Internal Revenue
bulletin

Bulletin No. 2002–16
April 22, 2002

HIGHLIGHTS OF THIS ISSUE

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

INCOME TAX

Rev. Rul. 2002–18, page 779.
LIFO; price indexes; department stores. The February 2002 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, February 28, 2002.

Rev. Rul. 2002–19, page 778.
Medical expenses. Uncompensated amounts paid by individuals for participation in a weight-loss program as treatment for a specific disease or diseases (including obesity) diagnosed by a physician are expenses for medical care under section 213 of the Code. The cost of purchasing diet food items is not deductible under section 213. Rev. Ruls. 55–261 and 79–151 distinguished.

T.D. 8986, page 780.
Final regulations under section 705 of the Code provide guidance for making basis adjustments necessary to coordinate sections 705 and 1032 in situations in which a corporation acquires an interest in a partnership that holds stock in that corporation.

REG–165706–01, page 787.
Proposed regulations modify the definition of a refunding issue under section 1.150–1(d) of the regulations in connection with a combination of section 501(c)(3) organizations. Generally, interest on bonds issued by state and local governments is excluded from gross income, however, this exclusion does not apply to certain refunding issues. A public hearing is scheduled for July 30, 2002.

REG–167648–01, page 790.
Proposed regulations under section 705 of the Code provide guidance for making basis adjustments necessary to coordinate sections 705 and 1032 in situations in which a corporation owns a direct or indirect interest in a partnership that holds stock in that corporation.

Announcement 2002–43, page 792.
This announcement describes a closing agreement program relating to certain state or local bonds issued in connection with affiliations of section 501(c)(3) hospital organizations.

EMPLOYEE PLANS

Notice 2002–24, page 785.
Section 6039D returns with respect to certain fringe benefits. This notice suspends the filing requirement imposed on specified fringe benefit plans by section 6039D of the Code. Notice 90–24 modified and superseded.

Notice 2002–28, page 785.
Weighted average interest rate update. The weighted average interest rate for April 2002 and the resulting permissible range of interest rates used to calculate current liability for purposes of the full funding limitation of section 412(c)(7) of the Code are set forth.

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Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

EXEMPT ORGANIZATIONS

REG–165706–01, page 787.
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The IRS Mission

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

Introduction

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

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

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

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

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.

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

Part II.—Treaties and Tax Legislation.

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

Part III.—Administrative, Procedural, and Miscellaneous.

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

Part IV.—Items of General Interest.

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

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

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Colleen Simpson
Tracy Scmall

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

Section 103.—Interest on State and Local Bonds

The Service announces a closing agreement program relating to certain state or local bonds issued in connection with affiliations of 501(c)(3) hospital organizations. See Ann. 2002–43, page 792.

Section 149(d).—Advance Refundings

The Service announces a closing agreement program relating to certain state or local bonds issued in connection with affiliations of 501(c)(3) hospital organizations. See Ann. 2002–43, page 792.

Section 150.—Definitions and Special Rules

26 CFR 1.150–1(d): Definition of refunding issue and related definitions.

The Service announces a closing agreement program relating to certain state or local bonds issued in connection with affiliations of 501(c)(3) hospital organizations. See Ann. 2002–43, page 792.

Section 213.—Medical, Dental, etc., Expenses

26 CFR 1.213–1: Medical, Dental, etc., Expenses. (Also § 262; 1.262–1.)

Medical expenses. Uncompensated amounts paid by individuals for participation in a weight-loss program as treatment for a specific disease or diseases (including obesity) diagnosed by a physician are expenses for medical care under section 213 of the Code. The cost of purchasing diet food items is not deductible under section 213 of the Code.

Rev. Rul. 2002–19

ISSUE

Are uncompensated amounts paid by individuals for participation in a weight-loss program as treatment for a specific disease or ailment (including obesity) diagnosed by a physician and for diet food items expenses for medical care that are deductible under § 213 of the Internal Revenue Code?

FACTS

Taxpayer *A* is diagnosed by a physician as obese. *A* does not suffer from any other specific disease. Taxpayer *B* is not obese but suffers from hypertension. *B* has been directed by a physician to lose weight as treatment for the hypertension.

A and *B* participate in the *X* weight-loss program. *A* and *B* are required to pay an initial fee to join *X* and an additional fee to attend periodic meetings. At the meetings participants develop a diet plan, receive diet menus and literature, and discuss problems encountered in dieting. *A* and *B* also purchase *X* brand reduced-calorie diet food items. Neither *A*'s nor *B*'s costs are compensated by insurance or otherwise.

LAW

Section 213(a) allows a deduction for uncompensated expenses for medical care of an individual, the individual's spouse or a dependent, to the extent the expenses exceed 7.5 percent of adjusted gross income. Section 213(d)(1) provides, in part, that medical care means amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body.

Under § 1.213–1(e)(1)(ii) of the Income Tax Regulations, the deduction for medical care expenses will be confined strictly to expenses incurred primarily for the prevention or alleviation of a physical or mental defect or illness. An expense that is merely beneficial to the general health of an individual is not an expense for medical care. Whether an expenditure is primarily for medical care or is merely beneficial to general health is a question of fact.

Section 262 provides that, except as otherwise expressly provided by the Code, no deduction is allowed for personal, living, or family expenses.

Rev. Rul. 79–151 (1979–1 C.B. 116) holds that a taxpayer who participates in a weight reduction program to improve the taxpayer's appearance, general health, and sense of well-being, and not to cure a specific ailment or disease, may not deduct the cost as a medical expense under § 213.

Rev. Rul. 55–261 (1955–1 C.B. 307) holds that medical care includes the cost of special food if (1) the food alleviates or treats an illness, (2) it is not part of the normal nutritional needs of the taxpayer, and (3) the need for the food is substantiated by a physician. However, special food that is a substitute for the food the taxpayer normally consumes and that satisfies the taxpayer's nutritional needs is not medical care.

ANALYSIS

Amounts paid for the primary purpose of treating a disease are deductible as medical care. Obesity is medically accepted to be a disease in its own right. The National Heart, Lung, and Blood Institute, part of the National Institutes of Health, describes obesity as a "complex, multifactorial chronic disease." *Clinical Guidelines on the Identification, Evaluation, and Treatment of Overweight and Obesity in Adults* (1998), page vii. This report is based on an evaluation by a panel of health professionals of scientific evidence published from 1980 to 1997.

Other government and scientific entities have reached similar conclusions. For example, in a preamble to final regulations the Food and Drug Administration states "obesity is a disease." 65 Fed. Reg. 1027, 1028 (Jan. 6, 2000). The World Health Organization states that "[o]besity is now well recognized as a disease in its own right ...." Press Release 46 (June 12, 1997).

In the present case, a physician has diagnosed *A* as suffering from a disease, obesity. Therefore, the cost of *A*'s participation in the *X* weight-loss program as treatment for *A*'s obesity is an amount paid for medical care under § 213(d)(1). Although *B* is not suffering from obesity, *B*'s participation in *X* is part of the treatment for *B*'s hypertension. Therefore, *B*'s cost of participating in the program is also an amount paid for medical care. *A* and *B* may deduct under § 213 (subject to the limitations of that section) the fees to

join the program and to attend periodic meetings. These situations are distinguishable from the facts of Rev. Rul. 79–151, in which the taxpayer was not suffering from any specific disease or ailment and participated in a weight-loss program merely to improve the taxpayer's general health and appearance. However, *A* and *B* may not deduct any portion of the cost of purchasing reduced-calorie diet foods because the foods are substitutes for the food *A* and *B* normally consume and satisfy their nutritional requirements.

HOLDING

Uncompensated amounts paid by individuals for participation in a weight-loss program as treatment for a specific disease or diseases (including obesity) diagnosed by a physician are expenses for medical care that are deductible under § 213, subject to the limitations of that section. The cost of purchasing diet food items is not deductible under § 213.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 79–151 and Rev. Rul. 55–261 are distinguished.

CONTACT INFORMATION

For further information regarding this revenue ruling, contact John T. Sapienza, Jr., at (202) 622–7900 (not a toll-free call).

Section 262.—Personal, Living, and Family Expenses

Are uncompensated amounts paid by individuals for participation in a weight-loss program as treatment for a specific disease or diseases (including obesity) diagnosed by a physician expenses for medical care under § 213. See Rev. Rul. 2002–19 on page 778.

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

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

LIFO; price indexes; department stores. The February 2002 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, February 28, 2002.

Rev. Rul. 2002–18

The following Department Store Inventory Price Indexes for February 2002 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, February 28, 2002.

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	Feb. 2001	Feb. 2002	Percent Change from Feb. 2001 to Feb. 2002[1]
1.	Piece Goods	507.2	485.6	-4.3
2.	Domestics and Draperies	606.8	580.1	-4.4
3.	Women's and Children's Shoes	642.9	621.0	-3.4
4.	Men's Shoes	881.9	877.6	-0.5
5.	Infants' Wear	620.5	609.4	-1.8
6.	Women's Underwear	563.4	571.0	1.3
7.	Women's Hosiery	351.5	351.1	-0.1
8.	Women's and Girls' Accessories	550.1	563.0	2.3
9.	Women's Outerwear and Girls' Wear	388.0	375.0	-3.4
10.	Men's Clothing	594.4	579.7	-2.5
11.	Men's Furnishings	608.1	586.7	-3.5
12.	Boys' Clothing and Furnishings	484.7	473.6	-2.3
13.	Jewelry	943.6	889.5	-5.7
14.	Notions	794.5	775.7	-2.4
15.	Toilet Articles and Drugs	986.1	975.9	-1.0
16.	Furniture and Bedding	685.9	626.0	-8.7
17.	Floor Coverings	630.2	618.8	-1.8

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

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

Groups	Feb. 2001	Feb. 2002	Percent Change from Feb. 2001 to Feb. 2002[1]
18. Housewares	774.9	757.3	-2.3
19. Major Appliances	227.8	224.5	-1.4
20. Radio and Television	56.3	51.7	-8.2
21. Recreation and Education[2]	90.7	87.9	-3.1
22. Home Improvements[2]	128.0	125.6	-1.9
23. Auto Accessories[2]	108.8	110.3	1.4
Groups 1 — 15: Soft Goods	592.0	575.3	-2.8
Groups 16 — 20: Durable Goods	433.1	415.5	-4.1
Groups 21 — 23: Misc. Goods[2]	99.2	97.4	-1.8
Store Total[3]	532.4	516.6	-3.0

[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 Michael Burkom of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Mr. Burkom at (202) 622–7718 (not a toll-free call).

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

26 CFR 1.705–1: Determination of basis of partner's interest.

T.D. 8986

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Determination of Basis of Partner's Interest; Special Rules

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations

SUMMARY: This document contains final regulations relating to special rules on determination of basis of a partner's interest under section 705 of the Internal Revenue Code. The final regulations are necessary to coordinate sections 705 and 1032.

DATES: *Effective Date*: These regulations are effective on March 29, 2002.

Applicability Date: These regulations are applicable with respect to sales or exchanges of stock occurring after December 6, 1999.

FOR FURTHER INFORMATION CONTACT: Barbara MacMillan or Rebekah A. Myers (202) 622–3050 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

In Rev. Rul. 99–57 (1999–2 C.B. 678), the IRS issued guidance with respect to the tax consequences for a partnership and a corporate partner where the corporate partner contributes its own stock to the partnership, and the partnership later exchanges the stock with a third party in a taxable transaction. Under that ruling, section 1032 will protect a corporate partner from recognizing gain or loss (to the extent allocated to such partner) when the partnership exchanges stock of the corporate partner in a taxable transaction. The ruling also concludes that, under section 705, the corporate partner increases its basis in its partnership interest by an amount equal to its share of the gain resulting from the partnership's sale or exchange of the stock.

In situations where a corporation acquires an interest in a partnership that holds that corporation's stock, a section 754 election is not in effect with respect to the partnership for the taxable year in which the corporation acquires the partnership interest, and the partnership later sells or exchanges the stock, it may be inconsistent with the intent of sections 705 and 1032 to increase the basis of the corporation's partnership interest by the full amount of the gain that is not recognized.

For instance, assume that a corporation (A) purchases a 50 percent interest in a partnership for $100,000. The partnership's only asset is A stock with a basis of $100,000 and a value of $200,000. If the

partnership had not made a section 754 election, then when the partnership disposes of the property for $200,000, A would be allocated $50,000 of gain. Under section 1032, the gain allocated to A would not be subject to tax. If A's basis in the partnership interest were increased to $150,000 under section 705(a)(1), A would recognize a corresponding $50,000 loss (or reduced gain) upon a subsequent sale of the partnership interest. In this situation, it would be inconsistent with the intent of sections 705 and 1032 to increase the basis of A's partnership interest for the gain that is not recognized. To do so would create a recognizable loss (or reduced gain) in a situation where no economic loss was incurred and no offsetting gain had previously been recognized.

Accordingly, in Notice 99–57 (1999–2 C.B. 692), the IRS announced that it intended to promulgate regulations under section 705 to address certain situations where a corporation acquires an interest in a partnership that holds stock in that corporation, and a section 754 election is not in effect with respect to the partnership for the taxable year in which the corporation acquired the interest. The IRS announced that rules regarding tiered-entity structures also would be included in the regulations. The IRS requested comments as to the appropriate scope of the regulations regarding other situations where the price paid for a partnership interest reflects built-in gain or accrued income items that will not be subject to tax, or built-in loss or accrued deductions that will be permanently denied, when allocated to the transferee partner, and the partnership has not made an election under section 754. No formal comments were received.

On January 3, 2001, the Treasury Department and the IRS published a notice of proposed rulemaking (REG–106702–00, 2001–4 I.R.B. 424) under section 705 of the Internal Revenue Code (Code) in the **Federal Register** (66 FR 315). Only one commentator submitted written comments in response to the notice of proposed rulemaking, and no public hearing was requested or held. After consideration of the comment, the proposed regulations are adopted as revised by this Treasury decision.

Explanation of Revisions and Summary of Contents

1. Overview of Provisions

As discussed in Notice 99–57, these final regulations are being issued in order to prevent inappropriate increases or decreases in the adjusted basis of a corporate partner's interest in a partnership resulting from the partnership's disposition of the corporate partner's stock.

The final regulations set forth a detailed statement of the purpose for these regulations which is consistent with the discussion in Notice 99–57. The final regulations then provide a specific rule implementing this purpose in situations where a corporate partner holds a direct interest in a partnership that owns stock of the corporate partner. This rule applies where a corporation acquires an interest in a partnership that holds stock in that corporation (or the partnership subsequently acquires stock in that corporation in an exchanged basis transaction), the partnership does not have an election under section 754 in effect for the year in which the corporation acquires the interest, and the partnership later sells or exchanges the stock. In these situations, the increase (or decrease) in the corporation's adjusted basis in its partnership interest resulting from the sale or exchange of the stock equals the amount of gain (or loss) that the corporate partner would have recognized (absent the application of section 1032) if, for the taxable year in which the corporation acquired the interest, a section 754 election had been in effect.

The purpose of these final regulations cannot be avoided through the use of tiered partnerships or other arrangements. For example, the final regulations provide that if a corporation acquires an indirect interest in its own stock through a chain of two or more partnerships (either where the corporation acquires a direct interest in a partnership or where one of the partnerships in the chain acquires an interest in another partnership), and gain or loss from the sale or exchange of the stock is subsequently allocated to the corporation, then the bases of the interests in the partnerships included in the chain shall be adjusted in a manner that is consistent with the purpose of the final regulations. As stated above, the final regulations include a statement describing the purpose of these regulations which is intended to guide taxpayers in making basis adjustments in the tiered partnership context. In addition, the final regulations include two examples illustrating the basis adjustments that are required by the final regulations where a corporation acquires an indirect interest in its own stock through a chain of two or more partnerships.

2. The Secretary's Authority

The only comment received in response to the notice of proposed rulemaking discussed the Secretary's authority under section 705 to issue the regulations as proposed. Specifically, the comment suggested that the regulations could be challenged as inconsistent with the plain language of section 705. The comment acknowledged that the proposed regulations are a reasonable interpretation of section 705, but argued that the aggregate treatment of partnerships in the context of section 1032 provides a stronger basis for the Secretary's authority.

Accordingly, the final regulations clarify that the authority for the regulations includes both sections 705 and 1032. As explained in Rev. Rul. 99–57, the use of the aggregate theory of partnerships in the context of section 1032 is necessary to carry out the intent of that section. To reflect this application of the aggregate theory of partnerships and prevent any unintended benefit or detriment to the partners, appropriate adjustments under section 705 must be made to a corporate partner's outside basis. See H.R. Rep. No. 1337, 83d Cong., 2d Sess. 225 (1954); S. Rep. No. 1337, 83d Cong. 2d Sess. 384 (1954). Thus, the regulations provide the mechanical rules necessary to implement Congressional intent under both sections 705 and 1032.

3. Technical Correction Relating to Tiered Partnerships

The comment suggested technical changes to the proposed regulations to prevent taxpayers in tiered partnership situations from inappropriately allocating to the corporate partner a loss resulting from a sale of a lower-tier partnership (LTP) interest that is attributable to gain

allocated to and recognized by the noncorporate partners upon the LTP's sale of the corporate partner's stock. The final regulations include modifications to prevent such inappropriate allocations.

4. De Minimis Rule

The comment suggested that an elective *de minimis* rule would be appropriate as a matter of administrative convenience. However, after considering the purpose of these regulations and issues of administrative burden and technical complexity, Treasury and the IRS have determined that a *de minimis* rule is unnecessary.

5. Scope of the Regulations

The comment suggested that the regulations provide guidance with respect to the issues addressed in Rev. Rul. 96–10 (1996–1 C.B. 138) (partners' bases in their partnership interests are increased to reflect gain from the sale of partnership property that is not recognized under sections 267(d) and 707(b)(1)) and Rev. Rul. 96–11 (1996–1 C.B. 140) (a charitable contribution of property by a partnership reduces each partner's basis in the partnership by the partner's share of the partnership's basis in the property contributed). Treasury and the IRS believe that these issues are beyond the scope of these regulations. Accordingly, this comment is not addressed in these regulations.

6. Other Developments

The notice of proposed rulemaking (REG–167648–01) issued elsewhere in this issue of the Bulletin addresses remaining issues that Treasury and the IRS considered during the development of the final regulations. Specifically, the proposed regulations apply principles similar to those applied in the final regulations where a corporation's indirect interest in its own stock held through one or more partnerships increases as the result of a distribution of partnership property to another partner and the partnership does not have a section 754 election in effect at the time of the distribution. In addition, the proposed regulations clarify that references in the regulations to stock of a corporate partner include any position in stock of a corporate partner to which section 1032 applies. Certain minor, nonsubstantive changes were made to the final regulations to accommodate the eventual incorporation of the proposed regulations.

Special Analyses

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

Drafting Information

The principal author of these regulations is Barbara MacMillan of the Office of the Associate Chief Counsel (Passthroughs and Special Industries). 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 part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Section 1.705–2 also issued under 26 U.S.C. 705 and 1032.

* * *

Par. 2. Section 1.705–1 is amended by adding paragraph (a)(7) to read as follows:

§ 1.705–1 Determination of basis of partner's interest.

(a) * * *

(7) For basis adjustments necessary to coordinate sections 705 and 1032 in certain situations in which a partnership disposes of stock of a corporation that holds a direct or indirect interest in the partnership, see § 1.705–2.

* * * * *

Par. 3. Section 1.705–2 is added to read as follows:

§ 1.705–2 Basis adjustments coordinating sections 705 and 1032.

(a) *Purpose*. This section coordinates the application of sections 705 and 1032 and is intended to prevent inappropriate increases or decreases in the adjusted basis of a corporate partner's interest in a partnership resulting from the partnership's disposition of the corporate partner's stock. The rules under section 705 generally are intended to preserve equality between the adjusted basis of a partner's interest in a partnership (outside basis) and such partner's share of the adjusted basis in partnership assets (inside basis). However, in situations where a section 754 election was not in effect for the year in which a partner acquired its interest, the partner's inside basis and outside basis may not be equal. In these situations, gain or loss allocated to the partner upon disposition of the partnership assets that is attributable to the difference between the adjusted basis of the partnership assets absent the section 754 election and the adjusted basis of the partnership assets had a section 754 election been in effect generally will result in an adjustment to the basis of the partner's interest in the partnership under section 705(a). Such gain (or loss), therefore, generally will be offset by a corresponding decrease in the gain or increase in the loss (or increase in the gain or decrease in the loss) upon the subsequent disposition by the partner of its interest in the partnership. Where such a difference exists with respect to stock of a corporate partner that is held by the partnership, gain or loss from the disposition of corporate partner stock attributable to the difference is not recognized by the corporate partner under section 1032. To adjust the basis of the corporate partner's interest in the partnership for this unrecognized gain or loss would not be appropriate because

it would create an opportunity for the recognition of taxable gain or loss on a subsequent disposition of the partnership interest where no economic gain or loss has been incurred by the corporate partner and no corresponding taxable gain or loss had previously been allocated to the corporate partner by the partnership.

(b) *Single partnership*—(1) *Required adjustments relating to acquisitions of partnership interest.* (i) This paragraph (b)(1) applies in situations where a corporation acquires an interest in a partnership that holds stock in that corporation (or the partnership subsequently acquires stock in that corporation in an exchanged basis transaction), the partnership does not have an election under section 754 in effect for the year in which the corporation acquires the interest, and the partnership later sells or exchanges the stock. In these situations, the increase (or decrease) in the corporation's adjusted basis in its partnership interest resulting from the sale or exchange of the stock equals the amount of gain (or loss) that the corporate partner would have recognized (absent the application of section 1032) if, for the year in which the corporation acquired the interest, a section 754 election had been in effect.

(ii) The provisions of this paragraph (b)(1) are illustrated by the following example:

Example. (i) A, B, and C form equal partnership PRS. Each partner contributes $30,000 in exchange for its partnership interest. PRS has no liabilities. PRS purchases stock in corporation X for $30,000, which appreciates in value to $120,000. PRS also purchases inventory for $60,000, which appreciates in value to $150,000. A sells its interest in PRS to corporation X for $90,000 in a year for which an election under section 754 is not in effect. PRS later sells the X stock for $150,000. PRS realizes a gain of $120,000 on the sale of the X stock. X's share of the gain is $40,000. Under section 1032, X does not recognize its share of the gain.

(ii) Normally, X would be entitled to a $40,000 increase in the basis of its PRS interest for its allocable share of PRS's gain from the sale of the X stock, but a special rule applies in this situation. If a section 754 election had been in effect for the year in which X acquired its interest in PRS, X would have been entitled to a basis adjustment under section 743(b) of $60,000 (the excess of X's basis for the transferred partnership interest over X's share of the adjusted basis to PRS of PRS's property). See § 1.743–1(b). Under § 1.755–1(b), the basis adjustment under section 743(b) would have been allocated $30,000 to the X stock (the amount of the gain that would have been allocated to X from the hypothetical sale of the stock), and $30,000 to the inventory (the amount of the gain that would have been allocated to X from the hypothetical sale of the inventory).

(iii) If a section 754 election had been in effect for the year in which X acquired its interest in PRS, the amount of gain that X would have recognized upon PRS's disposition of X stock (absent the application of section 1032) would be $10,000 (X's share of PRS's gain from the stock sale, $40,000, minus the amount of X's basis adjustment under section 743(b), $30,000). See § 1.743–1(j). Accordingly, the increase in the basis of X's interest in PRS is $10,000.

(2) [Reserved]

(c) *Tiered partnerships and other arrangements*—(1) *Required adjustments.* The purpose of these regulations as set forth in paragraph (a) of this section cannot be avoided through the use of tiered partnerships or other arrangements. For example, if a corporation acquires an indirect interest in its own stock through a chain of two or more partnerships (either where the corporation acquires a direct interest in a partnership or where one of the partnerships in the chain acquires an interest in another partnership), and gain or loss from the sale or exchange of the stock is subsequently allocated to the corporation, then the bases of the interests in the partnerships included in the chain shall be adjusted in a manner that is consistent with the purpose of this section.

(2) *Examples.* The provisions of this paragraph (c) are illustrated by the following examples:

Example 1. Acquisition of upper-tier partnership interest by corporation. (i) A, B, and C form a partnership (UTP), with each partner contributing $25,000. UTP and D form a partnership (LTP). UTP contributes $75,000 in exchange for its interest in LTP, and D contributes $25,000 in exchange for D's interest in LTP. Neither UTP nor LTP has any liabilities. LTP purchases stock in corporation E for $100,000, which appreciates in value to $1,000,000. C sells its interest in UTP to corporation E for $250,000 in a year for which an election under section 754 is not in effect for UTP or LTP. LTP later sells the E stock for $2,000,000. LTP realizes a $1,900,000 gain on the sale of the E stock. UTP's share of the gain is $1,425,000, and E's share of the gain is $475,000. Under section 1032, E does not recognize its share of the gain.

(ii) With respect to the basis of UTP's interest in LTP, if all of the gain from the sale of the E stock (including E's share) were to increase the basis of UTP's interest in LTP, UTP's basis in such interest would be $1,500,000 ($75,000 + $1,425,000). The fair market value of UTP's interest in LTP is $1,500,000. Because UTP did not have a section 754 election in effect for the taxable year in which E acquired its interest in UTP, UTP's basis in the LTP interest does not reflect the purchase price paid by E for its interest. Increasing the basis of UTP's interest in LTP by the full amount of the gain that would be recognized (in the absence of section 1032) on the sale of the E stock preserves the conformity between UTP's inside basis and outside basis with respect to LTP (*i.e.*, UTP's share of LTP's cash is equal to $1,500,000, and UTP's basis in the LTP interest is $1,500,000) and appropriately would cause UTP to recognize no gain or loss on the sale of UTP's interest in LTP immediately after the sale of the E stock. Accordingly, increasing the basis of UTP's interest in LTP by the entire amount of gain allocated to UTP (including E's share) from LTP's sale of the E stock is consistent with the purpose of this section. The $1,425,000 of gain allocated by LTP to UTP will increase the adjusted basis of UTP's interest in LTP under section 705(a)(1). The basis of UTP's interest in LTP immediately after the sale of the E stock is $1,500,000.

(iii) With respect to the basis of E's interest in UTP, if E's share of the gain allocated to UTP and then to E were to increase the basis of E's interest in UTP, E's basis in such interest would be $725,000 ($250,000 + $475,000) and the fair market value of such interest would be $500,000, so that E would recognize a loss of $225,000 if E sold its interest in UTP immediately after LTP's disposition of the E stock. It would be inappropriate for E to recognize a taxable loss of $225,000 upon a disposition of its interest in UTP because E would not incur an economic loss in the transaction, and E did not recognize a taxable gain upon LTP's disposition of the E stock that appropriately would be offset by a taxable loss on the disposition of its interest in UTP. Accordingly, increasing E's basis in its UTP interest by the entire amount of gain allocated to E from the sale of the E stock is not consistent with the purpose of this section. (Conversely, because A and B were allocated taxable gain on the disposition of the E stock, it would be appropriate to increase A's and B's bases in their respective interests in UTP by the full amount of the gain allocated to them.)

(iv) The appropriate basis adjustment for E's interest in UTP upon the disposition of the E stock by LTP can be determined as the amount of gain that E would have recognized (in the absence of section 1032) upon the sale by LTP of the E stock if both UTP and LTP had made section 754 elections for the taxable year in which E acquired the interest in UTP. If section 754 elections had been in effect for UTP and LTP for the year in which E acquired E's interest in UTP, the following would occur. E would be entitled to a $225,000 positive basis adjustment under section 743(b) with respect to the property of UTP. The entire basis adjustment would be allocated to UTP's only asset, its interest in LTP. In addition, the sale of C's interest in UTP would be treated as a deemed sale of E's share of UTP's interest in LTP for purposes of sections 754 and 743. The deemed selling price of E's share of UTP's interest in LTP would be $250,000 (E's share of UTP's adjusted basis in LTP, $25,000, plus E's basis adjustment under section 743(b) with respect to the assets of UTP, $225,000). The deemed sale of E's share of UTP's interest in LTP would trigger a basis adjustment under section 743(b) of $225,000 with respect to the assets of LTP (the excess of E's share of UTP's adjusted basis in LTP, including E's basis adjustment ($225,000), $250,000, over E's share of the adjusted basis of LTP's property, $25,000). This $225,000 adjustment by LTP would be allocated to

LTP's only asset, the E stock, and would be segregated and allocated solely to E. The amount of LTP's gain from the sale of the E stock (before considering section 743(b)) would be $1,900,000. E's share of this gain, $475,000, would be offset in part by the $225,000 basis adjustment under section 743(b), so that E would recognize gain equal to $250,000 in the absence of section 1032.

(v) If the basis of E's interest in UTP were increased by $250,000, the total basis of E's interest would equal $500,000. This would conform to E's share of UTP's basis in the LTP interest ($1,500,000 x 1/3 = $500,000) as well as E's indirect share of the cash held by LTP ((1/3 x 3/4) x $2,000,000 = $500,000). Such a basis adjustment does not create the opportunity for the recognition of an inappropriate loss by E on a subsequent disposition of E's interest in UTP and is consistent with the purpose of this section. Accordingly, under this paragraph (c), of the $475,000 gain allocated to E, only $250,000 will apply to increase the adjusted basis of E in UTP under section 705(a)(1). E's adjusted basis in its UTP interest following the sale of the E stock is $500,000.

Example 2. Acquisition of lower-tier partnership interest by upper-tier partnership. (i) A, corporation B, and C form an equal partnership (UTP), with each partner contributing $100,000. D, E, and F also form an equal partnership (LTP), with each partner contributing $30,000. LTP purchases stock in corporation B for $90,000, which appreciates in value to $900,000. LTP has no liabilities. UTP purchases D's interest in LTP for $300,000. LTP does not have an election under section 754 in effect for the taxable year of UTP's purchase. LTP later sells the B stock for $900,000. UTP's share of the gain is $270,000, and B's share of that gain is $90,000. Under section 1032, B does not recognize its share of the gain.

(ii) With respect to the basis of UTP's interest in LTP, if all of the gain from the sale of the B stock (including B's share) were to increase the basis of UTP's interest in LTP, UTP's basis in the LTP interest would be $570,000 ($300,000 + $270,000), and the fair market value of such interest would be $300,000, so that B would be allocated a loss of $90,000 (($570,000 — $300,000) x 1/3) if UTP sold its interest in LTP immediately after LTP's disposition of the B stock. It would be inappropriate for B to recognize a taxable loss of $90,000 upon a disposition of UTP's interest in LTP. B would not incur an economic loss in the transaction, and B was not allocated a taxable gain upon LTP's disposition of the B stock that appropriately would be offset by a taxable loss on the disposition of UTP's interest in LTP. Accordingly, increasing UTP's basis in its LTP interest by the gain allocated to B from the sale of the B stock is not consistent with the purpose of this section. (Conversely, because E and F were allocated taxable gain on the disposition of the B stock, it would be appropriate to increase E's and F's bases in their respective interests in LTP by the full amount of such gain.)

(iii) The appropriate basis adjustment for UTP's interest in LTP upon the disposition of the B stock by LTP can be determined as the amount of gain that UTP would have recognized (in the absence of section 1032) upon the sale by LTP of the B stock if the portion of the gain allocated to UTP that subsequently is allocated to B were determined as if LTP had made an election under section 754 for the taxable year in which UTP acquired its interest in LTP. If a section 754 election had been in effect for LTP for the year in which UTP acquired its interest in LTP, then with respect to B, the following would occur. UTP would be entitled to a $90,000 positive basis adjustment under section 743(b), allocable to B, in the property of LTP. The entire basis adjustment would be allocated to LTP's only asset, its B stock. The amount of LTP's gain from the sale of the B stock (before considering section 743(b)) would be $810,000. UTP's share of this gain, $270,000, would be offset, in part, by the basis adjustment under section 743(b), so that UTP would recognize gain equal to $180,000.

(iv) If the basis of UTP's interest in LTP were increased by $180,000, the total basis of UTP's partnership interest would equal $480,000. This would conform to the sum of UTP's share of the cash held by LTP ((1/3 x $900,000 = $300,000) and the taxable gain recognized by A and C on the disposition of the B stock that appropriately may be offset on the disposition of their interests in UTP ($90,000 + $90,000 = $180,000). Such a basis adjustment does not inappropriately create the opportunity for the allocation of a loss to B on a subsequent disposition of UTP's interest in LTP and is consistent with the purpose of this section. Accordingly, of the $270,000 gain allocated to UTP, only $180,000 will apply to increase the adjusted basis of UTP in LTP under section 705(a)(1). Such $180,000 basis increase must be segregated and allocated $90,000 each to solely A and C. UTP's adjusted basis in its LTP interest following the sale of the B stock is $480,000.

(v) With respect to B's interest in UTP, if B's share of the gain allocated to UTP and then to B were to increase the basis of B's interest in UTP, B would have a UTP partnership interest with an adjusted basis of $190,000 ($100,000 + $90,000) and a value of $100,000, so that B would recognize a loss of $90,000 if B sold its interest in UTP immediately after LTP's disposition of the B stock. It would be inappropriate for B to recognize a taxable loss of $90,000 upon a disposition of its interest in UTP because B would not incur an economic loss in the transaction, and B did not recognize a taxable gain upon LTP's disposition of the B stock that appropriately would be offset by a taxable loss on the disposition of its interest in UTP. Accordingly, increasing B's basis in its UTP interest by the gain allocated to B from the sale of the B stock is not consistent with the purpose of this section. (Conversely, because A and C were allocated taxable gain on the disposition of the B stock that is a result of LTP not having a section 754 election in effect, it would be appropriate for A and C to recognize an offsetting taxable loss on the disposition of A's and C's interests in UTP. Accordingly, it would be appropriate to increase A's and C's bases in their respective interests in UTP by the amount of gain recognized by A and C.)

(vi) The appropriate basis adjustment for B's interest in UTP upon the disposition of the B stock by LTP can be determined as the amount of gain that B would have recognized (in the absence of section 1032) upon the sale by LTP of the B stock if the portion of the gain allocated to UTP that is subsequently allocated to B were determined as if LTP had made an election under section 754 for the taxable year in which UTP acquired its interest in LTP. If a section 754 election had been in effect for LTP for the year in which UTP acquired its interest in LTP, then with respect to B, the following would occur. UTP would be entitled to a basis adjustment under section 743(b) in the property of LTP of $90,000 with respect to B. The entire basis adjustment would be allocated to LTP's only asset, its B stock. The amount of LTP's gain from the sale of the B stock (before considering section 743(b)) would be $810,000. UTP's share of this gain, $270,000, would be offset, in part, by the $90,000 basis adjustment under section 743(b), so that UTP would recognize gain equal to $180,000. The $90,000 basis adjustment would completely offset the gain that otherwise would be allocated to B.

(vii) If no gain were allocated to B so that the basis of B's interest in UTP was not increased, the total basis of B's interest would equal $100,000. This would conform to B's share of UTP's basis in the LTP interest (($480,000 - $180,000 (*i.e.*, A's and C's share of the basis that should offset taxable gain recognized as a result of LTP's failure to have a section 754 election)) x 1/3 = $100,000) as well as B's indirect share of the cash held by LTP ((1/3 x 1/3) x $900,000 = $100,000). Such a basis adjustment does not create the opportunity for the recognition of an inappropriate loss by B on a subsequent disposition of B's interest in UTP and is consistent with the purpose of this section. Accordingly, under this paragraph (c), of the $90,000 gain allocated to B, none will apply to increase the adjusted basis of B in UTP under section 705(a)(1). B's adjusted basis in its UTP interest following the sale of the B stock is $100,000.

(viii) Immediately after LTP's disposition of the B stock, UTP sells its interest in LTP for $300,000. UTP's adjusted basis in its LTP interest is $480,000, $180,000 of which must be allocated $90,000 each to A and C. Accordingly, upon UTP's sale of its interest in LTP, UTP realizes $180,000 of loss, and A and C in turn each realize $90,000 of loss.

(d) [Reserved] (e) *Effective date*. This section applies to gain or loss allocated with respect to sales or exchanges of stock occurring after December 6, 1999.

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved March 14, 2002.

Mark Weinberger,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on March 28, 2002, 8:45 a.m., and published in the issue of the Federal Register for March 29, 2002, 67 F.R. 15112)

Part III. Administrative, Procedural, and Miscellaneous

Section 6039D Reporting Requirements

Notice 2002–24

PURPOSE

This notice suspends the filing requirement imposed on specified fringe benefit plans by section 6039D of the Internal Revenue Code and modifies and supersedes Notice 90–24 (1990–1 C. B. 335).

BACKGROUND

Section 6039D of the Code, as enacted by Pub. L. 98–611, § 1, 98 Stat. 3176 (1984), required employers maintaining group legal services plans described in section 120, cafeteria plans described in section 125, and educational assistance programs described in section 127 to file an annual information return with the Internal Revenue Service. Announcement 86–20 (1986–7 I.R.B. 34) required the return for these plans to be filed on the Form 5500 Series Annual Return/Report. Section 1151(h) of the Tax Reform Act of 1986 (TRA '86), amended section 6039D and expanded the reporting requirement to group-term life insurance plans described in section 79, accident and health plans described in sections 105 and 106, and dependent care assistance programs described in section 129. Section 1601(h)(2)(D)(iii) of the Small Business Job Protection Act of 1996 added adoption assistance programs described in section 137 to the list of specified fringe benefit plans required to file annual returns under section 6039D.

Notice 90–24 suspended the filing requirement for those fringe benefit plans added to section 6039D by the TRA '86. The notice stated that, until the Service provides further guidance, employers maintaining plans under sections 79, 105, and 106, or 129, are not required to file information returns pursuant to section 6039D. However, the notice instructed employers maintaining plans under sections 120, 125, or 127 to continue to file the return for these plans on the Form 5500 Series Annual Return/Report. Current filing instructions provide that plans described in sections 125, 127, and 137 are considered fringe benefit plans and must file Schedule F attached to a completed Form 5500 to satisfy the annual return requirement of section 6039D. The IRS is evaluating whether this method of reporting the information required by section 6039D is appropriate.

RELIEF FROM FILING REQUIREMENTS AND EFFECTIVE DATE

Employers maintaining specified fringe benefit plans under sections 125, 127, or 137 are relieved from the requirement to file annual information returns (Schedule F) attached to a completed Form 5500 pursuant to section 6039D. This notice is effective upon publication and applies to all plan years for which information returns have not been filed. Any future reporting obligations under section 6039D will apply only to plan years beginning on or after the date of publication of further guidance.

This notice does not affect annual reporting requirements under Title I of the Employee Retirement Income Security Act of 1974 (ERISA), or relieve administrators of employee benefit plans from any obligation to file a Form 5500 and any required schedules (other than the Schedule F) under that title. For further information on annual reporting requirements applicable to employee benefit plans under Title I of ERISA, see the instructions for the Form 5500 Annual Return/Report and the Department of Labor's Regulations. The Form 5500 instructions may be obtained by calling 1–800–TAX FORM, or may be viewed at *www.efast.dol.gov* or *www.irs.gov*.

DRAFTING INFORMATION

The principal author of this notice is Felix J. Zech of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this notice, please contact Mr. Zech at (202) 622–6080 (not a toll-free number).

Weighted Average Interest Rate Update

Notice 2002–28

Sections 412(b)(5)(B) and 412(l)(7)(C)(i) of the Internal Revenue Code provide that the interest rates used to calculate current liability for purposes of determining the full funding limitation under § 412(c)(7) and the required contribution under § 412(l) must be within a permissible range around the weighted average of the rates of interest on 30-year Treasury securities during the four-year period ending on the last day before the beginning of the plan year.

Notice 88–73 (1988–2 C.B. 383) provides guidelines for determining the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of § 412(c)(7) of the Code.

Section 417(e)(3)(A)(ii)(II) of the Code defines the applicable interest rate, which must be used for purposes of determining the minimum present value of a participant's benefit under § 417(e)(1) and (2), as the annual rate of interest on 30-year Treasury securities for the month before the date of distribution or such other time as the Secretary may by regulations prescribe. Section 1.417(e)–1(d)(3) of the Income Tax Regulations provides that the applicable interest rate for a month is the annual interest rate on 30-year Treasury securities as specified by the Commissioner for that month in revenue rulings, notices or other guidance published in the Internal Revenue Bulletin.

The rate of interest on 30-year Treasury Securities for March 2002 is 5.71 percent. Pursuant to Notice 2002–26, the Service has determined this rate as the monthly average of the daily determination of yield on the 30-year Treasury bond maturing in February 2031.

Section 405 of the Job Creation and Worker Assistance Act of 2002 amended § 412(l)(7)(C) of the Code to provide that for plan years beginning in 2002 and 2003 the permissible range is extended to 120 percent.

The following rates were determined for the plan years beginning in the month shown below.

Month	Year	Weighted Average	90% to 120% Permissible Range	90% to 110% Permissible Range
April	2002	5.69	5.12 to 6.83	5.12 to 6.26

Drafting Information

The principal author of this notice is Todd Newman of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this notice, please contact the Employee Plans' taxpayer assistance telephone service at 1–877–829–5500 (a toll-free number), between the hours of 8:00 a.m. and 6:30 p.m. Eastern time, Monday through Friday. Mr. Newman may be reached at 1–202–283–9888 (not a toll-free number).

Part IV. Items of General Interest

Notice of Proposed Rulemaking and Notice of Public Hearing

Obligations of States and Political Subdivisions

REG–165706–01

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations on the definition of refunding issue applicable to tax-exempt bonds issued by States and local governments. This document provides a notice of public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by July 9, 2002. Outlines of topics to be discussed at the public hearing scheduled for July 30, 2002, at 10 a.m., must be received by July 9, 2002.

ADDRESSES: Send submissions to: CC:ITA:RU (REG–165706–01), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:ITA:RU (REG–165706–01), courier's desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, submissions may be made electronically to the IRS Internet site at *www.irs.gov/regs*. The public hearing will be held in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Michael P. Brewer (202) 622–3980; concerning submissions and the hearing, Treena Garrett (202) 622–7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Section 150 of the Internal Revenue Code (Code) provides certain definitions and special rules for purposes of applying the tax-exempt bond limitations contained in sections 103 and 141 through 150. On June 18, 1993, final regulations (T.D. 8476, 1993–2 C.B. 13) under section 150 were published in the **Federal Register** (58 FR 33510). On May 9, 1997, additional final regulations (T.D. 8718, 1997–1 C.B. 47) under section 150 were published in the **Federal Register** (62 FR 25502). This document proposes to modify the definition of refunding issue under § 1.150–1(d).

Explanation of Provisions

Section 1.150–1(d) of the current regulations provides a definition of *refunding issue*. In general, a refunding issue is an issue of obligations the proceeds of which are used to pay principal, interest, or redemption price on another issue. The current regulations contain certain exceptions to this general rule. One exception (the *change in obligor exception*) provides that an issue is not a refunding issue to the extent that the obligor of one issue is neither the obligor of the other issue nor a related party with respect to the obligor of the other issue. Another exception (the *six-month exception*) provides that if a person assumes (including taking subject to) obligations of an unrelated party in connection with an asset acquisition (other than a transaction to which section 381(a) applies if the person assuming the obligation is the acquiring corporation within the meaning of section 381(a)), and the assumed issue is refinanced within six months before or after the date of the debt assumption, the refinancing issue is not treated as a refunding issue.

Section 1.150–1(b) of the current regulations provides that the term *related party* means, in reference to a governmental unit or a 501(c)(3) organization, any member of the same controlled group. Section 1.150–1(e) of the current regulations provides that the term *controlled group* means a group of entities controlled directly or indirectly by the same entity or group of entities. The determination of control is made on the basis of all the relevant facts and circumstances. One entity or group of entities (the *controlling entity*) generally controls another entity or group of entities (the *controlled entity*) if the controlling entity possesses either of the following rights or powers and the rights or powers are discretionary and non-ministerial: (i) the right or power both to approve and to remove without cause a controlling portion of the governing body of the controlled entity; or (ii) the right or power to require the use of funds or assets of the controlled entity for any purpose of the controlling entity.

Recently, questions have arisen regarding the application of these provisions with respect to certain issuances of bonds for 501(c)(3) organizations that operate hospital systems. In question, generally is whether bonds issued in connection with the combination of two or more 501(c)(3) organizations to refinance outstanding bonds should be characterized as refunding bonds. One question is how the change in obligor exception and the six-month exception should be applied when the obligor of the new issue becomes related to the obligor of the other issue as part of the refinancing transaction. Another question is whether the acquisition by a 501(c)(3) organization of the sole membership interest in another 501(c)(3) organization should be treated as an asset acquisition for purposes of the six-month exception. A third question is what assets should be treated as financed by the new bonds under both the change in obligor exception and the six-month exception.

In general, the proposed regulations retain the change in obligor exception and the six-month exception, with certain modifications. The proposed regulations clarify that the determination of whether persons are related for purposes of the change in obligor exception and the six-month exception is generally made immediately before the transaction. However, a refinancing issue is a refunding issue under the proposed regulations if the obligor of the refinanced issue (or any person

that is related to the obligor of the refinanced issue immediately before the transaction) has or obtains in the transaction the right to appoint the majority of the members of the governing body of the obligor of the refinancing issue (or any person that controls the obligor of the refinancing issue).

The proposed regulations state that the six-month exception applies to *acquisition transactions*. An acquisition transaction is a transaction in which a person acquires from an unrelated party: (i) assets, other than an equity interest in an entity, if the acquirer is treated as acquiring such assets for all Federal income tax purposes; (ii) stock of a corporation with respect to which a valid election under section 338 is made; or (iii) control of a governmental unit or a 501(c)(3) organization through the acquisition of stock, membership interests or otherwise.

The proposed regulations retain the exclusion under which the six-month exception does not apply to transactions to which section 381(a) applies, and broaden its scope. In particular, under the proposed regulations the exclusion may apply even if the person assuming the obligations is not the acquiring corporation within the meaning of section 381(a) (for example, a transaction in which a corporation assumes the obligations of a target corporation in a transaction to which section 381(a) applies and then contributes all of the assets of the target corporation to a controlled subsidiary). The proposed regulations also extend the application of this rule for section 381(a) transactions to the change in obligor exception.

The proposed regulations provide two new, additional requirements for purposes of the change in obligor exception and the six-month exception. In certain circumstances where the obligors of the issues are affiliated before the transaction or become affiliated as part of the transaction, the proposed regulations provide that an issue will be treated as a refunding issue unless: (i) the refinanced issue is redeemed on the earliest date on which the issue may be redeemed, and (ii) the new issue is treated as being used to finance the assets that were financed with the proceeds of the refinanced issue. These new requirements are intended to further the Congressional policy against overburdening the tax-exempt bond market, as expressed in sections 148 and 149(d). In particular, they are intended to prevent overburdening in the case of transactions between affiliated persons that contain certain economic characteristics of a refunding.

Proposed Effective Date

The proposed regulations will apply to bonds sold on or after the date of publication of final regulations in the **Federal Register**. However, issuers may apply the proposed regulations in whole, but not in part, to any issue that is sold on or after the date the proposed regulations are published in the **Federal Register** and before the applicability date of the final regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments that are submitted timely (preferably a signed original and eight copies) to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for July 30, 2002, at 10:00 a.m. in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Because of access restrictions, visitors will not be admitted beyond the lobby more than 15 minutes before the hearing starts.

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

Persons who wish to present oral comments at the hearing must submit written comments by July 9, 2002, and submit an outline of the topics to be discussed and the amount of time to be devoted to each topic by July 9, 2002.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal authors of these regulations are Bruce M. Serchuk, Office of Chief Counsel (Tax Exempt and Government Entities), Internal Revenue Service and Stephen J. Watson, Office of Tax Legislative Counsel, Department of the Treasury. However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.150–1 is amended as follows:

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

2. Paragraphs (d)(2)(ii) and (d)(2)(v) are revised.

The added and revised provisions read as follows:

§ 1.150–1 Definitions.

(a) * * *

(2) * * *

(iii) *Special effective date for paragraphs (d)(2)(ii) and (d)(2)(v).* Paragraphs (d)(2)(ii) and (d)(2)(v) of this section apply to bonds sold on or after the

date of publication of final regulations in the **Federal Register**, and may be applied by issuers in whole, but not in part, to any issue that is sold on or after April 10, 2002.

* * * * *

(d) * * *

(2) * * *

(ii) *Certain issues with different obligors*—(A) *In general*. An issue is not a refunding issue to the extent that the obligor (as defined in paragraph (d)(2)(ii)(B) of this section) of one issue is neither the obligor of the other issue nor a related party with respect to the obligor of the other issue. The determination of whether persons are related for this purpose is generally made immediately before the issuance of the refinancing issue. This paragraph (d)(2)(ii)(A) does not apply to any issue that is issued in connection with a transaction to which section 381(a) applies.

(B) *Definition of obligor*. The obligor of an issue means the actual issuer of the issue, except that the obligor of the portion of an issue properly allocable to an investment in a purpose investment means the conduit borrower under that purpose investment. The obligor of an issue used to finance qualified mortgage loans, qualified student loans, or similar program investments (as defined in § 1.148–1) does not include the ultimate recipient of the loan (*e.g.*, the homeowner, the student).

(C) *Certain integrated transactions*. If, within six months before or after a person assumes (including taking subject to) obligations of an unrelated party in connection with an acquisition transaction (other than a transaction to which section 381(a) applies), the assumed issue is refinanced, the refinancing issue is not a refunding issue. An acquisition transaction is a transaction in which a person acquires from an unrelated party—

(*1*) Assets (other than an equity interest in an entity);

(*2*) Stock of a corporation with respect to which a valid election under section 338 is made; or

(*3*) Control of a governmental unit or a 501(c)(3) organization through the acquisition of stock, membership interests or otherwise.

(D) *Special rule for affiliated persons*. Paragraphs (d)(2)(ii)(A) and (C) of this section do not apply to any issue that is issued in connection with a transaction between affiliated persons (as defined in paragraph (d)(2)(ii)(E) of this section), unless—

(*1*) The refinanced issue is redeemed on the earliest date on which it may be redeemed (or otherwise within 90 days after the date of issuance of the refinancing issue); and

(*2*) The refinancing issue is treated for all purposes of sections 103 and 141 through 150 as financing the assets that were financed with the refinanced issue.

(E) *Affiliated persons*. For purposes of paragraph (d)(2)(ii)(D) of this section, persons are affiliated persons if—

(*1*) At any time during the six months prior to the transaction, more than 5 percent of the voting power of the governing body of either person is in the aggregate vested in the other person and its directors, officers, owners, and employees; or

(*2*) During the one-year period beginning six months prior to the transaction, the composition of the governing body of the acquiring person (or any person that controls the acquiring person) is modified or established to reflect (directly or indirectly) representation of the interests of the acquired person or the person from whom assets are acquired (or there is an agreement, understanding, or arrangement relating to such a modification or establishment during that one-year period).

(F) *Reverse acquisitions*. Notwithstanding any other provision of this paragraph (d)(2)(ii), a refinancing issue is a refunding issue if the obligor of the refinanced issue (or any person that is related to the obligor of the refinanced issue immediately before the transaction) has or obtains in the transaction the right to appoint the majority of the members of the governing body of the obligor of the refinancing issue (or any person that controls the obligor of the refinancing issue). See paragraph (d)(2)(v) *Example 2* of this section.

* * * * *

(v) *Examples*. The provisions of this paragraph (d)(2) are illustrated by the following examples:

Example 1. Consolidation of 501(c)(3) hospital organizations. (i) A and B are unrelated hospital organizations described in section 501(c)(3). A has assets with a fair market value of $175 million, and is the obligor of outstanding tax-exempt bonds in the amount of $75 million. B has assets with a fair market value of $145 million, and is the obligor of outstanding tax-exempt bonds in the amount of $50 million. In response to significant competitive pressures in the healthcare industry, and for other substantial business reasons, A and B agree to consolidate their operations. To accomplish the consolidation, A and B form a new 501(c)(3) hospital organization, C. A and B each appoint one-half of the members of the initial governing body of C. Subsequent to the initial appointments, C's governing body is self-perpetuating. On December 29, 2003, State Y issues bonds with sale proceeds of $129 million and lends the entire sale proceeds to C. The 2003 bonds are collectively secured by revenues of A, B, and C. Simultaneously with the issuance of the 2003 bonds, C acquires the sole membership interest in each of A and B. C's ownership of these membership interests entitles C to exercise exclusive control over the assets and operations of A and B. C uses the $129 million of sale proceeds of the 2003 bonds to defease the $75 million of bonds on which A was the obligor, and the $50 million of bonds on which B was the obligor. All of the defeased bonds will be redeemed on the first date on which they may be redeemed. In addition, C treats the 2003 bonds as financing the same assets as the defeased bonds. The 2003 bonds do not constitute a refunding issue because the obligor of the 2003 bonds (C) is neither the obligor of the defeased bonds nor a related party with respect to the obligors of those bonds immediately before the issuance of the 2003 bonds. In addition, the requirements of paragraph (d)(2)(ii)(D) of this section have been satisfied.

(ii) The facts are the same as in paragraph (i) of this *Example 1*, except that C acquires the membership interests in A and B subject to the obligations of A and B on their respective bonds, and the 2003 bonds are sold within six months after the acquisition by C of the membership interests. The 2003 bonds do not constitute a refunding issue.

Example 2. Reverse acquisition. D and E are unrelated hospital organizations described in section 501(c)(3). D has assets with a fair market value of $225 million, and is the obligor of outstanding tax-exempt bonds in the amount of $100 million. E has assets with a fair market value of $100 million. D and E agree to consolidate their operations. On May 18, 2004, Authority Z issues bonds with sale proceeds of $103 million and lends the entire sale proceeds to E. Simultaneously with the issuance of the 2004 bonds, E acquires the sole membership interest in D. In addition, D obtains the right to appoint the majority of the members of the governing body of E. E uses the $103 million of sale proceeds of the 2004 bonds to defease the bonds of which D was the obligor. All of the defeased bonds will be redeemed on the first date on which they may be redeemed. In addition, E treats the 2004 bonds as financing the same assets as the defeased bonds. The 2004 bonds constitute a refunding issue because the obligor of the defeased bonds (D) obtains in the transaction the right to appoint the majority of the members of the governing body of the obligor of the 2004 bonds (E). See paragraph (d)(2)(ii)(F) of this section.

Example 3. Relinquishment of control. The facts are the same as in *Example 2*, except that D does not obtain the right, directly or indirectly, to appoint any member of the governing body of E. Rather, E obtains the right both to approve and to remove

without cause each member of the governing body of D. In addition, prior to being acquired by E, D experiences financial difficulties as a result of mismanagement. Thus, as part of E's acquisition of D, all of the former members of D's governing body resign their positions and are replaced with persons appointed by E. The 2004 bonds do not constitute a refunding issue.

* * * * *

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on April 5, 2002, 2:41 p.m., and published in the issue of the Federal Register for April 10, 2002, 67 F.R. 17309)

Notice of Proposed Rulemaking

Amendments to Rules for Determination of Basis of Partner's Interest; Special Rules

REG–167648–01

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to special rules on determination of basis of a partner's interest under section 705. The proposed regulations are necessary to coordinate sections 705 and 1032.

DATES: Written or electronic comments and requests for a public hearing must be received by June 27, 2002.

ADDRESSES: Send submissions to: CC:ITA:RU (REG–167648–01), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:ITA:RU (REG–167648–01), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically directly to the IRS internet site at *www.irs.gov/regs*.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Barbara MacMillan or Rebekah A. Myers, (202) 622–3050; concerning submissions of comments or requests for a hearing, LaNita VanDyke at (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

On January 3, 2001, the Treasury Department and the IRS published a notice of proposed rulemaking (REG–106702–00, 2001–4 I.R.B. 424) under section 705 of the Internal Revenue Code (Code) in the **Federal Register** (66 FR 315). Those proposed regulations provided guidance on the coordination of sections 705 and 1032 in situations where a corporation acquires an interest in a partnership that holds stock in that corporation, a section 754 election is not in effect with respect to the partnership for the taxable year in which the corporation acquires the interest, and the partnership later sells or exchanges the stock. Final regulations for the issues addressed in those proposed regulations are being published elsewhere in T.D. 8986. These proposed regulations propose to revise the final regulations contained in § 1.705–2 of 26 CFR part 1 to address remaining issues that Treasury and the IRS considered during the development of the final regulations.

Explanation of Provisions

These proposed regulations provide guidance in situations in which a corporation owns a direct or indirect interest in a partnership that owns stock in that corporation, the partnership distributes money or other property to another partner and that partner recognizes gain on the distribution during a year in which the partnership does not have an election under section 754 in effect, and the partnership subsequently sells or exchanges the stock. For reasons similar to those explained in the preamble of the final regulations, in those situations it may be inconsistent with the intent of sections 705 and 1032 to increase the basis of the corporation's partnership interest by the full amount of any gain resulting from the partnership's sale or exchange of the stock which is not recognized by the corporation under section 1032.

Accordingly, the proposed regulations revise the purpose statement of § 1.705–2(a) to take into account situations involving such partnership distributions. The proposed regulations provide a specific rule implementing the revised purpose in single partnership cases. The proposed regulations also revise § 1.705–2(c) to clarify that the tiered partnerships rule applies to situations involving such partnership distributions.

In addition, the proposed regulations clarify that references in the regulations to stock of a corporate partner include any position in stock of a corporate partner to which section 1032 applies.

Proposed Effective Date

The regulations are proposed to apply to sales or exchanges of stock occurring after March 29, 2002.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are timely submitted to the IRS. The IRS and the Treasury Department request comments on the clarity of the proposed rule and how it may be made easier to understand. All comments will be available for public inspection and copying. A

public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

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

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.705–1 is amended by revising paragraph (a)(7) to read as follows:

§ 1.705–1 Determination of basis of partner's interest.

(a) * * *

(7) For basis adjustments necessary to coordinate sections 705 and 1032 in certain situations in which a partnership disposes of stock or any position in stock to which section 1032 applies of a corporation that holds a direct or indirect interest in the partnership, see § 1.705–2.

* * * * *

Par. 3. Section 1.705–2 is amended as follows:

1. Paragraph (a) is amended by adding a new sentence after the third sentence.

2. Paragraph (b) is amended by adding paragraph (b)(2).

3. Paragraph (c)(1) is amended by adding a new sentence after the second sentence.

4. Paragraph (d) is added.

5. Paragraph (e) is amended by removing the period at the end of the paragraph and adding a new phrase at the end of the paragraph.

The additions and revision read as follows:

§ 1.705–2 Basis adjustments coordinating sections 705 and 1032.

(a) * * * Similarly, in situations where a section 754 election was not in effect for the year in which a partnership distributes money or other property to another partner and that partner recognizes gain on the distribution, the remaining partners' inside basis and outside basis may not be equal. * * *

* * * * *

(b) * * *

(2) *Required adjustments relating to distributions*. (i) This paragraph (b)(2) applies in situations where a corporation owns a direct or indirect interest in a partnership that owns stock in that corporation, the partnership distributes money or other property to another partner and that partner recognizes gain on the distribution during a year in which the partnership does not have an election under section 754 in effect, and the partnership subsequently sells or exchanges the stock. In these situations, the increase (or decrease) in the corporation's adjusted basis in its partnership interest resulting from the sale or exchange of the stock equals the amount of gain (or loss) that the corporate partner would have recognized (absent the application of section 1032) if, for the year in which the partnership made the distribution, a section 754 election had been in effect.

(ii) The provisions of this paragraph (b)(2) are illustrated by the following example:

Example. (i) A, B, and corporation C form partnership PRS. A and B each contribute $10,000 and C contributes $20,000 in exchange for a partnership interest. PRS has no liabilities. PRS purchases stock in corporation C for $10,000, which appreciates in value to $70,000. PRS distributes $25,000 to A in complete liquidation of A's interest in PRS in a year for which an election under section 754 is not in effect. PRS later sells the C stock for $70,000. PRS realizes a gain of $60,000 on the sale of the C stock. C's share of the gain is $40,000. Under section 1032, C does not recognize its share of the gain.

(ii) Normally, C would be entitled to a $40,000 increase in the basis of its PRS interest for its allocable share of PRS's gain from the sale of the C stock, but a special rule applies in this situation. If a section 754 election had been in effect for the year in which PRS made the distribution to A, PRS would have been entitled to adjust the basis of partnership property under section 734(b)(1)(A) by $15,000 (the amount of gain recognized by A with respect to the distribution to A under section 731(a)(1)). See § 1.734–1(b). Under § 1.755–1(c)(1)(ii), the basis adjustment under section 734(b) would have been allocated to the C stock, increasing its basis to $25,000. (Where there is a distribution resulting in an adjustment under section 734(b)(1)(A) to the basis of undistributed partnership property, the adjustment is allocated only to capital gain property.)

(iii) If a section 754 election had been in effect for the year in which PRS made the distribution to A, the amount of gain that PRS would have recognized upon PRS's disposition of C stock would be $45,000 ($70,000 minus $25,000 basis in the C stock), and the amount of gain C would have recognized upon PRS's disposition of the C stock (absent the application of section 1032) would be $30,000 (C's share of PRS's gain of $45,000 from the stock sale). Accordingly, upon PRS's sale of the C stock, the increase in the basis of C's interest in PRS is $30,000.

* * * * *

(c)(1) * * * Similarly, if a corporation owns an indirect interest in its own stock through a chain of two or more partnerships, and a partnership in the chain distributes money or other property to another partner and that partner recognizes gain on the distribution during a year in which the partnership does not have an election under section 754 in effect, then upon any subsequent sale or exchange of the stock, the bases of the interests in the partnerships included in the chain shall be adjusted in a manner that is consistent with the purpose of this section.

* * * * *

(d) *Positions in Stock*. For purposes of this section, stock includes any position in stock to which section 1032 applies.

(e) * * * , except that the fourth sentence of paragraph (a), paragraph (b)(2), and the third sentence of paragraph (c)(1) of this section are applicable with respect to sales or exchanges of stock occurring on or after March 29, 2002.

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on March 28, 2002, 8:45 a.m., and published in the issue of the Federal Register for March 29, 2002, 67 F.R. 15132)

Hospital Refinancing Closing Agreement Program

Announcement 2002–43

Purpose

The Internal Revenue Service (the "Service"), Office of Tax Exempt Bonds, announces a program under which certain issuers of state or local bonds may request a closing agreement pursuant to which bonds (the "refinancing bonds") issued to refinance certain outstanding bonds (the "refinanced bonds") will be recognized as acquisition bonds (and therefore will not be treated as a refunding issue under § 1.150–1(d) of the Income Tax Regulations) and the allocations of proceeds to expenditures for such bonds will be respected.

Background

The closing agreement program applies to issues of state or local bonds issued in connection with hospital affiliation transactions where two or more existing 501(c)(3) organizations (the "Sellers") agreed to merge their operations by selling either the assets of the Sellers or control of the Sellers to a new or preexisting 501(c)(3) organization that the Sellers jointly control. In particular, the program applies where the issuer did not characterize the refinancing bonds as a refunding issue under § 1.150–1(d)(2) and did not treat proceeds of the refinancing bonds as being used for all of the purposes for which the proceeds of the refinanced bonds were used. The Service is providing the program because it recognizes the policy reasons for the hospital affiliation transactions and the uncertainty in applying the allocation rules and has a desire to quickly and fairly resolve the examinations of the refinancing bonds.

On April 10, 2002, proposed regulations were published relating to the definition of refunding under § 1.150–1(d). Issuers may apply the proposed regulations in whole, but not in part, to any issue that is sold on or after the date the proposed regulations were published in the Federal Register and before the effective date of the final regulations.

Closing Agreement Procedure

An issuer seeking relief must execute a closing agreement with the Service on or before December 31, 2002, following the procedures in this announcement. An issue of bonds is eligible for the program whether or not it is under examination. The closing agreement will be prepared by the Service and, in general, will be in substantially the same form as the model closing agreement set forth in IRM 7.6.2. For issues that are not under examination, issuers should submit a request for closing agreement pursuant to Notice 2001–60 (2001–40 I.R.B. 304).

As a condition to executing a closing agreement, the issuer must agree to take one of the following actions:

1. Pay, simultaneously with the execution by the issuer of the closing agreement, the applicable closing agreement amount (as described below). Proceeds of tax-exempt bonds may not be used to pay the closing agreement amount.

2. Treat the proceeds of the refinancing bonds as used for the purposes for which the proceeds of the refinanced issue were used and restructure the refinancing bonds in a manner such that the bonds comply with the applicable requirements of §§ 103 and 141 through 150 of the Internal Revenue Code that are impacted by such allocation.

Closing Agreement Amount

The closing agreement amount is equal to 30 percent of the present value of the arbitrage profit on the escrow investments that were purchased with the proceeds of the refinancing bonds to be used to repay the refinanced bonds, plus interest accruing at the underpayment rate under § 6621, beginning on the date that is 60 days from April 10, 2002. Arbitrage profit is the excess of the amount earned on the escrow investments over the amount that would have been earned if the investments bore a yield equal to the yield on the refinancing bonds. Present value is computed as of the issue date of the refinancing bonds, using the yield on the refinancing bonds as the discount rate.

Yield on an issue will be equal to the yield on the issue under § 148. If all or a portion of the refinancing bonds bear interest at a variable rate, the variable rate will be equal to the actual values of the variable rate of the refinancing bonds from the issue date until the date of any closing agreement, and the reasonably expected values of the variable rate for the remaining term of the refinancing bonds. Expectations regarding values will be treated as reasonable if the values are equal to the value of an objective index of tax-exempt variable rates (similar to the variable rate on the refinancing bonds) on the date of the closing agreement.

Restructuring Option

Any restructuring must be completed within 180 of days of the execution of the closing agreement. To the extent that a restructuring involves the redemption of bonds, the issuer must provide a written notice to the bondholders similar to the notice described in § 5.02(5) of Rev. Proc. 97–15 (1997–1 C.B. 635).

Allocations of proceeds to bonds for non-qualified purposes of § 145(a)(2) will be treated as reasonable if made consistently with the rule set forth in § 1.141–12(j)(2).

Submissions

Submissions with regard to the closing agreement program should be directed to:

Clifford J. Gannett
Manager, Outreach, Planning and Review
Internal Revenue Service
Attn: T:GE:TEB:O, Room 5T2
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Drafting Information

The principal authors of this announcement are Bruce M. Serchuk of the Office of Associate Chief Counsel (Tax Exempt and Government Entities) and W. Mark Scott of the Office of Tax Exempt Bonds, Tax Exempt and Government Entities Division. For further information regarding this announcement, contact W. Mark Scott at (202) 283–9815 (not a toll-free call).

Definition of Terms

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

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

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

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

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

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

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

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

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

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

Abbreviations

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

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

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[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2001–27 through 2001–53 is in Internal Revenue Bulletin 2002–1, dated January 7, 2002.

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[2] A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2001–27 through 2001–53 is in Internal Revenue Bulletin 2002–1, dated January 7, 2002.

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