sets forth procedures for making the section 645 election. These proposed regulations, when finalized, will replace Rev. Proc. 98-13. The proposed regulations, in some instances, contain different procedures than those provided in Rev. Proc. 98-13. Rev. Proc. 98-13, in most situations, requires a trust that will make a section 645 election to obtain a taxpayer identification number (TIN) and file a Form 1041 for the trust's short taxable year beginning with the decedent's death and ending December 31 of that year. In these situations, Rev. Proc. 98-13 provides that the section 645 election is made at the time the Form 1041 is filed for the trust. If a Form 1041 is not required to be filed for the trust, the election is considered made when the Form 1041 is filed for the estate. The proposed regulations, however, provide that if a section 645 election will be made for a trust, the trustee and the personal representative, if any, may choose not to obtain a TIN for the trust or file a Form 1041 for the trust's short taxable year. Under the proposed regulations, the section 645 election is considered made only upon the filing of a Form 1041, with the required election statement attached, for the first taxable year of the related estate, or, if there is no personal representative, the first taxable year of the trust filing as an estate.

C. General Form 1041 Filing Requirements and TINs for the Related Estate and Electing Trust During the Election Period

During the election period, the personal representative files one Form 1041 for

the combined electing trust and related estate under the name and TIN of the related estate. Thus, the electing trust must furnish payors of the trust with the TIN of the related estate. Except as required under the separate share rule of section 663(c), for purposes of filing the Form 1041 and computing the tax, the items of income, deduction, and credit of the electing trust and the related estate are combined. The proposed regulations do not provide rules for apportioning the tax liability of the combined estate and electing trust. The personal representative and trustee must allocate the tax burden of the combined electing trust and related estate to the trust and the estate in a manner that reasonably reflects the tax obligations of each. If the tax burdens are not reasonably allocated, gifts may be deemed to have been made.

If there is no personal representative, the trustee of the electing trust must file a Form 1041 treating the trust as an estate under section 645 during the election period. The trustee of the trust must obtain a TIN to be used by the trust during the election period to file as an estate and must furnish this TIN to payors of the trust.

D. Tax Treatment of the Electing Trust and Related Estate During the Election Period

Under the proposed regulations, the personal representative treats the electing trust as part of the related estate for all purposes of subtitle A of the Internal Revenue Code.

The electing trust and related estate are treated as separate shares under section 663(c) for purposes of computing distributable net income (DNI) and applying the distribution provisions of sections 661 and 662. The proposed regulations provide rules for adjusting the DNI of the separate shares with respect to distributions made from one share to another share of the combined electing trust and related estate to which sections 661 and 662 would apply had the distribution been made to a beneficiary other than another share. Under the proposed regulations, the share making the distribution reduces its DNI by the amount of the distribution deduction that it would have been entitled to under section 661 had the distribution

been made to a beneficiary other than another share of the combined related estate and electing trust, and, solely for purposes of calculating its DNI, the share receiving the distribution increases its gross income by this amount.

If there is no personal representative, the trustee of the electing trust treats the trust as an estate for all purposes of subtitle A of the Internal Revenue Code. Thus, the trustee of the electing trust may adopt a taxable year other than a calendar year.

E. Duration of the Election Period

The proposed regulations provide that the election period begins on the date of the decedent's death and terminates on the day before the applicable date. If a Form 706 is not required to be filed for the decedent's estate, the applicable date is the day which is two years after the date of the decedent's death.

If a Form 706 is required to be filed, the applicable date is the day that is 6 months after the date of final determination of liability for estate tax. The proposed regulations provide that the final determination of liability for estate tax is the earliest day on which any of the following has occurred: (A) the issuance of an estate tax closing letter, unless a claim for refund with respect to the estate tax is filed within six months after the issuance of the letter; (B) the final disposition of a claim for refund that resolves the liability for the estate tax, unless suit is instituted within six months of the disposition of the claim; (C) the execution of a settlement agreement that resolves the liability for estate tax; (D) the issuance of a decision, judgment, decree, or other order by a court of competent jurisdiction resolving the liability for estate tax unless a notice of appeal or petition for certiorari is filed within 90 days after the issuance of the decision, judgment, decree, or other order of a court; or (E) the expiration of the period of limitations for assessment of the estate tax provided in section 6501.

F. Tax Treatment of the Electing Trust and Related Estate Upon Termination of the Election Period

At the close of the last day of the election period, the combined related estate and electing trust, if there is a personal representative, or the electing trust, if

there is no personal representative, is deemed to distribute all the assets and liabilities of the share (or shares) comprising the electing trust to a new trust in a distribution to which sections 661 and 662 apply. Thus, the combined related estate and electing trust, or the electing trust, as appropriate, is entitled to a distribution deduction to the extent permitted under section 661 in the taxable year in which the election period terminates as a result of the deemed distribution. The new trust must include the deemed distribution in gross income to the extent required under section 662.

At the end of the election period, the new trust must obtain a new TIN. The related estate continues to report under the TIN assigned to the combined related estate and electing trust during the election period.

Following the termination of the election period, the taxable year of the new trust must be the calendar year. The related estate must continue to use the taxable year chosen by the combined related estate and electing trust during the election period.

G. Clarification of the Reporting Rules for Grantor Trusts Under §1.671-4

In the process of drafting these proposed regulations regarding section 645, the IRS and the Treasury Department received many taxpayer questions concerning the section 645 election procedures and the proper application of the reporting rules under §1.671-4 to a trust, or a portion of a trust, treated as owned by a grantor or another person for the taxable year ending with the death of the grantor or other person. Accordingly, these proposed regulations amend §1.671-4 to clarify those reporting rules.

The proposed regulations clarify that a trust, or portion of a trust, reports under §1.671-4 for the taxable year that ends with the death of the grantor or other person (decedent) treated as the owner of the trust. If the trust was filing a Form 1041 under §1.671-4(a) during the life of the decedent, the proposed regulations also provide that the due date for the return for the trust or portion of the trust for the taxable year ending with the death of the decedent shall be the date specified under section 6072 as though the decedent had

lived throughout the decedent's last taxable year.

The proposed regulations provide that a trust that was wholly owned by the decedent must obtain a new TIN upon the death of the decedent whether or not a TIN was obtained for the trust prior to the death of the decedent; however, if a section 645 election will be made for the trust, a new TIN need not be obtained for the trust. For administrative convenience, the proposed regulations clarify that with respect to a trust which was treated as owned by two or more grantors or other persons, following the death of one of the deemed owners, the trust, including the portion formerly owned by the decedent (if it remains part of the original trust following the death of the deemed owner), continues to report under the TIN used by the trust prior to the death of the decedent.

Proposed Effective Date

These regulations are proposed to apply on or after the date that final regulations are published in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the understanding of the IRS and Treasury Department that the number of trusts and estates making the election is not substantial, and none are small entities within the meaning of the Regulatory Flexibility Act. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

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

comments (a signed original and eight (8) copies) that are submitted timely (in the manner described in the ADDRESSES caption) to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for February 21, 2001, beginning at 10 a.m., in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit timely written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by January 31, 2001. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

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

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Section 1.645-1 also issued under 26 U.S.C. 645. * * *

Par. 2. Section 1.641(b)-3 is amended by adding a sentence to the end of paragraph (a) to read as follows:

§1.641(b)-3 Termination of estates and trusts.

(a) * * * Notwithstanding the above, if the estate has joined a valid election under section 645 to treat a qualified revocable trust, as defined under section 645(b)(1), as part of the estate, the estate shall not terminate under this paragraph prior to the termination of the section 645 election period. See section 645 and the regulations thereunder for rules regarding the termination of the section 645 election period.

* * * * *

Par. 3. In §1.642(c)-1, the last sentence of paragraph (a)(1) is revised to read as follows:

§1.642(c)-1 Unlimited deduction for amounts paid for a charitable purpose.

(a) * * * (1) * * * In applying this paragraph without reference to paragraph (b) of this section, a deduction shall be allowed for an amount paid during the taxable year in respect of gross income received in a previous taxable year, but only if no deduction was allowed for any previous taxable year to the estate or trust, or in the case of a section 645 election, to a related estate, as defined under §1.645-1(b), for the amount so paid.

* * * * *

Par. 4. Section 1.645-1 is added under a new undesignated center heading to read as follows:

Election to treat trust as part of an estate.

§1.645-1 Election by certain revocable trusts to be treated as part of estate.

(a) *In general.* If an election is filed for a qualified revocable trust, as defined in paragraph (b)(1) of this section, in accordance with the rules set forth in paragraph (c) of this section, the qualified revocable trust is treated and taxed as part of its related estate, as defined in paragraph (b)(4) of this section (and not as a separate

trust) during the election period, as defined in paragraph (b)(6) of this section. Rules regarding the use of taxpayer identification numbers (TINs) by an electing trust, as defined in paragraph (b)(2) of this section, are in paragraph (d) of this section. Rules regarding obtaining a TIN and filing requirements for a qualified revocable trust for which a section 645 election will or may be made are also in paragraph (d) of this section. Rules regarding the tax treatment of an electing trust and related estate and the general filing requirements for the combined entity during the election period are in paragraph (e)(2) of this section. Rules regarding the tax treatment of an electing trust and its filing requirements during the election period if no personal representative, as defined in paragraph (b)(5) of this section, is appointed for a related estate are in paragraph (e)(3) of this section. Rules for determining the duration of the section 645 election period are in paragraph (f) of this section. Rules regarding the tax effects of the termination of the election are in paragraph (h) of this section. Rules regarding the tax consequences of the appointment of a personal representative after a trustee has made a section 645 election believing that a personal representative would not be appointed for a related estate are in paragraph (g) of this section.

(b) *Definitions.* For purposes of this section:

(1) *Qualified revocable trust.* A *qualified revocable trust* (QRT) is any trust (or portion thereof) that on the date of death of the decedent was treated as owned by the decedent under section 676 by reason of a power held by the decedent (determined without regard to section 672(e)). A trust that was treated as owned by the decedent under section 676 by reason of a power that was exercisable by the decedent only with the approval or consent of another person is not a QRT. In addition, a trust that was treated as owned by the decedent under section 676 solely by reason of a power held by a nonadverse party is not a QRT. A QRT must be a domestic trust as defined in section 7701(a)(30)(E). A section 645 election for a QRT must result in a domestic estate as defined in section 7701(a)(30)(D).

(2) *Electing trust.* An *electing trust* is a QRT for which a valid section 645 election has been made. Once a section 645 election has been made for the trust, the

trust shall be treated as an electing trust throughout the entire election period.

(3) *Decedent.* The *decedent* is the individual who was treated as the owner of the QRT under section 676 on the date of that individual's death.

(4) *Related estate.* A *related estate* is the estate of the decedent who was treated as the owner of the QRT on the date of the decedent's death. A related estate must be a domestic estate as defined in section 7701(a)(30)(D).

(5) *Personal representative.* A *personal representative* is an executor or administrator that has obtained letters of appointment to administer the decedent's estate through formal or informal appointment procedures.

(6) *Election period.* The *election period* is the period of time during which an electing trust is treated and taxed as part of its related estate. The rules for determining the duration of the election period are in paragraph (f) of this section.

(7) *Payor.* A *payor* is any person who is required by any provision of the Internal Revenue Code and the regulations thereunder to make any type of information return with respect to an electing trust or the related estate for the taxable year. A payor includes a person who makes payments to an electing trust or related estate and a person who collects (or otherwise acts as a middleman with respect to) payments on behalf of an electing trust or related estate.

(c) *The election—(1) Filing the election if there is a personal representative—(i) Time and manner for filing the election.* If there is a personal representative of the related estate, the trustee of the QRT and the personal representative of the related estate make an election under section 645 and this section to treat a QRT as part of its related estate in a written statement described in paragraph (c)(1)(ii) of this section. The statement must be attached to the Form 1041, "U.S. Income Tax Return for Estates and Trusts," filed for the first taxable year of the related estate. See paragraph (e)(2) for rules regarding the filing of this return. For the election to be valid, the Form 1041 and the attached statement must be filed not later than the time prescribed under section 6072 (including extensions) for filing the return for such taxable year.

(ii) *Written statement.* The written statement must—

(A) Identify the election as an election under section 645;

(B) Contain the name, address, date of death, and TIN of the decedent;

(C) Contain the name and address of the QRT and, if a TIN has been obtained after the death of the decedent, the TIN of the QRT;

(D) Contain the name, address and TIN of the related estate;

(E) Provide a representation that the trust for which the election is being made meets the definition of a QRT under section 645 and paragraph (b)(1) of this section;

(F) Contain a statement from the personal representative, signed and dated under penalties of perjury, stating that the personal representative elects to treat the QRT as part of the related estate under section 645 and that the personal representative understands that the personal representative is required to make a timely return of income for the combined related estate and QRT on Form 1041 and to pay timely any tax due thereon; and

(G) Contain a statement from the trustee of the QRT, signed and dated under penalties of perjury, stating that the trustee elects to treat the trust as part of the related estate under section 645 and agrees to cooperate with the personal representative to insure that a return of income is timely made for the combined related estate and QRT, and that any tax due thereon is timely paid.

(2) *Filing the election if there is no personal representative*—(i) *Time and manner for filing the election.* If there is no personal representative for a related estate, an election to treat a QRT as an estate is made by the trustee, in a written statement described in paragraph (c)(2)(ii) of this section. The statement must be attached to the Form 1041 filed for the first taxable year of the QRT taking into account the trustee's election to treat the trust as an estate under section 645. See paragraph (e)(3) for other rules regarding the filing of this return. For the election to be valid, the Form 1041 of the QRT and the attached statement must be filed not later than the time prescribed under section 6072 (including extensions) for filing the return for such taxable year.

(ii) *Written statement.* The written statement must—

(A) Identify the election as an election under section 645;

(B) Contain the name, address, date of death, and TIN of the decedent;

(C) Contain the name and address of the QRT and, if a TIN has been obtained after the death of the decedent, the TIN of the QRT;

(D) Provide a representation that the trust for which the election is being made meets the definition of a QRT under section 645 and paragraph (b)(1) of this section;

(E) Provide a representation that there is no personal representative and to the trustee's knowledge and belief, one will not be appointed;

(F) Contain the TIN obtained by the trust to file as an estate under §301.6109-1(a)(4)(ii)(B) of this chapter; and

(G) Contain a statement from the trustee of the QRT, signed and dated under penalties of perjury, stating that the trustee elects to treat the trust as an estate under section 645 and that the trustee understands that the trustee is required to make a timely return of income for the trust on Form 1041 taking into account the section 645 election and to pay timely any tax due thereon.

(d) *TIN for an electing trust and QRT*—(1) *Obtaining a TIN*—(i) *For an electing trust*—(A) *If there is a personal representative.* If there is a personal representative, a TIN must be obtained for the related estate but the electing trust is not required to obtain a TIN in its own name. See §301.6109-1(a)(4)(ii)(A)(1) of this chapter for rules for completing the Form SS-4, "Application for Employer Identification Number," filed for the related estate.

(B) *If there is no personal representative.* If there is no personal representative, the trustee must obtain a TIN to file as an estate. See §301.6109-1(a)(4)(ii)(B) of this chapter for rules regarding obtaining a TIN for an electing trust to file as an estate during the election period. The trustee is not required to obtain a TIN for the electing trust to file as a trust.

(ii) *Obtaining a TIN and filing a Form 1041 for a QRT*—(A) *Option not to obtain a TIN or file a Form 1041 for a QRT for which a section 645 election will be made.* If a section 645 election will be

made for a QRT, the personal representative of the related estate, if any, and the trustee of the QRT may treat the QRT as an electing trust from the decedent's date of death until the due date for the section 645 election. Accordingly, the trustee of the QRT is not required to obtain a TIN for the QRT following the death of the decedent as required under §301.6109-1(a)(3)(i) of this chapter or file a Form 1041 for the QRT for the short taxable year beginning with the decedent's date of death and ending with December 31 of that year. However, if a QRT is treated as an electing trust under this paragraph from the decedent's date of death until the due date for the section 645 election and a valid section 645 election is not made for the QRT, the QRT will be subject to penalties and interest for failing to obtain a TIN and file a Form 1041 and pay the tax due thereon.

(B) *Requirement to obtain a TIN and file a Form 1041 for QRT if paragraph (d)(1)(ii)(A) of this section does not apply*—(1) *Requirement to obtain TIN and file Form 1041.* If the trustee of the QRT and the personal representative of the related estate, if any, do not treat the QRT as an electing trust as provided under paragraph (d)(1)(ii)(A) of this section, or if the trustee of the electing trust and the personal representative, if any, are uncertain whether a section 645 election will be made for a QRT, the trustee of the QRT must obtain a TIN in the name of the QRT as required under §301.6109-1(a)(3)(i) of this chapter and must file a Form 1041 for the short taxable year beginning with the decedent's death and ending December 31 of that year (unless, the QRT is not required to file a Form 1041 under section 6012 for this period).

(2) *Requirement to amend return if section 645 election is made.* If a valid section 645 election is made for a QRT after a Form 1041 is filed for the QRT pursuant to paragraph (d)(1)(ii)(B)(1) of this section, the trustee must amend the Form 1041. The trustee must indicate on the Form 1041 that the return is a final return and must attach a copy of the statement described in paragraph (c) of this section to the amended Form 1041 filed pursuant to this paragraph. In addition, the trustee must provide the following statement at the top of the return: "FILED PUR-

SUANT TO §1.645-1.” The QRT’s items of income, deduction, and credit must be excluded from the amended Form 1041 filed under this paragraph and must be included on the Form 1041 filed for the first taxable year of the related estate under paragraph (e)(2)(ii)(A) of this section, if there is a personal representative, or for the first taxable year of the electing trust under (e)(3)(ii) of this section, if there is no personal representative. The section 645 election is not considered made upon the filing, under this paragraph, of an amended Form 1041 for the QRT with the attached statement. To be valid, a section 645 election must be filed in the time and manner specified in paragraph (c) of this section.

(2) *Furnishing TIN to payors*—(i) *If there is a personal representative for a related estate.* If there is a personal representative, all payors of an electing trust shall be furnished a Form W-9, “Request for Taxpayer Identification Number and Certification,” or an acceptable substitute Form W-9 with the name of the related estate as the primary name on the form, the name of the electing trust as the secondary name on the form, the TIN of the related estate, and the address of the trustee. The form must be signed under penalties of perjury by the personal representative. See section 3406 and the regulations thereunder for the information to include on, and the manner of executing, the Form W-9, depending on the type of reportable payments made by the payor to the trust.

(ii) *If there is no personal representative.* If there is no personal representative, the trustee of the electing trust shall furnish a Form W-9 or an acceptable substitute Form W-9 with the name required by, and the TIN obtained under, §301.6109-1(a)(4)(ii)(B) of this chapter. See section 3406 and the regulations thereunder for the information to include on, and the manner of executing, the Form W-9, depending on the type of reportable payments made by the payor to the trust.

(e) *Tax treatment and general filing requirements of electing trust and related estate during the election period*—(1) *Effect of election.* The section 645 election once made is irrevocable.

(2) *If there is a personal representative*—(i) *Tax treatment of the combined electing trust and related estate.* If there is a per-

sonal representative, during the election period the personal representative treats the electing trust as part of the related estate for all purposes of subtitle A of the Internal Revenue Code. For example, the electing trust is treated as part of the related estate for purposes of the subchapter S shareholder requirements of section 1361(b)(1) and the special offset for rental real estate activities in section 469(i)(4).

(ii) *Filing requirements*—(A) *Filing the Form 1041 for the combined electing trust and related estate during the election period.* If there is a personal representative, one income tax return is filed under the name and TIN of the related estate for the electing trust and the related estate. See §301.6109-1(a)(4)(ii)(A)(I) of this chapter. Except as required under the separate share rule of section 663(c), for purposes of filing the Form 1041 under this paragraph and computing the tax, the items of income, deduction, and credit of the electing trust and related estate are combined. One personal exemption in the amount of \$600 is permitted under section 642(b) and the tax is computed under section 1(e), taking into account section 1(h), for the combined taxable income.

(B) *Filing a Form 1041 for the electing trust is not required.* The trustee of the electing trust does not file a Form 1041 for the electing trust during the election period. In certain situations, the trustee of a QRT may be required to file a Form 1041 for the QRT’s short taxable year beginning with the decedent’s date of death and ending December 31 of that year. See paragraph (d)(1)(ii) of this section.

(iii) *Application of the separate share rules*—(A) *Distributions to beneficiaries (other than to a share (or shares) of the combined electing trust and related estate).* Under the separate share rules of section 663(c), the electing trust and related estate are treated as separate shares for purposes of computing distributable net income (DNI) and applying the distribution provisions of sections 661 and 662. Further, the electing trust share or the related estate share may each contain two or more shares. Thus, if during the taxable year, a distribution is made by the electing trust or the related estate, the DNI of the share making the distribution must be determined and the distribution provisions of sections 661 and 662 must be

applied using the separately determined DNI applicable to the distributing share.

(B) *Adjustments to the DNI of the separate shares for distributions between shares to which sections 661 and 662 would apply.* A distribution from one share to another share to which sections 661 and 662 would apply if made to a beneficiary other than another share of the combined related estate and electing trust affects the computation of the DNI of the share making the distribution and the share receiving the distribution. The share making the distribution reduces its DNI by the amount of the distribution deduction that it would be entitled to under section 661, had the distribution been made to another beneficiary, and, solely for purposes of calculating DNI, the share receiving the distribution increases its gross income by the same amount. The distribution has the same character in the hands of the recipient share as in the hands of the distributing share. The following example illustrates the provisions of this paragraph (e)(2)(iii)(B):

Example. (i) A’s will provides that after the payment of debts, expenses, and taxes, the residue of A’s estate is to be distributed to Trust, an electing trust. The sole beneficiary of Trust is C. The estate share has \$15,000 of gross income, \$5,000 of deductions, and \$10,000 of taxable income and DNI for the taxable year based on the assets held in A’s estate. During the taxable year, A’s estate distributes \$15,000 to Trust. The distribution reduces the DNI of the estate share by \$10,000, the amount of the distribution deduction A’s estate would be entitled to if A’s estate made the distribution to a beneficiary other than Trust.

(ii) For the same taxable year, the trust share has \$25,000 of gross income and \$5,000 of deductions. None of the modifications provided for under section 643(a) apply. In calculating the DNI for the trust share, the gross income of the trust share is increased by \$10,000, the amount of the reduction in the DNI of the estate share as a result of the distribution to Trust. Thus, solely for purposes of calculating DNI, the trust share has gross income of \$35,000, and taxable income of \$30,000. Therefore, the trust share has \$30,000 of DNI for the taxable year.

(iii) During the same taxable year, Trust distributes \$35,000 to C. The distribution deduction reported on the Form 1041 filed for A’s estate and Trust is \$30,000. As a result of the distribution by Trust to C, C must include \$30,000 in gross income for the taxable year. The gross income reported on the Form 1041 filed for A’s estate and Trust is \$40,000.

(iv) *Application of the governing instrument requirement of section 642(c).* A deduction is allowed in computing the taxable income of the combined related

estate and electing trust to the extent permitted under section 642(c) for—

(A) Any amount of the gross income of the related estate that is paid or set aside during the taxable year pursuant to the terms of the governing instrument of the related estate for a purpose specified in section 170(c); and

(B) Any amount of gross income of the electing trust that is paid or set aside during the taxable year pursuant to the terms of the governing instrument of the electing trust for a purpose specified in section 170(c).

(3) *If there is no personal representative—*(i) *Tax treatment of the electing trust.* If there is no personal representative, during the election period the trustee treats the electing trust as an estate for all purposes of subtitle A of the Internal Revenue Code. Thus, for example, an electing trust is treated as an estate for purposes of the set-aside deduction under section 642(c)(2), the subchapter S shareholder requirements of section 1361(b)(1), and the special offset for rental real estate activities under section 469(i)(4). The trustee may also adopt a taxable year other than a calendar year.

(ii) *Filing the Form 1041 for the electing trust.* If there is no personal representative, during the election period the trustee of the electing trust must file Form 1041 treating the trust as an estate. See §301.6109-1(a)(4)(ii)(B) of this chapter for rules regarding the name and TIN to be used in filing a Form 1041 under this paragraph (e)(3)(iii). Any return filed by a trustee of an electing trust, in accordance with this paragraph, shall be treated under section 6012 as a return filed for the electing trust and not as a return filed for any subsequently discovered related estate. Accordingly, the period of limitations provided in section 6501 for assessments with respect to a subsequently discovered related estate does not start until a return is filed with respect to the related estate.

(f) *Duration of election period—*(1) *In general.* The election period begins on the date of the decedent's death and terminates on the day before the applicable date. The election does not apply to successor trusts.

(2) *Definition of applicable date—*(i) *Applicable date if no Form 706 (United States Estate (and Generation Skipping*

Transfer) Tax Return) is required to be filed. If a Form 706 is not required to be filed for the decedent's estate, the applicable date is the day which is 2 years after the date of the decedent's death.

(ii) *Applicable date if a Form 706 is required to be filed.* If a Form 706 is required to be filed for the decedent's estate, the applicable date is the day that is 6 months after the date of final determination of liability for estate tax. Solely for purposes of determining the applicable date under section 645, the date of final determination of liability is the earliest day on which any of the following has occurred—

(A) The issuance by the Internal Revenue Service of an estate tax closing letter, unless a claim for refund with respect to the estate tax is filed within six months after the issuance of the letter;

(B) The final disposition of a claim for refund, as defined in paragraph (f)(2)(iii) of this section, that resolves the liability for the estate tax, unless suit is instituted within six months after a final disposition of the claim;

(C) The execution of a settlement agreement with the Internal Revenue Service that determines the liability for the estate tax;

(D) The issuance of a decision, judgment, decree, or other order by a court of competent jurisdiction resolving the liability for the estate tax unless a notice of appeal or a petition for *certiorari* is filed within 90 days after the issuance of a decision, judgment, decree, or other order of a court; or

(E) The expiration of the period of limitations for assessment of the estate tax provided in section 6501.

(iii) *Definition of final disposition of claim for refund.* For purposes of paragraph (f)(2)(ii)(B) of this section, a claim for refund shall be deemed finally disposed of by the Secretary when all items have been either allowed or disallowed. If a waiver of notification with respect to disallowance is filed with respect to a claim for refund prior to disallowance of the claim, the claim for refund will be treated as disallowed on the date the waiver is filed.

(iv) *Examples.* The application of this paragraph (f)(2) is illustrated by the following examples:

Example 1. A died on October 20, 1999. The personal representative of A's estate and the trustee

of Trust, an electing trust, made a section 645 election. A Form 706 is not required to be filed for A's estate. The applicable date is October 20, 2001, the day that is two years after A's date of death. The last day of the election period is October 19, 2001. Beginning October 20, 2001, Trust will no longer be treated and taxed as part of A's estate.

Example 2. Assume the same facts as *Example 1*, except that a Form 706 is required to be filed for A's estate. The Internal Revenue Service issues an estate tax closing letter accepting the Form 706 as filed on March 15, 2001. The estate does not file a claim for refund by September 15, 2001, the day that is six months after the date of issuance of the estate tax closing letter. The final determination of liability is March 15, 2001 and the applicable date is September 15, 2001. The last day of the election period is September 14, 2001. Beginning September 15, 2001, Trust will no longer be treated and taxed as part of A's estate.

Example 3. Assume the same facts as *Example 1*, except that a Form 706 is required to be filed for A's estate. The Form 706 is audited and a notice of deficiency authorized under section 6212 is mailed to the personal representative of A's estate as a result of the audit. The personal representative files a petition in Tax Court. The Tax Court issues a decision resolving the liability for estate tax on December 14, 2003 and neither party appeals. The final determination of liability is December 14, 2003. The applicable date is June 14, 2004, the day that is six months after the date of final determination of liability. The last day of the election period is June 13, 2004. Beginning June 14, 2004, Trust will no longer be treated and taxed as part of A's estate.

(g) *Personal Representative appointed after the section 645 election is made—*

(1) *Effect on the election.* If a personal representative for the related estate is not appointed until after the trustee has made a valid section 645 election, the personal representative is deemed to agree to the election and to accept the associated responsibilities unless, within 60 days of appointment, the personal representative notifies the trustee in writing of the personal representative's refusal to agree to the election. If the personal representative refuses to agree to the election, the election period terminates the day before the effective date of the personal representative's appointment. If the personal representative and the trustee are the same person, the personal representative cannot refuse to agree to the election.

(2) *Continuation of election period.* If the personal representative does not refuse to agree to the section 645 election, the personal representative of the related estate and the trustee of the electing trust must file amended Forms 1041 reflecting the items of income, deduction, and credit of the related estate and the electing trust for all taxable years ending after the

death of the decedent. If the period of limitations for making assessments has expired with respect to the electing trust for any of the Forms 1041 filed by the trustee, the personal representative must obtain a TIN for the related estate and file Forms 1041 for any items of income, deduction, and credit of the related estate that cannot be properly included on amended forms for the electing trust.

(3) *Termination of the election period.* If the election period terminates as a result of the personal representative's refusing to agree to the election, the personal representative must obtain a new TIN for the related estate. The personal representative must file returns under the new TIN for all taxable years of the related estate ending after the death of the decedent. The trustee of the electing trust is not required to amend any returns filed for the electing trust during the election period. Following termination of the election period, the trustee of the electing trust must obtain a new TIN as required under §301.6109-1(a)(4)(iii) of this chapter.

(h) *Treatment of an electing trust and related estate following termination of the election—*(1) *The share (or shares) comprising the electing trust is deemed to be distributed by its related estate upon termination of the election period.* On the close of the last day of the election period, the combined related estate and electing trust, if there is a personal representative, or, the electing trust, if there is no personal representative, is deemed to distribute the share (or shares, as determined under section 663(c)) comprising the electing trust to a new trust in a distribution to which sections 661 and 662 apply. Thus, the combined related estate and electing trust, if there is a personal representative, or the electing trust, if there is no personal representative, is entitled to a distribution deduction to the extent permitted under section 661 in the taxable year in which the election period terminates as a result of the deemed distribution. The new trust shall include such distribution in gross income to the extent required under section 662.

(2) *Filing of the Form 1041 upon the termination of the section 645 election—*(i) *If there is a personal representative—*If there is a personal representative, the Form 1041 filed under the name and TIN of the related estate for the taxable year in

which the election terminates includes—

(A) The items of income, deduction, and credit of the electing trust attributable to the period beginning with the first day of the related estate and electing trust's taxable year and ending with the last day of the election period;

(B) The items of income, deduction, and credit, if any, of the related estate for the taxable year; and

(C) A deduction for the deemed distribution of the share (or shares) comprising the electing trust to the new trust as provided for under paragraph (h)(1) of this section.

(ii) *If there is no personal representative.* If there is no personal representative, the taxable year of the electing trust closes on the last day of the election period. A Form 1041 is filed in the manner prescribed under paragraph (e)(3)(ii) of this section reporting the items of income, deduction, and credit of the electing trust for the short period ending with the last day of the election period. The Form 1041 filed under this paragraph includes a distribution deduction for the deemed distribution provided for under paragraph (h)(1) of this section. The Form 1041 must indicate that it is a final return.

(3) *Use of TINs following termination of the election.* Upon termination of the section 645 election, a former electing trust must obtain a new TIN, as required under §301.6109-1(a)(4)(iii) of this chapter. If the related estate continues after the termination of the election period, the related estate must continue to use the TIN assigned to the estate during the election period.

(4) *Taxable year of estate and trust upon termination of the election—*(i) *Estate.* Upon termination of the election, if the estate will continue, the taxable year of the estate is the same taxable year used during the election period.

(ii) *Trust.* Upon termination of the election, the taxable year of the new trust is the calendar year. See section 644.

(i) *Reserved.*

(j) *Effective date.* This section applies on or after the date final regulations are published in the **Federal Register**.

Par. 5. Section 1.671-4 is amended as follows:

1. The text of paragraph (d) is redesignated paragraph (d)(1) and a paragraph heading is added for newly designated

paragraph (d)(1).

2. Paragraph (d)(2) is added

3. Paragraphs (h) and (i) are redesignated as paragraphs (i) and (j).

4. New paragraph (h) is added.

The additions and revisions read as follows:

§1.671-4 Method of Reporting.

* * * * *

(d) *Due date and other requirements with respect to statement required to be furnished by trustee—*(1) *In general.* * * *

(2) *Statement for the taxable year ending with the death of the grantor or other person treated as the owner of the trust.* If a trust ceases to be treated as owned by the grantor, or other person, by reason of the death of that grantor or other person (decedent), the due date for the statement required to be furnished for the taxable year ending with the death of the decedent shall be the date specified by section 6034A(a) as though the decedent had lived throughout the decedent's last taxable year. See paragraph (h) of this section for special reporting rules for a trust or portion of the trust that ceases to be treated as owned by the grantor or other person by reason of the death of the grantor or other person.

* * * * *

(h) *Reporting rules for a trust, or portion of a trust, that ceases to be treated as owned by a grantor or other person by reason of the death of the grantor or other person—*(1) *Definition of decedent.* For purposes of this paragraph (h), the *decedent* is the grantor or other person treated as the owner of the trust, or portion of the trust, under subpart E, part I, subchapter J, chapter 1 of the Internal Revenue Code on the date of death of that person.

(2) *In general.* The provisions of §1.671-4 apply to a trust, or portion of a trust, treated as owned by a decedent for the taxable year that ends with the decedent's death. Following the death of the decedent, the trust or portion of a trust that ceases to be treated as owned by the decedent, by reason of the death of the decedent, may no longer report under §1.671-4. A trust, all of which was treated as owned by the decedent, must obtain a new TIN upon the death of the decedent, if the trust will continue after the death of the decedent. See §301.6109-1(a)(3)(i) of this chapter for rules regarding obtain-

ing a TIN upon the death of the decedent. An electing trust as defined in §1.645-1(b)(2) is not required to obtain a TIN following the death of the decedent. A qualified revocable trust, as defined in section 645(b) and §1.645-1(b)(1), for which a section 645 election will be made, need not obtain a TIN. See §301.6109-1(a)(4) of this chapter and §1.645-1(d)(1)(ii)(A).

(3) *Special rules*—(i) *Trusts reporting pursuant to paragraph (a) of this section for the taxable year ending with the decedent's death.* The due date for filing of a return pursuant to paragraph (a) of this section for the taxable year ending with the decedent's death shall be the due date provided for under §1.6072-1(a)(2). The return filed under this paragraph for a trust all of which was treated as owned by the decedent must indicate that it is a final return.

(ii) *Trust reporting pursuant to paragraph (b)(2)(B) of this section for the taxable year of the decedent's death.* A trust that reports pursuant to paragraph (b)(2)(B) of this section for the taxable year ending with the decedent's death must indicate on each Form 1096 (Annual Summary and Transmittal of the U.S. Information Returns) that it files (or appropriately on magnetic media) for the taxable year ending with the death of the decedent that it is the final return of the trust.

(iii) *Trust reporting under paragraph (b)(3) of this section.* If a trust has been filing under paragraph (b)(3) of this section, the trustee may not report under that paragraph if any portion of the trust has a short taxable year by reason of the death of the decedent and the portion treated as owned by the decedent does not terminate on the death of the decedent.

(4) *Effective date.* This paragraph (h) applies on or after the date final regulations are published in the **Federal Register**.

Par. 6. Section 1.6072-1 is amended as follows:

1. The text of paragraph (a) is redesignated as paragraph (a)(1) and a paragraph heading is added for newly designated paragraph (a)(1).

2. Paragraph (a)(2) is added.

The additions are as follows:

§1.6072-1 Time for filing returns of individuals, estates, and trusts.

(a) *In general*—(1) *Returns of income for individuals, estates and trusts.* * * *

(2) *Return of trust, or portion of a trust, treated as owned by a decedent*—(i) *In general.* In the case of a return of a trust, or portion of a trust, that was treated as owned by a decedent under subpart E (section 671 and following), part I, subchapter J, chapter 1 of the Internal Revenue Code as of the decedent's date of death that is filed in accordance with §1.671-4(a) for the fractional part of the year ending with the date of death of the decedent, the due date of such return shall be the fifteenth day of the fourth month following the close of the 12-month period which began with the first day of such fractional part of the year.

(ii) *Effective date.* This paragraph (a)(2) applies on or after the date final regulations are published in the Federal Register.

* * * * *

PART 301-PROCEDURE AND ADMINISTRATION

Par. 7. The authority citation for part 301 continues to read in part as follows:

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

Par. 8. Section 301.6109-1 is amended as follows:

1. Paragraph (a)(2)(iii) is removed.

2. Paragraphs (a)(3) through (a)(6) are added.

The additions are as follows:

§301.6109-1 Identifying numbers.

(a) * * *

(3) *Obtaining a taxpayer identification number for a trust, or portion of a trust, following the death of the individual treated as the owner*—(i) *In general*—(A) *A trust all of which was treated as owned by a decedent.* In general, a trust all of which is treated as owned by a decedent under subpart E (section 671 and following), part 1, subchapter J, chapter 1 of the Internal Revenue Code as of the decedent's date of death must obtain a new taxpayer identification number following the death of the decedent if the trust will continue after the death of the decedent. See, however, §301.6109-1(a)(4) for rules regarding obtaining a taxpayer identification number for a qualified revocable trust, as defined in section 645(b)(1), for which a section 645 election has been or will be made.

(B) *Taxpayer identification numbers of trust with multiple owners.* With respect to a portion of a trust treated as owned under subpart E (section 671 and following), part 1, subchapter J, chapter 1 of the Internal Revenue Code by a decedent as of the date of the decedent's death, if, following the death of the decedent, the portion treated as owned by the decedent remains part of the original trust and the other portion (or portions) of the trust continue to report under the taxpayer identification number assigned to the trust prior to the decedent's death, the portion of the trust treated as owned by the decedent prior to the decedent's death continues to report under the taxpayer identification number used for reporting by the other portion (or portions) of the trust.

(ii) *Furnishing correct taxpayer identification number to payors following the death of the decedent.* If the trust continues after the death of the decedent and is required to obtain a new taxpayer identification number under paragraph (a)(3)(i)(A) of this section, the trustee must furnish payors with a new Form W-9, or an acceptable substitute Form W-9, containing the new taxpayer identification number required under paragraph (a)(3)(i)(A) of this section, the name of the trust, and the address of the trustee.

(4) *Taxpayer identification numbers if a section 645 election has been, or will be, made*—(i) *Definitions.* For purposes of this paragraph (a)(4), the terms *qualified revocable trust (QRT)*, *electing trust*, *related estate*, *election period*, and *personal representative* shall have the meanings provided in §1.645-1(b) of this chapter.

(ii) *Taxpayer identification number to be used during the election period*—(A) *If there is a personal representative*—(1) *In general.* If there is a personal representative for a related estate, a taxpayer identification number does not need to be obtained for an electing trust. The personal representative of the related estate must obtain a taxpayer identification number in the name of the estate. A trustee of a QRT for which a section 645 election will be made and the personal representative of the related estate, if any, may choose to treat the QRT as an electing trust and not obtain a taxpayer identification number for the trust. See §1.645-1(d)(1)(ii)(A) of this chapter. If

the personal representative knows that a section 645 election has been made for an electing trust or will be made for a QRT at the time the personal representative files the Form SS-4, "Application for Employer Identification Number," for the related estate, the personal representative may enter the name of the trust as a secondary name on the form. All returns filed for the combined related estate and electing trust during the election period must be filed using the name of the related estate as the primary name on the return.

(2) *Obligations of persons who make payments to electing trusts.* Any payor that is required to file an information return with respect to payments of income or proceeds to an electing trust must show the name of the related estate, as the primary name on the return, the name of the electing trust as the secondary name on the return, and the taxpayer identification number of the related estate on the return. Nevertheless, the statement to recipients must be furnished by the payor to the trustee of the trust, rather than the personal representative of the related estate. Under these circumstances, the payor satisfies all information reporting sections that require the payor to show the name and taxpayer identification number of the payee on the information return and to furnish the statement to recipients to the person whose taxpayer identification number is required to be shown on the

form.

(B) *If there is no personal representative.* If there is no personal representative for a related estate, the trustee of an electing trust must obtain a taxpayer identification number as an estate. The name entered on the Form SS-4 filed by the trustee must be the name of the trust followed by "filing as an estate under section 645." Any returns filed by the electing trust in accordance with section 645 during the election period must be filed under the name required to be entered on the Form SS-4 under this paragraph and under the taxpayer identification number obtained pursuant to this paragraph. A trustee of a QRT for which a section 645 election will be made may choose to treat the QRT as an electing trust and obtain a taxpayer identification number as an estate under this paragraph and not as a trust. See §1.645-1(d)(1)(ii)(A) of this chapter.

(iii) *Taxpayer identification number to be used by a trust upon termination of the election period.* Upon the termination of the election period, the trustee must obtain a taxpayer identification number in the name of the new trust. If there is no personal representative and the trustee obtained a taxpayer identification number under paragraph (a)(4)(ii)(B) of this section for the trust to file as an estate under section 645, the trustee must obtain a new taxpayer identification number for the new trust. See §1.645-1(h) of this chap-

ter for rules regarding the treatment of an electing trust upon termination of the election period. The trustee must furnish to all payors of the trust a completed Form W-9 or acceptable substitute Form W-9 signed under penalties of perjury by the trustee providing each payor with the name of the new trust, the TIN required to be used under this paragraph (a)(4)(iii), and the address of the trustee.

(5) *Persons treated as payors.* For purposes of paragraphs (a)(2), (3), and (4) of this section, a *payor* is a person described in §§1.671-4(b)(4) and 1.645-1(b)(7) of this chapter.

(6) *Effective date.* Paragraphs (a)(3), (4), and (5) of this section apply on or after the date final regulations are published in the **Federal Register**.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 9. The authority citation for part 602 continues to read as follows:

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

Par. 10. In §602.101, paragraph (b) is amended by adding an entry in numerical order to the table to read as follows:

§602.101 OMB Control numbers.
* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.645-1	1545-1578
* * * * *	

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

(Filed by the Office of the Federal Register on December 15, 2000, 8:45 a.m., and published in the issue of the Federal Register for December 18, 2000,

65 F.R. 79015)

Announcement of the Consent Voluntary Suspension of Attorneys, Certified Public Accountants, Enrolled Agents, and Enrolled Actuaries From Practice Before the Internal Revenue Service

Under 31 Code of Federal Regulations, Part 10, an attorney, certified public accountant, enrolled agent or enrolled actuary, in order to avoid the institution or

conclusion of a proceeding for his disbarment or suspension from practice before the Internal Revenue Service, may offer his consent to suspension from such prac-

tice. The Director of Practice, in his discretion, may suspend an attorney, certified public accountant, enrolled agent or enrolled actuary in accordance with the con-

sent offered.

Attorneys, certified public accountants, enrolled agents and enrolled actuaries are prohibited in any Internal Revenue Service matter from directly or indirectly employing, accepting assistance from, being employed by or sharing fees with, any practitioner disbarred or suspended from practice before the Internal Revenue Service.

To enable attorneys, certified public accountants, enrolled agents and enrolled ac-

tuaries to identify practitioners under consent suspension from practice before the Internal Revenue Service, the Director of Practice will announce in the Internal Revenue Bulletin the names and addresses of practitioners who have been suspended from such practice, their designation as attorney, certified public accountant, enrolled agent or enrolled actuary, and date or period of suspension. This announcement will appear in the weekly Bulletin at the earliest practicable date after such ac-

tion and will continue to appear in the weekly Bulletins for five successive weeks or for as many weeks as is practicable for each attorney, certified public accountant, enrolled agent or enrolled actuary so suspended and will be consolidated and published in the Cumulative Bulletin.

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

Name	Address	Designation	Date of Suspension
Sinclair, Gerald A.	Hammond, IN	Enrolled Agent	August 16, 2000 to August 15, 2001
Barrett, Norman	Dover, DE	CPA	September 1, 2000 to November 30, 2001
Janus, Stephen E.	Michigan City, IN	CPA	September 20, 2000 to September 19, 2003
McCormack, Frank J.	Castlebury, FL	CPA	September 20, 2000 to September 19, 2003
Serio, Vinson J.	Metairie, LA	Enrolled Agent	October 1, 2000 to September 30, 2003
Baker, Linda L.	West Orange, NJ	CPA	October 20, 2000 to April 19, 2004
Duncanson, Thomas D.	Mankato, MN	CPA	November 7, 2000 to May 6, 2003
West, Keith	Pasadena, CA	Enrolled Agent	November 15, 2000 to May 14, 2001
Overbeck, Marietta	Evansville, IN	CPA	November 15, 2000 to November 14, 2002
Garrison, John L.	Guymon, OK	CPA	November 20, 2000 to November 19, 2002
Aiken, Kim Allen	Olympia, WA	CPA	December 10, 2000 to June 9, 2002
D'Arata, David J.	Buffalo, NY	CPA	January 1, 2001 to June 30, 2003
Gambrel, Thomas R.	Corbin, KY	CPA	January 1, 2001 to December 31, 2004

Announcement of the Expedited Suspension of Attorneys, Certified Public Accountants, Enrolled Agents, and Enrolled Actuaries From Practice Before the Internal Revenue Service

Under title 31 of the Code of Federal Regulations, section 10.76, the Director of Practice is authorized to immediately suspend from practice before the Internal Revenue Service any practitioner who, within five years, from the date the expedited proceeding is instituted, (1) has had a license to practice as an attorney, certified public accountant, or actuary suspended or revoked for cause; or (2) has been convicted of any crime under title 26 of the United States Code or, of a felony under title 18 of the United States Code involving dishonesty or breach of trust.

Attorneys, certified public accountants, enrolled agents, and enrolled actuaries are

prohibited in any Internal Revenue Service matter from directly or indirectly employing, accepting assistance from, being employed by, or sharing fees with, any practitioner disbarred or suspended from practice before the Internal Revenue Service.

To enable attorneys, certified public accountants, enrolled agents, and enrolled actuaries to identify practitioners under expedited suspension from practice before the Internal Revenue Service, the Director of Practice will announce in the Internal Revenue Bulletin the names and addresses of practitioners who have been suspended from such practice, their designation as attorney, certified public accountant, enrolled

agent, or enrolled actuary, and date or period of suspension. This announcement will appear in the weekly Bulletin at the earliest practicable date after such action and will continue to appear in the weekly Bulletins for five successive weeks or for as many weeks as is practicable for each attorney, certified public accountant, enrolled agent, or enrolled actuary so suspended and will be consolidated and published in the Cumulative Bulletin.

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

Name	Address	Designation	Date of Suspension
Barger, Robert E.	Garden Ridge, TX	Attorney	Indefinite from October 10, 2000
Roberts, Thomas W.	Cincinnati OH	CPA	Indefinite from October 24, 2000

Announcement of the Disbarment and Suspension of Attorneys, Certified Public Accountants, Enrolled Agents, and Enrolled Actuaries From Practice Before the Internal Revenue Service

Under Section 330, Title 31 of the United States Code, the Secretary of the Treasury, after due notice and opportunity for hearing, is authorized to suspend or disbar from practice before the Internal Revenue Service any person who has violated the rules and regulations governing the recognition of attorneys, certified public accountants, enrolled agents or enrolled actuaries to practice before the Internal Revenue Service.

Attorneys, certified public accountants, enrolled agents, and enrolled actuaries are prohibited in any Internal Revenue Service

matter from directly or indirectly employing, accepting assistance from, being employed by, or sharing fees with any practitioner disbarred or under suspension from practice before the Internal Revenue Service.

To enable attorneys, certified public accountants, enrolled agents and enrolled actuaries to identify such disbarred or suspended practitioners, the Director of Practice will announce in the Internal Revenue Bulletin the names and addresses of practitioners who have been suspended from such practice, their designation as attorney, certified public accountant, enrolled

agent or enrolled actuary, and the date of disbarment or period of suspension. This announcement will appear in the weekly Bulletin for five successive weeks or as long as it is practicable for each attorney, certified public accountant, enrolled agent or enrolled actuary so suspended or disbarred and will be consolidated and published in the Cumulative Bulletin.

After due notice and opportunity for hearing before an administrative law judge, the following individual has been disbarred from further practice before the Internal Revenue Service:

Name	Address	Designation	Effective Date
Joyner, Joseph	Gary, IN	CPA	November 24, 2000

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 ap-

plies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

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

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

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the

new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case the previously published ruling is first modified and then, as modified, is superseded.

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

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

Abbreviations

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

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.

E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
FR.—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.

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