

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

Ct. D. 2072, page 379.

Under section 172 of the Code, an affiliated group's product liability loss (PLL) must be figured on a consolidated, single-entity basis, not by aggregating PLLs separately determined company by company. **United Dominion Industries, Inc. v. United States.**

EMPLOYEE PLANS

Announcement 2001-106, page 416.

Saver's credit; employee plans and individual retirement arrangements. This announcement sets forth frequently asked questions and the related answers about the Saver's Credit described in section 25B of the Code. It also contains examples and a table regarding eligibility for this new nonrefundable credit.

EXEMPT ORGANIZATIONS

Announcement 2001-108, page 419.

A list is provided of organizations now classified as private foundations.

EMPLOYMENT TAX

Ct. D. 2071, page 385.

The Compensation Clause of the U.S. Constitution prevents the government from collecting Social Security taxes, but not Medicare taxes, from federal judges who held office before 1983, when Congress extended those taxes to federal employees. **United States v. Hatter, et al.**

ADMINISTRATIVE

Notice 2001-66, page 396.

This notice requests comments on and contains proposed audit guidelines for qualified intermediaries (QIs). These QIs are a key component of the withholding and reporting regulations that became effective on January 1, 2001 (T.D. 8734, 1997-2 C.B. 109 and T.D. 8881, 2000-23 I.R.B. 1158).

Announcement 2001-107, page 419.

The Service announces that the Martinsburg Computing Center (MCC) Information Reporting Program Call Site now has a toll-free telephone number.

Announcement 2001-93, page 416.

The Service announces new reporting requirements for employee elective deferral "catch-up" contributions on the 2002 Form W-2. Similar reporting requirements will be addressed in the 2002 Instructions for Forms 1099-R and 5498.

Finding Lists begin on page ii.



The IRS Mission

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

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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.

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

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.

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

Part II.—Treaties and Tax Legislation.

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

Part III.—Administrative, Procedural, and Miscellaneous.

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

Part IV.—Items of General Interest.

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

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

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

Section 172.—Net Operating Loss Deduction

Ct. D. 2072

SUPREME COURT OF THE UNITED STATES

No. 00–157

UNITED DOMINION INDUSTRIES, INC. v. UNITED STATES

CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

June 4, 2001

Syllabus

Under the Internal Revenue Code of 1954, a “net operating loss” (NOL) results from deductions in excess of gross income for a given year. 26 U.S.C. Sec. 172(c). A taxpayer may carry its NOL either backward or forward to other tax years in order to set off its lean years against its lush years. Sec. 172(b)(1)(A). The carryback period for “product liability loss[es]” is 10 years. Sec. 172(b)(1)(I). Because a product liability loss (PLL) is the total of a taxpayer’s product liability expenses (PLEs) up to the amount of its NOL, Sec. 172(j)(1), a taxpayer with a positive annual income, and thus no NOL, may have PLEs but can have no PLL. An affiliated group of corporations may file a single consolidated return. Sec. 1501. Treasury Regulations provide that such a group’s “consolidated taxable income” (CTI), or, alternatively, its “consolidated net operating loss” (CNOL), is determined by taking into account several items, the first of which is the “separate taxable income” (STI) of each group member. In calculating STI, the member must disregard items such as capital gains and losses, which are considered, and factored into CTI or CNOL, on a consolidated basis. Petitioner’s predecessor in interest, AMCA International Corporation, was the parent of an affiliated group filing consolidated returns for the years 1983 through 1986. In each year, AMCA reported CNOL exceeding the aggregate of its 26 individual members’ PLEs. Five group members with PLEs reported positive STIs. Nonetheless,

AMCA included those PLEs in determining its PLL for 10-year carryback under a “single-entity” approach in which it compared the group’s CNOL and total PLEs to determine the group’s total PLL. In contrast, the Government’s “separate-member” approach compares each affiliate’s STI and PLEs in order to determine whether each affiliate suffers a PLL, and only then combines any PLLs of the individual affiliates to determine a consolidated PLL. Under this approach, PLEs incurred by an affiliate with positive STI cannot contribute to a PLL. In 1986 and 1987, AMCA petitioned the Internal Revenue Service for refunds based on its PLL calculations. The IRS ruled in AMCA’s favor, but was reversed by a joint congressional committee that controls refunds exceeding a certain threshold. AMCA then filed this refund action. The District Court applied AMCA’s single-entity approach, concluding that so long as the affiliated group’s consolidated return reflects CNOL in excess of the group’s aggregate PLEs, the total of those expenses is a PLL that may be carried back. In reversing, the Fourth Circuit applied the separate-member approach.

Held: An affiliated group’s PLL must be figured on a consolidated, single-entity basis, not by aggregating PLLs separately determined company by company. Pp. 5–15.

(a) The single-entity approach to calculating an affiliated group’s PLL is straightforward. The first step in applying Sec. 172(j)’s definition of PLL requires a taxpayer filing a consolidated return to calculate an NOL. The Code and regulations governing affiliated groups of corporations filing consolidated returns provide only one definition of NOL: “consolidated” NOL. The absence of a separate NOL for a group member in this context is underscored by the fact that the regulations provide a measure of separate NOL in a different context, for any year in which an affiliated corporation files a separate return. The exclusive definition of NOL as CNOL at the consolidated level is important. Neither the Code nor the regulations indicate that the essential relationship between NOL and PLL for a consolidated group differs from their re-

lationship for a conventional corporate taxpayer. Comparable treatment of PLL for the group and the conventional taxpayer can be achieved only if PLEs are compared with the loss amount at the consolidated level after CNOL has been determined, for CNOL is the only NOL measure for the group. An approach based on comparable treatment is also (relatively) easy to understand and to apply. Pp. 5–7.

(b) The case for the separate-member approach is not so easily made. Because there is no NOL below the consolidated level, there is nothing for comparison with PLEs to produce a PLL at any stage before the CNOL calculation. Thus, a separate-member proponent must identify some figure in the consolidated return scheme with a plausible analogy to NOL at the affiliated corporations level. An individual member’s STI is not analogous, for it excludes several items that an individual taxpayer would normally count in computing income or loss, but which an affiliated group may tally only at the consolidated level. The “separate net operating loss,” Treas. Reg. Sec. 1.1502–79(a)(3), used by the Fourth Circuit fares no better. Although that figure accounts for some gains or losses that STI does not, Sec. 1.1502–79(a)(3)’s purpose is to allocate CNOL to an affiliate member seeking to carry back a loss to a year in which the member was not part of the consolidated group. Such returns are not at issue here. Pp. 8–11.

(c) Several objections to the single-entity approach—that it allows affiliated groups a double deduction, that the omission of PLEs from the series of items that Treas. Reg. Sec. 1.1502–12 requires to be tallied at the consolidation level indicates that PLEs were not meant to be tallied at that level, and that the single-entity approach would permit significant tax avoidance abuses—are rejected. Pp. 11–15.

208 F.3d 452, reversed and remanded.

SOUTER, J., delivered the opinion of the Court, in which REHNQUIST, C.J., and O’CONNOR, SCALIA, KENNEDY, THOMAS, GINSBURG, and BREYER, JJ., joined. THOMAS, J., filed a concurring opinion. STEVENS, J., filed a dissenting opinion.

SUPREME COURT OF THE
UNITED STATES

No. 00–157

UNITED DOMINION INDUSTRIES,
INC., PETITIONER v. UNITED
STATES

532 U.S. ____ (2001)

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF
APPEALS FOR THE
FOURTH CIRCUIT

June 4, 2001

JUSTICE SOUTER delivered the opinion of the Court.

Under Sec. 172(b)(1)(I) of the Internal Revenue Code of 1954, a taxpayer may carry back its “product liability loss” up to 10 years in order to offset prior years’ income. The issue here is the method for calculating the product liability loss of an affiliated group of corporations electing to file a consolidated federal income tax return. We hold that the group’s product liability loss must be figured on a consolidated basis in the first instance, and not by aggregating product liability losses separately determined company by company.

I

A “net operating loss” results from deductions in excess of gross income for a given year. 26 U.S.C. Sec. 172(c).¹ Under Sec. 172(b)(1)(A), a taxpayer may carry its net operating loss either backward to past tax years or forward to future tax years in order to “set off its lean years against its lush years, and to strike something like an average taxable income computed over a period longer than one year,” *Libson Shops, Inc. v. Koehler*, 353 U.S. 382, 386 (1957).

Although the normal carryback period was at the time three years, in 1978, Congress authorized a special 10-year carryback for “product liability loss[es],” 26 U.S.C. Sec. 172(b)(1)(I), since, it understood, losses of this sort tend to be particularly “large and sporadic.” Joint Committee on Taxation, 95th Cong., General Explanation of the Revenue Act of 1978,

232 (Comm. Print 1979). The Code defines “product liability loss,” for a given tax year, as the lesser of (1) the taxpayer’s “net operating loss for such year” and (2) its allowable deductions attributable to product liability “expenses.” 26 U.S.C. Sec. 172(j)(1). In other words, a taxpayer’s product liability loss (PLL) is the total of its product liability expenses (PLEs), limited to the amount of its net operating loss (NOL). By definition, then, a taxpayer with positive annual income, and thus no NOL, may have PLEs but can have no PLL.²

Instead of requiring each member company of “[a]n affiliated group of corporations” to file a separate tax return, the Code permits the group to file a single consolidated return, 26 U.S.C. Sec. 1501, and leaves it to the Secretary of the Treasury to work out the details by promulgating regulations governing such returns, Sec. 1502. Under Treas. Regs. Secs. 1.1502–11(a) and 1.1502–21(f),³ an affiliated group’s “consolidated taxable income” (CTI), or, alternatively, its “consolidated net operating loss” (CNOL), is determined by “taking into account” several items. The first is the “separate taxable income” (STI) of each group member. A member’s STI (whether positive or negative) is computed as though the member were a separate corporation (*i.e.*, by netting income and expenses), but subject to several important “modifications.” Treas. Reg. Sec. 1.1502–12. These modifications require a group member calculating its STI to disregard, among other items, its capital gains and losses, charitable-contribution deductions, and dividends-received deductions. *Ibid.* These excluded items are accounted for on a consolidated basis, that is, they are com-

bined at the level of the group filing the single return, where deductions otherwise attributable to one member (say, for a charitable contribution) can offset income received by another (from a capital gain, for example). Treas. Regs. Secs. 1.1502–11(a)(3)–(8); 1.1502–21(f)(2) to (6). A consolidated group’s CTI or CNOL, therefore, is the sum of each member’s STI, plus or minus a handful of items considered on a consolidated basis.

II

Petitioner United Dominion’s predecessor in interest, AMCA International Corporation, was the parent of an affiliated group of corporations that properly elected to file consolidated tax returns for the years 1983 through 1986. In each of these years, AMCA reported CNOL (the lowest being \$85 million and the highest, \$140 million) that exceeded the aggregate of its 26 individual members’ PLEs (\$3.5 million to \$6.5 million). This case focuses on the PLEs of five of AMCA’s member companies, which, together, generated roughly \$205,000 in PLEs in 1983, \$1.6 million in 1984, \$1.3 million in 1985, and \$250,000 in 1986. No one disputes these amounts or their characterization as PLEs. See 208 F.3d 452, 453 (CA4 2000) (“The parties agree” with respect to the amount of “the product liability expenses incurred by the five group members in the relevant years”). Rather, the sole question here is whether the AMCA affiliated group may include these amounts on its consolidated return, in determining its PLL for 10-year carryback. The question arises because of the further undisputed fact that in each of the relevant tax years, each of the five companies in question (with minor exceptions not relevant here), reported a positive STI.

AMCA answered this question by following what commentators have called a “single-entity” approach⁴ to calculating its “consolidated” PLL. For each tax year, AMCA (1) calculated its CNOL pursuant to Treas. Reg. Sec. 1.1502–11(a), and (2) aggregated its individual members’ PLEs. Because, as noted above, for each tax year AMCA’s CNOL was greater

¹ Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954, 26 U.S.C. Sec. 1 *et seq.* (1982 ed. and Supp. V), as in effect between 1983 and 1986, the tax years here in question.

² If, for example, a company had \$100 in taxable income, \$50 in deductible PLEs, and \$75 in additional deductions, its NOL would be \$25 (*i.e.*, \$100–\$50–\$75=–\$25); it could count only \$25 of its \$50 in PLEs as PLL. If the company had \$100 in income, \$50 in PLEs, and \$125 in additional deductions, its NOL would be \$75, and it could count its entire \$50 in PLEs as PLL. And, finally, if the company had \$100 in income, \$50 in PLEs, and \$40 in additional deductions, it would have positive income and, thus, no NOL and no PLL.

³ Unless otherwise noted, Treasury Regulation references are to the regulations in effect between 1983 and 1986, 26 CFR Sec. 1.1502–11 *et seq.* (1982–1986).

⁴ Axelrod & Blank, *The Supreme Court, Consolidated Returns, and 10-Year Carrybacks*, 90 Tax Notes, No. 10, p. 1383 (Mar. 5, 2001) (hereinafter Axelrod & Blank).

than the sum of its members' PLEs, AMCA treated the full amount of the PLEs as consolidated PLL eligible for 10-year carryback. In AMCA's view, the fact that several member companies throwing off large PLEs also, when considered separately, generated positive taxable income was of no significance.

From the Government's perspective, however, the fact that the several affiliated members with PLEs also generated positive separate taxable income is of critical significance. According to the Government's methodology, which we will call the "separate-member" approach,⁵ PLEs incurred by an affiliate with positive separate taxable income cannot contribute to a PLL eligible for 10-year carryback. Whereas AMCA compares the group's total income (or loss) and total PLEs in an effort to determine the group's total PLL, the Government compares each affiliate's STI and PLEs in order to determine whether each affiliate suffers a PLL, and only then combines any PLLs of the individual affiliates to determine a consolidated PLL amount.

In 1986 and 1987, AMCA petitioned the Internal Revenue Service for refunds of taxes based on its PLL calculations. The IRS first ruled in AMCA's favor but was reversed by the Joint Committee on Internal Revenue Taxation of the United States Congress, which controls refunds exceeding a certain threshold, 26 U.S.C. Sec. 6405(a). AMCA then filed this refund action in the United States District Court for the Western District of North Carolina. The District Court agreed with AMCA that an affiliated group's PLL is determined on a single-entity basis, and held that, so long as the group's consolidated return reflects CNOL in excess of the group's aggregate PLEs, the total of those expenses (including those incurred by members with positive separate taxable income) is a PLL that "may be carried back the full ten years." No. 3:95-CV-341-MU (June 19, 1998), App. to Pet. for Cert. 39a. The United States Court of Appeals for the Fourth Circuit reversed, and held that "determining 'product liability loss' separately for each group member is correct and consistent with [Treasury] regulations." 208 F.3d, at 458.

⁵ *Ibid.*

Because the Fourth Circuit's separate-member approach to calculating PLL conflicted with the Sixth Circuit's adoption of the single-entity approach in *Intermet Corp. v. Commissioner*, 209 F.3d 901 (CA6 2000), we granted certiorari, 531 U.S. 1009 (2000).⁶ We now reverse.

III

The case for the single-entity approach to calculating an affiliated group's PLL is straightforward. Section 172(j)(1) defines a taxpayer's "product liability loss" for a given tax year as the lesser of its "net operating loss for such year" and its product liability "expenses." In order to apply this definition, the taxpayer first determines whether it has taxable income or NOL, and in making that calculation it subtracts PLEs. If the result is NOL, the taxpayer then makes a simple comparison between the NOL figure and the total PLEs. The PLE total becomes the PLL to the extent it does not exceed NOL. That is, until NOL has been determined, there is no PLL.

The first step in applying the definition and methodology of PLL to a taxpayer filing a consolidated return thus requires the calculation of NOL. As United Dominion correctly points out, the Code and regulations governing affiliated groups of corporations filing consolidated returns provide only one definition of NOL: "consolidated" NOL, see Treas. Reg. Sec. 1.1502-21(f). There is no definition of separate NOL for a member of an affiliated group. Indeed, the fact that Treasury Regulations do provide a measure of separate NOL in a different context, for an affiliated corporation as to any year in which it filed a separate return, *infra*, at ____, underscores the absence of such a measure for an affiliated corporation filing as a group member. Given this apparently exclusive definition of NOL as CNOL in the instance of affiliated entities

⁶ *Intermet* involved "specified liability losses" (SLLs), not PLLs. The difference, however, does not matter. The PLL was a statutory predecessor to the SLL, and PLLs were folded into the SLL provision in Sec. 11811(b)(1) of the Omnibus Budget Reconciliation Act of 1990, 104 Stat. 1388-532. Thus, "[i]n all relevant respects, the provisions on [PLLs] and SLLs are the same." Leatherman, *Current Developments for Consolidated Groups*, 486 *PLI/Tax* 389, 393, n. 5 (2000) (hereinafter *Leatherman, Current Developments*).

with a consolidated return (and for reasons developed below, *infra*, at ____ we think it is fair to say, as United Dominion says, that the concept of separate NOL "simply does not exist." Brief for Petitioner 15.⁷ The exclusiveness of NOL at the consolidated level as CNOL is important here for the following reasons. The Code's authorization of consolidated group treatment contains no indication that for a consolidated group the essential relationship between NOL and PLL will differ from their relationship for a conventional corporate taxpayer. Nor does any Treasury Regulation purport to change the relationship in the consolidated context. If, then, the relationship is to remain essentially the same, the key to understanding it lies in the regulations' definition of net operating loss exclusively at the consolidated level. Working back from that, PLEs should be considered first in calculating CNOL, and they are: because any PLE of an affiliate affects the calculation of its STI, that same PLE necessarily affects the CTI or CNOL in exactly the same way, dollar for dollar. And because, by definition, there is no NOL measure for a consolidated return group or any affiliate except CNOL, PLEs cannot be compared with any NOL to produce PLL until CNOL has been calculated. Then, and only then in the case of the consolidated filer, can total PLEs be compared with a net operating loss. In sum, comparable treatment of PLL in the instances of the usual corporate taxpayer and group filing a consolidated return can be achieved only if the comparison of PLEs with a limiting loss amount occurs at the consolidated level after CNOL has been determined. This approach resting on comparable treatment has a further

⁷ In addition to Treas. Reg. Sec. 1.1502-79(a)(3), discussed *infra*, at ____, two other provisions, 26 U.S.C. Sec. 1503(f)(2) and the current version (though not the version applicable between 1983 and 1986) of Treas. Reg. Sec. 1502-21(b) (2000), refer to separate group members' NOLs. The parties here have not emphasized those provisions, and with good reason. Not only are they inapplicable to the question before us (either substantively, temporally, or both), but, as one commentator has observed, their references to separate NOLs "stem[] more from careless drafting than meaningful design." Leatherman, *Are Separate Liability Losses Separate for Consolidated Groups?*, 52 *Tax. Law.* 663, 705 (1999) (hereinafter *Leatherman, Separate Liability Losses*).

virtue entitled to some weight in case of doubt: it is (relatively) easy to understand and to apply.

The case for the separate-member approach, advanced (in one variant) by the Government and adopted (on a different rationale) by the Court of Appeals, is not so easily made. In the analysis of comparable treatment just set out, of course, there is no NOL below the consolidated level and hence nothing for comparison with PLEs to produce PLL at any stage before the CNOL calculation. At the least, then, a proponent of the separate-member approach must identify some figure in the consolidated return scheme that could have a plausible analogy to NOL at the level of the affiliated corporations. See A. Dubroff, J. Blanchard, J. Broadbent, & K. Duvall, *Federal Income Taxation of Corporations Filing Consolidated Returns* Sec. 41.04[06], p. 41–75 (2d ed. 2000) (hereinafter Dubroff) (“Even if separate entity treatment was appropriate, it is unclear how a member with [PLEs] would compute its separate NOL”). The Government and the Court of Appeals have suggested different substitute measures. Neither one works.

The Government has argued that an individual group member’s STI, as determined under Treas. Reg. Sec. 1.1502–12, is analogous to a “separate” NOL, so that an affiliate’s STI may be compared with its PLEs in order to determine any separate PLL. An individual member’s PLL would be the amount of its separate PLEs up to the amount of its negative STI; a member having positive STI could have no PLL.

The Government claims that an STI-based comparison places the group member closest to the position it would have occupied if it had filed a separate return. But that is simply not so. We have seen already that the calculation of a group member’s STI by definition excludes several items that an individual taxpayer would normally account for in computing income or loss, but which an affiliated group may tally only at the consolidated level, such as capital gains and losses, charitable-contribution deductions, and dividends-received deductions. Treas. Reg. Secs. 1.1502–12(j) to (n). Owing to these exclusions, an affiliate’s STI will tend to be inflated by eliminating deductions it would have taken if it had filed

separately, or deflated by eliminating an income item like capital gain.

When pushed, the Government concedes that STI is “not necessarily equivalent to the income or [NOL] figure that the corporation would have computed if it had filed a separate return.” Brief for United States 21, n. 14. But, the Government claims, “[t]here has never been a taxpayer with [PLEs] who had a positive [STI] but a negative separate [NOL].” Tr. of Oral Arg. 27. In other words, the Government says that the deductions excluded from STI have never once made a difference and, therefore, that STI is, in fact, a decent enough proxy for a group member’s “separate” NOL. But whether or not the excluded items have made a difference in the past, or make a difference here, they certainly could make a difference and, given the potential importance of some of the deductions involved (a large charitable contribution, for example), it is not hard to see how the difference could favor the Government.

The Court of Appeals was therefore right to reject the Government’s reliance on STI as a functional surrogate for an affiliate’s “separate” NOL. 208 F.3d, at 459–460. But what the Court of Appeals used in place of STI fares no better. The court relied on Treas. Reg. Sec. 1.1502–79, which contains a definition of “separate net operating loss” that the court believed to be “analogous to an individual’s ‘net operating loss’ on a separate return.” 208 F.3d at 460. Section 1.1502–79(a)(3) provides that, “[f]or purposes of this subparagraph,” the “separate net operating loss of a member of the group shall be determined under Sec. 1.1502–12 . . . , adjusted for the . . . items taken into account in the computation of” the CNOL. As the Court of Appeals said, the directive of Sec. 1.1502–79(a)(3) (unlike the definition of STI) “takes into account, for example, [a] member’s charitable contributions” and other consolidated deductions. 208 F.3d, at 460–461.

But this sounds too good. It is true that, insofar as Sec. 1.1502–79(a)(3) accounts for gains and losses that STI does not, it gets closer to a commonsense notion of a group member’s “separate” NOL than STI does. But the fact that Sec. 1.1502–79(a)(3) improves on STI simply by undoing what Sec. 1.1502–12 requires in defining STI is suspicious, and it turns

out that the suspicion is justified. Section 1.1502–79(a)(3) unbakes the cake for only one reason, and that reason has no application here. The definition on which the Court of Appeals relied applies, by its terms, only “for purposes of” Sec. 1.1502–79(a)(3), and context makes clear that the purpose is to provide a way to allocate CNOL to an affiliate member that seeks to carry back a loss to a “separate return year,” that is, to a year in which the member was not part of the consolidated group. See Treas. Reg. Sec. 1.1502–79 (titled “Separate return years”); Sec. 1.1502–79(a) (titled “Carryover and carryback of [CNOL] to separate return years”); Sec. 1.1502–79(a)(1) (“[i]f a [CNOL] can be carried . . . to a separate return year . . .”). No separate return years are at issue before us; all NOL carrybacks relevant here apply to years in which the five corporations were affiliated in the group. The Court of Appeals thus applied concepts addressing separate return years to a determination for a consolidated return year, without any statutory or regulatory basis for doing so. Cf. 49 Fed. Reg. 30530 (1984) (“[A]lthough the consolidated net operating loss is apportioned to individual members for purposes of carrybacks to separate return years [under Sec. 1.1502–79(a)], the apportioned amounts are not separate NOLs of each member”). Hence, while Sec. 1.1502–79 might not distort an affiliate’s separate NOL in the same way that STI does, the facial inapplicability of that regulation only underscores the exclusive concern of Sec. 1.1502–11(a) with consolidated NOL.

In sum, neither method for computing PLL on a separate-member basis squares with the notion of comparability as applied to consolidated return regulations. On the contrary, by expressly and exclusively defining NOL as CNOL, the regulations support the position that group members’ PLEs should be aggregated and the affiliated group’s PLL determined on a consolidated, single-entity basis.

IV

Several objections have been raised to a single-entity approach to calculating PLL that we have not considered yet. First, the Government insists that a single-entity rule allows affiliated groups a “double deduction.” The Government ar-

gues that because PLEs are not included among the specific items (charitable-contribution deductions, etc.) for which consolidated, single-entity treatment is required under Treas. Reg. Sec. 1.1502-12, PLEs are “consumed” or “used up” in computing members’ STIs, which, pursuant to Treas. Regs. Secs. 1.1502-11(a) and 1.1502-21(f), are then used to calculate the group’s CTI or CNOL. According to the Government, to permit the use of PLEs first to reduce an individual member’s STI and then to contribute to an aggregate PLL for carryback purposes would be tantamount to a double deduction.

The double-deduction argument may have superficial appeal, but any appeal it has rests on a fundamental misconception of the function of STI in computing an affiliated group’s tax liability. Calculation of a group member’s STI is not in and of itself the basis for any tax event, and there is no separate tax saving when STI is calculated; that occurs only when deductions on the consolidated return equal income and (if they exceed income and produce a CNOL) are carried back against prior income. STI is merely an accounting construct devised as an interim step in computing a group’s CTI or CNOL; it “has no other purpose.” *Intermet*, 209 F.3d, at 906 (“A member’s STI is simply a step along the way to calculating the group’s taxable income or CNOL”). The fact that a group member’s PLEs reduce its STI, which in turn either reduces the group’s CTI or contributes to its CNOL “dollar for dollar,” *ibid.*, is of no other moment.⁸ If there were anything wrong in what AMCA proposes to do, it would be wrong in relation to AMCA’s CNOL and its use for any carryback. Yet, as noted above, no one here disputes that the group members had PLEs in the total amount claimed or that the AMCA group is entitled to carry back the full amount of its CNOL to offset income in prior years. The only

question is what portion, if any, of AMCA’s CNOL is PLL and, as such, eligible for 10-year, as opposed to 3-year carryback treatment. There is no more of a double deduction with a 10-year carryback than one for three years.

A second objection was the reason that the Court of Appeals rejected the single-entity approach. That court attached dispositive significance to the fact that, while the Treasury Regulation we have discussed, Sec. 1.1502-12, specifically provides that several items (capital gains and losses, charitable-contribution deductions, etc.) shall be accounted for on a consolidated basis, it does not similarly provide for accounting for PLEs on a consolidated basis: “The regulations provide for blending the group members’ [NOLs], and they explicitly define [CNOL] without an accompanying reference to consolidated [PLEs]. This omission . . . makes clear that blending those expenses is not permitted. . . .” 208 F.3d, at 458.

We think the omission of PLEs from the series of items that Sec. 1.1502-12 requires to be tallied at the consolidated level has no such clear lesson, however. The logic that invests the omission with significance is familiar: the mention of some implies the exclusion of others not mentioned. *Leatherman v. Tarrant County Narcotics Intelligence and Coordination Unit*, 507 U.S. 163, 167 (1993) (“*Expressio unius est exclusio alterius*”). But here, as always, the soundness of that premise is a function of timing: if there was a good reason to consider the treatment of consolidated PLL at the time the regulation was drawn, then omitting PLL from the list of items for consolidated treatment may well have meant something. But if there was no reason to consider PLL then, its omission would mean nothing at all. And in fact, there was no reason. When the consolidated return regulations were first promulgated in 1966, there was no carryback provision pegged to PLEs or PLLs; those notions did not become separate carryback items until 1978, when the 10-year rule was devised. See Revenue Act of 1978, Sec. 371, 92 Stat. 2859; see also *Leatherman*, Current Developments 393, n. 5. Omission of PLEs or PLLs from the series set out for consolidated treatment in the 1966 regulation therefore meant absolutely

nothing in 1966. The issue, then, is the significance, not of omission, but of failure to include later: has the significance of the earlier regulation changed solely because the Treasury has never amended it, even though PLL is now a separate carryback? We think that is unlikely. The Treasury’s relaxed approach to amending its regulations to track Code changes is well documented. See, e.g., Dubroff 41-72, n. 193; Axelrod & Blank 1391; *Leatherman*, Separate Liability Losses 708-709. The absence of any amendment to Sec. 1.1502-12 that might have added PLEs or PLLs to the list of items for mandatory single-member treatment therefore is more likely a reflection of the Treasury’s inattention than any affirmative intention on its part to say anything at all.

Last, the Government warns that “[t]he rule that petitioner advocates would permit significant tax avoidance abuses.” Brief for United States 40. Specifically:

“Under petitioner’s approach, a corporation that is currently unprofitable but that had substantial income in prior years could (i) acquire a profitable corporation with product liability expense deductions in the year of acquisition, (ii) file a consolidated return and (iii) thereby create an otherwise nonexistent ‘product liability loss’ for the new affiliated group that would allow the acquiring corporation to claim refunds of the tax it paid in prior years. *Ibid.*”

The Government suggests, for example, that “a manufacturing company (with prior profits and current losses) that has no product liability exposure could purchase a tobacco company (with both prior and current profits) that has significant product liability expenses,” and that “[t]he combined entity could . . . assert a ten-year carryback of ‘product liability losses’ even though the tobacco company has always made a profit and never incurred a ‘loss’ of any type.” *Id.*, at 40-41, n. 27.

There are several answers. First, on the score of tax avoidance, the separate-member approach is no better (and is perhaps worse) than the single-entity treatment; both entail some risk of tax-motivated behavior. See *Leatherman*, Separate Liabil-

⁸ It makes no difference whatsoever whether the affiliate’s PLEs are (1) first netted against each member’s income and then aggregated or (2) first aggregated and then netted against the group’s combined income: under either method, AMCA’s CNOL is the same. See Axelrod & Blank 1394 (noting that this conclusion follows from “the associative principle of arithmetic (which holds that the groupings of items in the case of addition and subtraction have no effect on the result)”).

ity Losses 681 (Under the separate-member approach, “[d]espite sound non-tax business reasons, a group may be disinclined to form a new member or transfer assets between members, because it may worry that it would lose the benefit of a ten-year carryback,” and “may be encouraged to transfer assets between members to increase its consolidated [PLL], even when those transfers would otherwise be ill-advised”). Second, the Government may, as always, address tax-motivated behavior under Internal Revenue Code Sec. 269, which gives the Secretary ample authority to “disallow [any] deduction, credit, or other allowance” that results from a transaction “the principal purpose [of] which . . . is evasion or avoidance of Federal income tax.” 26 U.S.C. Sec. 269(a). And finally, if the Government were to conclude that Sec. 269 provided too little protection and that it simply could not live with the single-entity approach, the Treasury could exercise the authority provided by the Code, 26 U.S.C. Sec. 1502, and amend the consolidated return regulations.

* * *

Thus, it is true, as the Government has argued, that “[t]he Internal Revenue Code vests ample authority in the Treasury to adopt consolidated return regulations to effect a binding resolution of the question presented in this case.” Brief for United States 19–20. To the extent that the Government has exercised that authority, its actions point to the single-entity approach as the better answer. To the extent the Government disagrees, it may amend its regulations to provide for a different one.

The judgment of the Court of Appeals is reversed, and the case is remanded for proceedings consistent with this opinion.

It is so ordered.

**SUPREME COURT OF THE
UNITED STATES**

No. 00–157

UNITED DOMINION INDUSTRIES,
INC., PETITIONER v. UNITED
STATES

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF
APPEALS FOR THE
FOURTH CIRCUIT

June 4, 2001

JUSTICE THOMAS, concurring.

I agree with the Court that the Internal Revenue Code provision and the corresponding Treasury Regulations that control consolidated filings are best interpreted as requiring a single-entity approach in calculating product liability loss. I write separately, however, because I respectfully disagree with the dissent’s suggestion that, when a provision of the Code and the corresponding regulations are ambiguous, this Court should defer to the Government’s interpretation. See *post*, at 1–2. At a bare minimum, in cases such as this one, in which the complex statutory and regulatory scheme lends itself to any number of interpretations, we should be inclined to rely on the traditional canon that construes revenue-raising laws against their drafter. See *Leavell v. Blades*, 237 Mo. 695, 700–701, 141 S.W. 893, 894 (1911) (“When the tax gatherer puts his finger on the citizen, he must also put his finger on the law permitting it”); *United States v. Merriam*, 263 U.S. 179, 188 (1923) (“If the words are doubtful, the doubt must be resolved against the Government and in favor of the taxpayer”); *Bowers v. New York & Albany Literage Co.*, 273 U.S. 346, 350 (1927) (“The provision is part of a taxing statute; and such laws are to be interpreted liberally in favor of the taxpayers”). Accord *American Net & Twine Co. v. Worthington*, 141 U.S. 468, 474 (1891); *Benziger v. United States*, 192 U.S. 38, 55 (1904).

**SUPREME COURT OF THE
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ON WRIT OF CERTIORARI TO THE
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APPEALS FOR THE
FOURTH CIRCUIT

June 4, 2001

JUSTICE STEVENS, dissenting.

This is a close and difficult case, in which neither the statute nor the regulations offer a definitive answer to the crucial textual question. Absent a clear textual anchor, I would credit the Secretary of the Treasury’s concerns about the po-

tential for abuse created by the petitioner’s reading of the statutory scheme and affirm the decision of the Court of Appeals on that basis.¹

As the majority accurately reports, during the time relevant to this case, Sec. 172(b)(1)(I) of the Internal Revenue Code of 1954 allowed any “taxpayer” who “ha[d] a product liability loss” to carry back its excess product liability losses for 10 years. The resolution of this case turns on whether, when a group of affiliated corporations files a consolidated tax return, the entire group should be considered the “taxpayer” for the purposes of implementing this provision or whether each individual corporation should be seen as a “taxpayer.”

There is no obvious answer to this question. On the one hand, it is generally accepted that the rationale behind the consolidated return regulations is to allow affiliated corporations that are run as a single-entity to elect to be treated for tax purposes as a single-entity. See, e.g., Brief for Petitioner 17–19 (collecting sources in which the Internal Revenue Service so stated). On the other hand, it is quite clear that each corporation in such a group remains in both a legal and a literal sense a “taxpayer,” a status that has important consequences. See *Woolford Realty Co. v. Rose*, 286 U.S. 319, 328 (1932) (“The fact is not to be ignored that each of two or more corporations joining . . . in a consolidated return is none the less a taxpayer”); 26 U.S.C. Sec. 7701(a)(14) (defining a “taxpayer” as “any person subject to any internal revenue tax,” where a related provision defines “person” to include corporations). As both the group and the individual corpora-

¹ JUSTICE THOMAS accurately points to a tradition of cases construing “revenue-raising laws” against their drafter. See *ante*, at 1 (THOMAS, J., concurring). However, when the ambiguous provision in question is not one that imposes tax liability but rather one that crafts an exception from a general revenue duty for the benefit of some taxpayers, a countervailing tradition suggests that the ambiguity should be resolved in the government’s favor. See, e.g., *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84 (1992); *Interstate Transit Lines v. Commissioner*, 319 U.S. 590, 593 (1943); *Deputy v. Du Pont*, 308 U.S. 488, 493 (1940); *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934); *Woolford Realty Co. v. Rose*, 286 U.S. 319, 326 (1932).

tions are considered “taxpayers” in different contexts, the statute presents a genuine ambiguity.

When a provision of the Internal Revenue Code presents a patent ambiguity, Congress, the courts, and the IRS share a preference for resolving the ambiguity via executive action. See, e.g., *National Muffler Dealers Assn., Inc. v. United States*, 440 U.S. 472, 477 (1979). This is best achieved by the issuing of a Treasury Regulation resolving the ambiguity. *Ibid.* In this instance, however, the Secretary of the Treasury issued no such regulation. In the absence of such a regulation, the majority has scoured tangentially related regulations, looking for clues to what the Secretary might intend. For want of a more precise basis for resolving this case, that approach is sound.

It is at this point, however, that I part company with the majority’s analysis. The fact that the regulations forward a particular method for calculating a consolidated “net operating loss” (NOL) for a group of affiliated companies, see Treas. Reg. Sec. 1.1502–21(f), tells us how the Secretary wants the NOL to be calculated whenever it is necessary to determine a consolidated NOL, but it does not tell us what provisions of the Code require the calculation of a consolidated NOL. That is a separate and prior question. Even if we were to draw some mild significance from the presence of such a regulation (and the absence, at the time these returns were filed, of a similar regulation for the calculation of corporation-specific NOL’s), the power of that inference is counterbalanced by the fact that the regulations listing deductions that must be reported at the consolidated level makes no mention of product liability expenses. See Treas. Reg. Sec. 1.1502–12; see also *H. Enterprises Int’l, Inc. v. Commissioner*, 105 T.C. 71, 85 (1995) (construing Treas. Reg. Sec. 1.1502–80(a) to provide “[w]here the consolidated return regulations do not require that corporations filing such returns be treated differently from the way separate entities would be treated, those corporations shall be treated as separate entities when applying provisions of the Code”). In addition, the subsequent promulgation of a method for calculating a corporation-

specific NOL (albeit for a different purpose), see Sec. 1.1502–79(a)(3) (defining “separate net operating loss”), demonstrates that there are no inherent problems implicit in undertaking such a calculation.

In short, I find no answer to this case in the text of the statute or in any Treasury Regulation.² However, the government does forward a valid policy concern that militates against petitioner’s construction of the statute: the fear of tax abuse. See Brief for United States 40–42. Put simply, the Government fears that currently unprofitable but previously profitable corporations might receive a substantial windfall simply by acquiring a corporation with significant product liability expenses but no product liability losses. See *id.*, at 40. On a subjective level, I find these concerns troubling. Cf. *Woolford Realty Co.*, 286 U.S., at 330 (rejecting “the notion that Congress in permitting a consolidated return was willing to foster an opportunity for juggling so facile and so obvious”). More importantly, however, I credit the Secretary of the Treasury’s concerns about the potential scope of abuse. Perhaps the Court is correct in suggesting that these concerns can be alleviated through applications of other anti-abuse provisions of the Tax Code, see *ante*, at 15, but I am not persuaded of my own ability to make that judgment. When we deal “with a subject that is highly specialized and so complex as to be the despair of judges,” *Dobson v. Commissioner*, 320 U.S. 489, 498 (1943), an ounce of deference is appropriate.

I respectfully dissent.³

² I am also in full agreement with the Court’s rejection of the Government’s double-deduction argument. See *ante*, at 11–12.

³ Because I agree with the majority that the calculation contemplated by Treas. Reg. Sec. 1.1502–79(a)(3) better approximates the NOL that each company would have had reported if filing individually than the alternative forwarded by the Government, see *ante*, at 10, I agree with the Court of Appeals’ decision to adopt that measure and would affirm the decision below in its entirety.

Section 3101.—Rate of Tax

Ct. D. 2071

SUPREME COURT OF THE UNITED STATES

No. 99–1978

UNITED STATES v. HATTER, JUDGE,
UNITED STATES DISTRICT COURT
FOR THE CENTRAL DISTRICT OF
CALIFORNIA, ET AL.

CERTIORARI TO THE UNITED
STATES COURT OF APPEALS FOR
THE FEDERAL CIRCUIT

May 21, 2001

Syllabus

In 1982, Congress extended Medicare to federal employees. That new law meant, *inter alia*, that then-sitting federal judges, like all other federal employees and most other citizens, began to have Medicare taxes withheld from their salaries. In 1983, Congress required all newly hired federal employees to participate in Social Security and permitted, without requiring, about 96% of the then-currently employed federal employees to participate in that program. The remaining 4%—a class consisting of the President, other high-level Government employees, and all federal judges—were required to participate, except that those who contributed to a “covered” retirement program could modify their participation in a manner that left their total payroll deduction for retirement and Social Security unchanged, in effect allowing them to avoid any additional financial obligation as a result of joining Social Security. A “covered” program was defined to include any retirement system to which an employee had to contribute, which did not encompass the noncontributory pension system for federal judges, whose financial obligations (and payroll deductions) therefore had to increase. A number of federal judges appointed before 1983 filed this suit, arguing that the 1983 law violated the Compensation Clause, which guarantees federal judges a “Compensation, which shall not be diminished during their Continuance in Office,” U.S. Const., Art. III, Sec. 1. Initially, the Court of Federal Claims ruled against the judges, but the Federal Circuit reversed. On cer-

tiorari, because some Justices were disqualified and this Court failed to find a quorum, the Federal Circuit's judgment was affirmed "with the same effect as upon affirmance by an equally divided court." 519 U.S. 801. On remand, the Court of Federal Claims found that the judges' Medicare claims were time barred and that a 1984 judicial salary increase promptly cured any violation, making damages minimal. The Federal Circuit reversed, holding that the Compensation Clause prevented the Government from collecting Medicare and Social Security taxes from the judges and that the violation was not cured by the 1984 pay increase.

Held:

1. The Compensation Clause prevents the Government from collecting Social Security taxes, but not Medicare taxes, from federal judges who held office before Congress extended those taxes to federal employees. Pp. 6–19.

(a) The Court rejects the judges' claim that the "law of the case" doctrine now prevents consideration of the Compensation Clause because an affirmance by an equally divided Court is conclusive and binding upon the parties. *United States v. Pink*, 315 U.S. 203, 216, on which the judges rely, concerned an earlier case in which the Court heard oral argument and apparently considered the merits before affirming by an equally divided Court. The law of the case doctrine presumes a hearing on the merits. See, e.g., *Quern v. Jordan*, 440 U.S. 332, 347, n. 18. When this case previously was here, due to absence of a quorum, the Court could not consider either the merits or whether to consider those merits through a grant of certiorari. This fact, along with the obvious difficulty of finding other equivalent substitute forums, convinces the Court that *Pink* does not control here. Pp. 6–7.

(b) Although the Compensation Clause prohibits taxation that singles out judges for specially unfavorable treatment, it does not forbid Congress to enact a law imposing a nondiscriminatory tax (including an increase in rates or a change in conditions) upon judges and other citizens. See *O'Malley v. Woodrough*, 307 U.S. 277, 282. Insofar as *Evans v. Gore*, 253 U.S. 245, 255, holds to the contrary, that case is overruled. See *O'Malley*,

supra, at 283. There is no good reason why a judge should not share the tax burdens borne by all citizens. See *Evans, supra*, at 265, 267 (Holmes, J., dissenting); *O'Malley, supra*, at 281–283. Although Congress cannot *directly* reduce judicial salaries even as part of an equitable effort to reduce *all* Government salaries, a tax law, unlike a law mandating a salary reduction, affects compensation indirectly, not directly. See *United States v. Will*, 449 U.S. 200, 226. And those prophylactic considerations that may justify an absolute rule forbidding direct salary reductions are absent here, where indirect taxation is at issue. In practice, the likelihood that a nondiscriminatory tax represents a disguised legislative effort to influence the judicial will is virtually nonexistent. Hence the potential threats to judicial independence that underlie the Compensation Clause, see *Evans, supra*, at 251–252, cannot justify a special judicial exemption from a commonly shared tax, not even as a preventive measure to counter those threats. Because the Medicare tax is nondiscriminatory, the Federal Circuit erred in finding its application to federal judges unconstitutional. Pp. 7–13.

(c) However, because the special retroactivity-related Social Security rules enacted in 1983 effectively singled out then-sitting federal judges for unfavorable treatment, the Compensation Clause forbids the application of the Social Security tax to those judges. Four features of the law, taken together, lead to the conclusion that it discriminates in a manner the Clause forbids. First, the statutory history, context, purpose, and language indicate that the category of "federal employees" is the appropriate class against which the asserted discrimination must be measured. Second, the practical upshot of defining "covered" system in the way the law did was to permit nearly every then-current federal employee, but not federal judges, to avoid the newly imposed obligation to pay Social Security taxes. Third, the new law imposed a substantial cost on federal judges with little or no expectation of substantial benefit for most of them. Inclusion meant a deduction of about \$2,000 per year, whereas 95% of the then-active judges had already qualified for Social Security (due to private sector employment) before becoming judges. And

participation would benefit only the minority of judges who had not worked the quarters necessary to be fully insured under Social Security. Fourth, the Government's sole justification for the statutory distinction between judges and other high-level federal employees—*i.e.*, equalizing the financial burdens imposed by the noncontributory judicial retirement system and the contributory system to which the other employees belonged—is unsound because such equalization takes place not by offering all current federal employees (including judges) the same opportunities, but by employing a statutory disadvantage which offsets an advantage related to those protections afforded judges by the Clause, and because the two systems are not equalized with any precision. Thus, the 1983 law is very different from the nondiscriminatory tax upheld in *O'Malley, supra*, at 282. The Government's additional arguments—that Article III protects judges only against a reduction in stated salary, not against indirect measures that only reduce take-home pay; that there is no evidence here that Congress singled out judges for special treatment in order to intimidate, influence, or punish them; and that the law disfavored not only judges but also the President and other high-ranking federal employees—are unconvincing. Pp. 13–19.

2. The Compensation Clause violation was not cured by the 1984 pay increase for federal judges. The context in which that increase took place reveals nothing to suggest that it was intended to make whole the losses sustained by the pre-1983 judges. Rather, everything in the record suggests that the increase was meant to halt a slide in purchasing power resulting from continued and unadjusted-for inflation. Although a circumstance-specific approach is more complex than the Government's proposed automatic approach, whereby a later salary increase would terminate a Compensation Clause violation regardless of the increase's purpose, there is no reason why such relief as damages or an exemption from Social Security would prove unworkable. *Will, supra*, distinguished. Pp. 19–22.

203 F.3d 795, affirmed in part, reversed in part, and remanded.

BREYER, J., delivered the opinion of the Court, in which REHNQUIST, C.J., and KENNEDY, SOUTER, and GINS-

BURG, JJ., joined, and in which SCALIA, J., joined as to Parts I, II, and V. SCALIA, J., filed an opinion concurring in part and dissenting in part. THOMAS, J., filed an opinion concurring in the judgment in part and dissenting in part. STEVENS, J., and O'CONNOR, J., took no part in the consideration or decision of the case.

**SUPREME COURT OF THE
UNITED STATES**

No. 99–1978

UNITED STATES, PETITIONER v.
TERRY J. HATTER, JR., JUDGE,
UNITED STATES DISTRICT COURT
FOR THE CENTRAL DISTRICT OF
CALIFORNIA, ET AL.

532 U.S. ___ (2001)

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF
APPEALS FOR THE FEDERAL
CIRCUIT

May 21, 2001

JUSTICE BREYER delivered the opinion of the Court.

The Constitution's Compensation Clause guarantees federal judges a "Compensation, which shall not be diminished during their Continuance in Office." U.S. Const., Art. III, Sec. 1. The Court of Appeals for the Federal Circuit held that this Clause prevents the Government from collecting certain Medicare and Social Security taxes from a small number of federal judges who held office nearly 20 years ago—before Congress extended the taxes to federal employees in the early 1980's.

In our view, the Clause does not prevent Congress from imposing a "non-discriminatory tax laid generally" upon judges and other citizens, *O'Malley v. Woodrough*, 307 U.S. 277, 282 (1939), but it does prohibit taxation that singles out judges for specially unfavorable treatment. Consequently, unlike the Court of Appeals, we conclude that Congress may apply the Medicare tax—a nondiscriminatory tax—to then-sitting federal judges. The special retroactivity-related Social Security rules that Congress enacted in 1984, however, effectively singled out then-sitting federal judges for unfavorable treatment. Hence, like the Court of Ap-

peals, we conclude that the Clause forbids the application of the Social Security tax to those judges.

I

A

The Medicare law before us is straightforward. In 1965, Congress created a Federal Medicare "hospital insurance" program and tied its financing to Social Security. See Social Security Amendments of 1965, 79 Stat. 291. The Medicare law required most American workers (whom Social Security covered) to pay an additional Medicare tax. But it did not require Federal Government employees (whom Social Security did not cover) to pay that tax. See 26 U.S.C. Sections 3121(b)(5), (6) (1982 ed.).

In 1982, Congress, believing that "[f]ederal workers should bear a more equitable share of the costs of financing the benefits to which many of them eventually became entitled," S. Rep. No. 97–494, pt. 1, p. 378 (1982), extended both Medicare eligibility and Medicare taxes to all currently employed federal employees as well as to all newly hired federal employees, Tax Equity and Fiscal Responsibility Act of 1982, Sec. 278, 96 Stat. 559–563. That new law meant that (as of January 1, 1983) all federal judges, like all other federal employees and most other citizens, would have to contribute between 1.30% and 1.45% of their federal salaries to Medicare's hospital insurance system. See 26 U.S.C. Sections 3101(b)(4)–(6).

The Social Security law before us is more complex. In 1935, Congress created the Social Security program. See Social Security Act, 49 Stat. 620. For nearly 50 years, that program covered employees in the private sector, but it did not cover Government employees. See 26 U.S.C. Sections 3121(b)(5), (6) (1982 ed.) (excluding federal employees); Sec. 3121(b)(7) (excluding state employees). In 1981, a National Commission on Social Security Reform, convened by the President and chaired by Alan Greenspan, noting the need for "action . . . to strengthen the financial status" of Social Security, recommended that Congress extend the program to cover Federal, but not state or local, Government employees. Report of the National Commission on

Social Security Reform 2–1, 2–7 (Jan. 1983). In particular, the Commission recommended that Congress *require* all incoming federal employees (those hired after January 1, 1984) to enter the Social Security system and to pay Social Security taxes. *Id.*, at 2–7. The Commission emphasized that "present Federal employees will *not* be affected by this recommendation." *Id.*, at 2–8.

In 1983, Congress enacted the Commission's recommendation into law (effective January 1, 1984) with an important exception. See Social Security Amendments of 1983, Sec. 101(b)(1), 97 Stat. 69 (amending 26 U.S.C. Sections 3121(b)(5), (6)). As the Commission had recommended, Congress *required* all newly hired federal employees to participate in the Social Security program. It also *permitted*, without requiring, almost all (about 96%) then-currently employed federal employees to participate.

Contrary to the Commission's recommendation, however, the law added an exception. That exception seemed to restrict the freedom of choice of the remaining 4% of all current employees. This class consisted of the President, Vice President, high-level Executive Branch employees, Members of Congress, a few other Legislative Branch employees, and all federal judges. See 42 U.S.C. Sections 410(a)(5)(C)–(G); see also H.R. Rep. No. 98–25, p. 39 (1983); H.R. Conf. Rep. No. 98–542, p. 13 (1983) (noting that for these current federal employees "the rules are being changed in the middle of the game"). The new law seemed to *require* this class of current federal employees to enter into the Social Security program, see 42 U.S.C. Sections 410(a)(5)(C)–(G). But, as to almost all of these employees, the new law imposed no additional financial obligation or burden.

That is because the new law then created an exception to the exception, see Federal Employees' Retirement Contribution Temporary Adjustment Act of 1983, Secs. 203(a)(2), 208, 97 Stat. 1107, 1111 (codified at note following 5 U.S.C. Sec. 8331). The exception to the exception said that any member of this small class of current high-level officials (4% of all then-current employees) who contributed to a "covered" retirement program nonetheless could choose to modify their participation in a manner that left their

total payroll deduction—for retirement and Social Security—unchanged. A “covered” employee paying 7% of salary to a “covered” program could continue to pay that 7% and no more, in effect avoiding any additional financial obligation as a result of joining Social Security.

The exception to the exception defined a “covered” program to include the Civil Service Retirement and Disability System—a program long available to almost all federal employees—as well as any other retirement system to which an employee must contribute. Secs. 203(a)(2)(A), (D). The definition of “covered” program, however, did not encompass the pension system for federal judges—a system that is noncontributory in respect to a judge (but contributory in respect to a spouse).

The upshot is that the 1983 law was specifically aimed at extending Social Security to federal employees. It left about 96% of those who were currently employed free to choose not to participate in Social Security, thereby avoiding any increased financial obligation. It required the remaining 4% to participate in Social Security while freeing them of any added financial obligation (or additional payroll deduction) so long as they previously had participated in other contributory retirement programs. But it left those who could not participate in a contributory program without a choice. Their financial obligations (and payroll deductions) had to increase. And this last mentioned group consisted almost exclusively of federal judges.

B

This litigation began in 1989, when eight federal judges, all appointed before 1983, sued the Government for “compensation” in the United States Claims Court. They argued that the 1983 law, in requiring them to pay Social Security taxes, violated the Compensation Clause. Initially, the Claims Court ruled against the judges on jurisdictional grounds. 21 Cl. Ct. 786 (1990). The Court of Appeals reversed. 953 F.2d 626 (CA Fed. 1992). On remand, eight more judges joined the lawsuit. They contested the extension to judges of the Medicare tax as well.

The Court of Federal Claims held against the judges on the merits. 31 Fed. Cl. 436 (1994). The Federal Circuit re-

versed, ordering summary judgment for the judges as to liability. 64 F.3d 647 (1995). The Government petitioned this Court for writ of certiorari. Some Members of this Court were disqualified from hearing the matter, and we failed to find a quorum of six Justices. See 28 U.S.C. Sec. 1. Consequently, the Court of Appeals’ judgment was affirmed “with the same effect as upon affirmance by an equally divided court.” 519 U.S. 801 (1996); see 28 U.S.C. Sec. 2109.

On remand from the Court of Appeals, the Court of Federal Claims found (a) that the 6-year statute of limitations, see 28 U.S.C. Sections 2401(a), 2501, barred some claims, including all Medicare claims; and (b) that, in any event, a subsequently enacted judicial salary increase promptly cured any violation, making damages minimal. 38 Fed. Cl. 166 (1997). The Court of Appeals (eventually en banc) reversed both determinations. 203 F.3d 795 (CA Fed. 2000).

The Government again petitioned for certiorari. It asked this Court to consider two questions:

(1) Whether Congress violated the Compensation Clause when it extended the Medicare and Social Security taxes to the salaries of sitting federal judges; and

(2) If so, whether any such violation ended when Congress subsequently increased the salaries of all federal judges by an amount greater than the new taxes.

Given the specific statutory provisions at issue and the passage of time, seven Members of this Court had (and now have) no financial stake in the outcome of this case. Consequently a quorum was, and is, available to consider the questions presented. And we granted the Government’s petition for writ of certiorari.

II

At the outset, the judges claim that the “law of the case” doctrine prevents us from now considering the first question presented, namely, the scope of the Compensation Clause. They note that the Government presented that same question in its petition from the Court of Appeals’ earlier ruling on liability. They point out that our earlier denial of that petition for lack of a quorum had the “same effect as” an “affirmance by an equally divided court,” 28 U.S.C. Sec. 2109. And they add that this Court has said that an affir-

mance by an equally divided Court is “conclusive and binding upon the parties as respects that controversy.” *United States v. Pink*, 315 U.S. 203, 216 (1942).

Pink, however, concerned a case, *United States v. Moscow Fire Ins. Co.*, 309 U.S. 624 (1940), in which this Court had heard oral argument and apparently considered the merits prior to concluding that affirmance by an equally divided Court was appropriate. The law of the case doctrine presumes a hearing on the merits. See, e.g., *Quern v. Jordan*, 440 U.S. 332, 347, n. 18 (1979). This case does not involve a previous consideration of the merits. Indeed, when this case previously was before us, due to absence of a quorum, we could not consider either the merits or whether to consider those merits through grant of a writ of certiorari. This fact, along with the obvious difficulty of finding other equivalent substitute forums, convinces us that *Pink’s* statement does not control the outcome here, that the “law of the case” doctrine does not prevent our considering both issues presented, and that we should now proceed to decide them.

III

The Court of Appeals upheld the judges’ claim of tax immunity upon the authority of *Evans v. Gore*, 253 U.S. 245 (1920). That case arose in 1919, when Judge Walter Evans challenged Congress’ authority to include sitting federal judges within the scope of a federal income tax law that the Sixteenth Amendment had authorized a few years earlier. See Revenue Act of 1918, Sec. 213, 40 Stat. 1065 (defining “gross income” to include judicial salaries). In *Evans* itself, the Court held that the Compensation Clause barred application of the tax to Evans, who had been appointed a judge before Congress enacted the tax. 253 U.S., at 264. A few years later, the Court extended *Evans*, making clear that its rationale covered not only judges appointed before Congress enacted a tax but also judges whose appointments took place after the tax had become law. See *Miles v. Graham*, 268 U.S. 501, 509 (1925).

Fourteen years after deciding *Miles*, this Court overruled *Miles*. *O’Malley v. Woodrough*, 307 U.S. 277 (1939). But, as the Court of Appeals noted, this Court did not expressly overrule *Evans* itself.

64 F.3d, at 650. The Court of Appeals added that if “changes in judicial doctrine” had significantly undermined *Evans*’ holding, this “Court itself would have overruled the case.” *Ibid.* Noting that this case is like *Evans* (involving judges appointed *before* enactment of the tax), not like *O’Malley* (involving judges appointed *after* enactment of the tax), the Court of Appeals held that *Evans* controlled the outcome. 64 F.3d, at 650. Hence application of both Medicare and Social Security taxes to these pre-enactment judges violated the Compensation Clause.

The Court of Appeals was correct in applying *Evans* to the instant case, given that “it is this Court’s prerogative alone to overrule one of its precedents.” *State Oil Co. v. Khan*, 522 U.S. 3, 20 (1997); see also *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477, 484 (1989). Nonetheless, the court below, in effect, has invited us to reconsider *Evans*. We now overrule *Evans* insofar as it holds that the Compensation Clause forbids Congress to apply a generally applicable, nondiscriminatory tax to the salaries of federal judges, whether or not they were appointed before enactment of the tax.

The Court’s opinion in *Evans* began by explaining why the Compensation Clause is constitutionally important, and we begin by reaffirming that explanation. As *Evans* points out, 253 U.S., at 251–252, the Compensation Clause, along with the Clause securing federal judges appointments “during good Behavior,” U.S. Const., Art. III, Sec. 1—the practical equivalent of life tenure—helps to guarantee what Alexander Hamilton called the “complete independence of the courts of justice.” The Federalist No. 78, p. 466 (C. Rossiter ed. 1961). Hamilton thought these guarantees necessary because the Judiciary is “beyond comparison the weakest of the three” branches of government. *Id.*, at 465–466. It has “no influence over either the sword or the purse.” *Id.*, at 465. It has “no direction either of the strength or of the wealth of the society.” *Ibid.* It has “neither FORCE nor WILL but merely judgment.” *Ibid.*

Hamilton’s view, and that of many other Founders, was informed by firsthand experience of the harmful consequences brought about when a King of

England “made Judges dependent on his Will alone, for the tenure of their offices, and the amount and payment of their salaries.” The Declaration of Independence, Par. 11. And Hamilton knew that “a power over a man’s subsistence amounts to a power over his will.” The Federalist No. 79, at 472. For this reason, he observed, “[n]ext to permanency in office, nothing can contribute more to the independence of the judges than a fixed provision for their support.” *Ibid.*; see also *id.*, No. 48 at 310 (J. Madison) (“[A]s the legislative department alone has access to the pockets of the people, and has . . . full discretion . . . over the pecuniary rewards of those who fill the other departments, a dependence is thus created in the latter, which gives still greater facility to encroachments of the former”).

Evans properly added that these guarantees of compensation and life tenure exist, “not to benefit the judges,” but “as a limitation imposed in the public interest.” 253 U.S., at 253. They “promote the public weal,” *id.*, at 248, in part by helping to induce “learned” men and women “to quit the lucrative pursuits” of the private sector, 1 J. Kent, Commentaries on American Law *294, but more importantly by helping to secure an independence of mind and spirit necessary if judges are “to maintain that nice adjustment between individual rights and governmental powers which constitutes political liberty,” W. Wilson, Constitutional Government in the United States 143 (1911).

Chief Justice John Marshall pointed out why this protection is important. A judge may have to decide “between the Government and the man whom that Government is prosecuting: between the most powerful individual in the community, and the poorest and most unpopular.” Proceedings and Debates of the Virginia State Convention, of 1829–1830, p. 616 (1830). A judge’s decision may affect an individual’s “property, his reputation, his life, his all.” *Ibid.* In the “exercise of these duties,” the judge must “observe the utmost fairness.” *Ibid.* The judge must be “perfectly and completely independent, with nothing to influence or contro[ll] him but God and his conscience.” *Ibid.* The “greatest scourge . . . ever inflicted,” Marshall thought, “was an ignorant, a corrupt, or a dependent Judiciary.” *Id.*, at 619.

Those who founded the Republic recognized the importance of these constitutional principles. See, e.g., Wilson, Lectures on Law (1791), in 1 Works of James Wilson 363 (J. Andrews ed. 1896); (stating that judges should be “completely independent” in “their salaries, and in their offices”); McKean, Debate in Pennsylvania Ratifying Convention, Dec. 11, 1787, in 2 Debates on the Federal Constitution 539 (J. Elliot ed. 1836) (the security of undiminished compensation disposes judges to be “more easy and independent”); see also 1 Kent, *supra*, at *294 (“permanent support” and the “tenure of their office” “is well calculated . . . to give [judges] the requisite independence”). They are no less important today than in earlier times. And the fact that we overrule *Evans* does not, in our view, diminish their importance.

We also agree with *Evans* insofar as it holds that the Compensation Clause offers protections that extend beyond a legislative effort directly to diminish a judge’s pay, say by ordering a lower salary. 253 U.S., at 254. Otherwise a legislature could circumvent even the most basic Compensation Clause protection by enacting a discriminatory tax law, for example, that precisely but indirectly achieved the forbidden effect.

Nonetheless, we disagree with *Evans*’ application of Compensation Clause principles to the matter before it—a nondiscriminatory tax that treated judges the same way it treated other citizens. *Evans*’ basic holding was that the Compensation Clause forbids such a tax because the Clause forbids “all diminution,” including “taxation,” “whether for one purpose or another.” *Id.*, at 255. The Federal Circuit relied upon this holding. 64 F.3d, at 650. But, in our view, it is no longer sound law.

For one thing, the dissenters in *Evans* cast the majority’s reasoning into doubt. Justice Holmes, joined by Justice Brandeis, wrote that the Compensation Clause offers “no reason for exonerating” a judge “from the ordinary duties of a citizen, which he shares with all others. To require a man to pay the taxes that all other men have to pay cannot possibly be made an instrument to attack his independence as a judge.” *Evans*, 253 U.S., at 265. Holmes analogized the “diminution” that a tax might bring about to the burden that a state law might impose upon interstate

commerce. If “there was no discrimination against such commerce, the tax constituted one of the ordinary burdens of government from which parties were not exempted.” *Id.*, at 267.

For another thing, this Court’s subsequent law repudiated *Evans*’ reasoning. In 1939, 14 years after *Miles* extended *Evans*’ tax immunity to judges appointed after enactment of the tax, this Court retreated from that extension. See *O’Malley*, 307 U.S., at 283 (overruling *Miles*). And in so doing the Court, in an opinion announced by Justice Frankfurter, adopted the reasoning of the *Evans* dissent. The Court said that the question was whether judges are immune “from the incidences of taxation to which everyone else within the defined classes . . . is subjected.” *Id.*, at 282. Holding that judges are not “immun[e] from sharing with their fellow citizens the material burden of the government,” *ibid.*, the Court pointed out that the legal profession had criticized *Evans*’ contrary conclusion, and that courts outside the United States had resolved similar matters differently, *id.*, at 281. And the Court concluded that “a nondiscriminatory tax laid generally on net income is not, when applied to the income of a federal judge, a diminution of his salary within the prohibition of Article III.” *Id.*, at 282. The Court conceded that *Miles* had reached the opposite conclusion, but it said that *Miles* “cannot survive.” 307 U.S., at 283. Still later, this Court noted that “[b]ecause *Miles* relied on *Evans v. Gore*, *O’Malley* must also be read to undermine the reasoning of *Evans*.” *United States v. Will*, 449 U.S. 200, 227, n. 31 (1980).

Finally, and most importantly, we believe that the reasoning of Justices Holmes and Brandeis, and of this Court in *O’Malley*, is correct. There is no good reason why a judge should not share the tax burdens borne by *all* citizens. We concede that this Court has held that the Legislature cannot *directly* reduce judicial salaries even as part of an equitable effort to reduce *all* Government salaries. See 449 U.S., at 226. But a tax law, unlike a law mandating a salary reduction, affects compensation indirectly, not directly. See *ibid.* (distinguishing between measures that directly and those that indirectly diminish judicial compensation). And those prophylactic considerations that may jus-

tify an absolute rule forbidding direct salary reductions are absent here, where indirect taxation is at issue. In practice, the likelihood that a nondiscriminatory tax represents a disguised legislative effort to influence the judicial will is virtually nonexistent. Hence, the potential threats to judicial independence that underlie the Constitution’s compensation guarantee cannot justify a special judicial exemption from a commonly shared tax, not even as a preventive measure to counter those threats.

For these reasons, we hold that the Compensation Clause does not forbid Congress to enact a law imposing a nondiscriminatory tax (including an increase in rates or a change in conditions) upon judges, whether those judges were appointed before or after the tax law in question was enacted or took effect. Insofar as *Evans* holds to the contrary, that case, in *O’Malley*’s words, “cannot survive.” 307 U.S., at 283.

The Government points out that the Medicare tax is just such a nondiscriminatory tax. Neither the courts below, nor the federal judges here, argue to the contrary. Hence, insofar as the Court of Appeals found that application of the Medicare tax law to federal judges is unconstitutional, we reverse its decision.

IV

The Social Security tax is a different matter. Respondents argue that the 1983 law imposing that tax upon then-sitting judges violates the Compensation Clause, for it discriminates against judges in a manner forbidden by the Clause, even as interpreted in *O’Malley*, not *Evans*. Cf. *O’Malley*, *supra*, at 282 (stating question as whether judges are immune “from the incidences of taxation to which everyone else within the defined classes . . . is subjected” (emphasis added)). After examining the statute’s details, we agree with the judges that it does discriminate in a manner that the Clause forbids. Four features of the law, taken together, lead us to this conclusion.

First, federal employees had remained outside the Social Security system for nearly 50 years prior to the passage of the 1983 law. Congress enacted the law pursuant to the Social Security Commission’s recommendation to bring those employees within the law. See *supra*, at 3. And

the law itself deals primarily with that subject. Thus, history, context, statutory purpose, and statutory language, taken together, indicate that the category of “federal employees” is the appropriate class against which we must measure the asserted discrimination.

Second, the law, as applied in practice, in effect imposed a new financial obligation upon sitting judges, but it did not impose a new financial burden upon any other group of (then) current federal employees. We have previously explained why that is so. See *supra*, at 3–5. The law required all newly hired federal employees to join Social Security and pay related taxes. It gave 96% of all current employees (employed as of January 1, 1984 or earlier) total freedom to enter, or not to enter, the system as they chose. It gave the remaining 4% of all current employees the freedom to maintain their pre-1984 payroll deductions, provided that they were currently enrolled in a “covered” system. And it defined “covered” system in a way that included virtually all of that 4%, except for federal judges. See *supra*, at 4–5. The practical upshot is that the law permitted nearly every current federal employee, but not federal judges, to avoid the newly imposed financial obligation.

Third, the law, by including sitting judges in the system, adversely affected most of them. Inclusion meant a requirement to pay a tax of about \$2,000 per year, deducted from a monthly salary check. App. 49. At the same time, 95% of the then-active judges had already qualified for Social Security (due to private sector employment) before becoming judges. See *id.*, at 115. And participation in Social Security as judges would benefit only a minority. See *id.*, at 116–119 (reviewing examples of individual judges and demonstrating that participation in Social Security primarily would benefit the minority of judges who had not worked the 40 quarters necessary to be fully insured). The new law imposed a substantial cost on federal judges with little or no expectation of substantial benefit for most of them.

Fourth, when measured against Compensation Clause objectives, the Government’s justification for the statutory distinction (between judges, who do, and other federal employees, who do not,

incur additional financial obligations) is unsound. The sole justification, according to the Government, is one of “equaliz[ing]” the retirement-related obligations that pre-1983 law imposed upon judges with the retirement-related obligations that pre-1983 law imposed upon other current high-level federal employees. Brief for United States 40. Thus, the Government says that the new financial burden imposed upon judges was meant to make up for the fact that the judicial retirement system is basically a noncontributory system, while the system to which other federal employees belonged was a contributory system. *Id.*, at 39–40; Reply Brief for United States 16.

This rationale, however, is the Government’s and not necessarily that of Congress, which was silent on the matter. Cf. *Motor Vehicle Mfrs. Assn. of United States, Inc. v. State Farm Mut. Automobile Ins. Co.*, 463 U.S. 29, 50 (1983) (expressing concern at crediting *post hoc* explanation of agency action).

More importantly, the judicial retirement system is noncontributory because it reflects the fact that the Constitution itself guarantees federal judges life tenure—thereby constitutionally permitting federal judges to draw a salary for life simply by continuing to serve. Cf. *Booth v. United States*, 291 U.S. 339, 352 (1934) (holding that Compensation Clause protects salary of judge who has retired). That fact means that a contributory system, in all likelihood, would not work. And, of course, as of 1982, the noncontributory pension salary benefits were themselves part of the judge’s compensation. The 1983 statute consequently singles out judges for adverse treatment solely because of a feature required by the Constitution to preserve judicial independence. At the same time, the “equaliz[ation]” in question takes place not by offering all current federal employees (including judges) the same opportunities but by employing a statutory disadvantage which offsets a constitutionally guaranteed advantage. Hence, to accept the “justification” offered here is to permit, through similar reasoning, taxes which have the effect of weakening or eliminating those constitutional guarantees necessary to secure judicial independence, at least insofar as similar guarantees are not enjoyed by others. This point

would be obvious were Congress, say, to deny some of the benefits of a tax reduction to those with constitutionally guaranteed life tenure to make up for the fact that other employees lack such tenure. Although the relationships here—among advantages and disadvantages—are less distant and more complex, the principle is similar.

Nor does the statute “equaliz[e]” with any precision. On the one hand, the then-current retirement system open to all federal employees except judges required a typical employee to contribute 7% to 8% of his or her annual salary. See generally 5 U.S.C. Sec. 8334(a)(1). In return it provided a Member of Congress, for instance, with a pension that vested after five years and increased in value (by 2.5% of the Member’s average salary) with each year of service to a maximum of 80% of salary, and covered both employee and survivors. See 5 U.S.C. Sections 8339, 8341. On the other hand, the judges’ retirement system (based on life tenure) required no contribution for a judge who retired at age 65 (and who met certain service requirements) to receive full salary. But the right to receive that salary did not vest until retirement. The system provided nothing for a judge who left office before age 65. Nor did the law provide any coverage for a judge’s survivors. Indeed, in 1984, a judge had to contribute 4.5% of annual salary to obtain a survivor’s annuity, which increased in value by 1.25% of the judge’s salary per year to a maximum of 40% of salary. 28 U.S.C. Sections 376(b), (1) (1982 ed.).

These two systems were not equal either before or after Congress enacted the 1983 law. Before 1983, a typical married federal employee other than a judge had to contribute 7 to 8% of annual salary to receive benefits that were better in some respects (vesting period, spousal benefit) and worse in some respects (80% salary maximum) than his married judicial counterpart would receive in return for a 4.5% contribution. The 1983 law imposed an added 5.7% burden upon the judge, in return for which the typical judge received little, or no, financial benefit. Viewed purely in financial equalization terms, and as applied to typical judges, the new requirement seems to over-equalize, putting the typical married judge at a financial disadvantage—though perhaps it would

produce greater equality when applied to other, less typical examples.

Taken together, these four characteristics reveal a law that is special—in its manner of singling out judges for disadvantageous treatment, in its justification as necessary to offset advantages related to constitutionally protected features of the judicial office, and in the degree of permissible legislative discretion that would have to underlie any determination that the legislation has “equalized” rather than gone too far. For these reasons, the law before us is very different from the “nondiscriminatory” tax that *O’Malley* upheld. 307 U.S., at 282. Were the Compensation Clause to permit Congress to enact a discriminatory law with these features, it would authorize the Legislature to diminish, or to equalize away, those very characteristics of the Judicial Branch that Article III guarantees—characteristics which, as we have said, see *supra*, at 9–10, the public needs to secure that judicial independence upon which its rights depend. We consequently conclude that the 1983 Social Security tax law discriminates against the Judicial Branch, in violation of the Compensation Clause.

The Government makes additional arguments in support of reversal. But we find them unconvincing. It suggests that Article III protects judges only against a reduction in stated salary, not against indirect measures that only reduce take-home pay. Brief for United States 28. In *O’Malley*, however, this Court, when upholding a “nondiscriminatory” tax, strongly implied that the Compensation Clause would bar a discriminatory tax. 307 U.S., at 282. The commentators whose work *O’Malley* cited said so explicitly. See Fellman, *The Diminution of Judicial Salaries*, 24 Iowa L. Rev. 89, 99 (1938); see also Hall, *Case Comment*, 20 Ill. L. Rev. 376, 377 (1925); Corwin, *Constitutional Law in 1919–1920*, 14 Am. Pol. Sci. Rev. 635, 642 (1920). And in *Will*, the Court yet more strongly indicated that the Compensation Clause bars indirect efforts to reduce judges’ salaries through taxes when those taxes discriminate. 449 U.S., at 226. Indeed, the Government itself “assume[s] that discriminatory taxation of judges would contravene fundamental principles underlying Article III, if not the [Compensation] Clause itself.” Brief for United States 37, n. 27.

The Government also argues that there is no evidence here that Congress singled out judges for special treatment in order to intimidate, influence, or punish them. But, this Court has never insisted upon such evidence. To require it is to invite legislative efforts that embody, but lack evidence of, some such intent, engendering suspicion among the branches and consequently undermining that mutual respect that the Constitution demands. Cf. Wilson, Lectures on Law, in 1 Works of James Wilson, at 364 (stating that judges “should be removed from the most distant apprehension of being affected, in their judicial character and capacity, by anything, except their own behavior and its consequences”). Nothing in the record discloses anything other than benign congressional motives. If the Compensation Clause is to offer meaningful protection, however, we cannot limit that protection to instances in which the Legislature manifests, say, direct hostility to the Judiciary.

Finally, the Government correctly points out that the law disfavored not only judges but also the President of the United States and certain Legislative Branch employees. As far as we can determine, however, all Legislative Branch employees were free to join a covered system, and the record provides us with no example of any current Legislative Branch employee who had failed to do so. See Tr. of Oral Arg. 16–17, 37–38. The President’s pension is noncontributory. See note following 3 U.S.C. Sec. 102. And the President himself, like the judges, is protected against diminution in his “[c]ompensation.” See U.S. Const., Art. II, Sec. 1. These facts may help establish congressional good faith. But, as we have said, we do not doubt that good faith. And we do not see why, otherwise, the separate and special example of that single individual, the President, should make a critical difference here.

We conclude that, insofar as the 1983 statute required then-sitting judges to join the Social Security System and pay Social Security taxes, that statute violates the Compensation Clause.

V

The second question presented is whether the

“constitutional violation ended when Congress increased the statutory salaries of federal judges by an amount greater than the amount [of the Social Security] taxes deducted from respondents’ judicial salaries.” Pet. for Cert. (I).

The Government argues for an affirmative answer. It points to a statutory salary increase that all judges received in 1984. It says that this increase, subsequent to the imposition of Social Security taxes on judges’ salaries, cured any earlier unconstitutional diminution of salaries in a lesser amount. Otherwise, if “Congress improperly reduced judges salaries from \$140,000” per year “to \$130,000” per year, the judges would be able to collect the amount of the improper reduction, here \$10,000, forever—even if Congress cured the improper reduction by raising salaries \$20,000, to \$150,000, a year later. Reply Brief for United States 18. To avoid this consequence, the Government argues, we should simply look to the fact of a later salary increase “whether or not one of Congress’s purposes in increasing the salaries” was “to terminate the constitutional violation.” *Ibid.*

But how could we always decide whether a later salary increase terminates a constitutional violation without examining the purpose of that increase? Imagine a violation that affected only a few. To accept the Government’s position, would leave those few at a permanent salary disadvantage. If, for example, Congress reduced the salaries of one group of judges by 20%, a later increase of 30% applicable to all judges would leave the first group permanently 20% behind. And a pay cut that left those judges at a permanent disadvantage, would perpetuate the very harm that the Compensation Clause seeks to prevent.

The Court of Appeals consequently examined the context in which the later pay increases took place in order to determine their relation to the earlier Compensation Clause violation. It found “nothing to suggest” that the later salary increase at issue here sought “to make whole the losses sustained by the pre-1983 judges.” 185 F.3d, at 1362–1363. The Government presents no evidence to the contrary.

The relevant economic circumstances surrounding the 1984, and subsequent, salary increases include inflation suffi-

ciently serious to erode the real value of judicial salaries and salary increases insufficient to maintain real salaries or real compensation parity with many other private-sector employees. See Report of 1989 Commission on Executive, Legislative, and Judicial Salaries, Hearings before the Senate Committee on Governmental Affairs, 101st Cong., 1st Sess., 12–13 (1989) (testimony of Lloyd Cutler regarding effect of inflation on judges’ salaries since 1969). For instance, while consumer prices rose 363% between 1969 and 1999, salaries in the private sector rose 421%, and salaries for district judges rose 253%. See American Bar Association, Federal Judicial Pay Erosion 11 (Feb. 2001). These figures strongly suggest that the judicial salary increases simply reflected a congressional effort to restore both to judges and to Members of Congress themselves some, but not all, of the real compensation that inflation had eroded. Those salary increases amounted to a congressional effort to adjust judicial salaries to reflect “fluctuations in the value of money,” The Federalist No. 79, at 473 (A. Hamilton)—the kind of adjustment that the Founders believed “may be requisite,” McKean, Debate in Pennsylvania Ratifying Convention, Dec. 11, 1787, in 2 Debates on the Federal Constitution, at 539; see also Rosenn, The Constitutional Guaranty Against Diminution of Judicial Compensation, 24 UCLA L. Rev. 308, 314–315 (1976).

We have found nothing to the contrary. And, we therefore agree with the Court of Appeals’ similar conclusion. 185 F.3d at 1363 (“[E]verything in the record” suggests that the increase was meant to halt “the slide in purchasing power resulting from continued and unadjusted-for inflation”).

The Government says that a circumstance-specific approach may prove difficult to administer. Brief for United States 43. And we concede that examining the circumstances in order to determine whether there is or is not a relation between an earlier violation and a later increase is more complex than the Government’s proposed automatic approach. But we see no reason why such relief as damages or an exemption from Social Security would prove unworkable.

Finally, the Government looks to our decision in *Will* for support. In that case,

SUPREME COURT OF THE
UNITED STATES

No. 99–1978

UNITED STATES, PETITIONER v.
TERRY J. HATTER, JR., JUDGE,
UNITED STATES DISTRICT COURT
FOR THE CENTRAL DISTRICT OF
CALIFORNIA, ET AL.

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF
APPEALS FOR THE
FEDERAL CIRCUIT

May 21, 2001

JUSTICE SCALIA, concurring in part
and dissenting in part.

I agree with the Court that extending the Social Security tax to sitting Article III judges in 1984 violated Article III's Compensation Clause. I part paths with the Court on the issue of extending the Medicare tax to federal judges in 1983, which I think was also unconstitutional.¹

I

As an initial matter, I think the Court is right in concluding that *Evans v. Gore*, 253 U.S. 245 (1920)—holding that new taxes of general applicability cannot be applied to sitting Article III judges—is no longer good law, and should be overruled. We went out of our way in *O'Malley v. Woodrough*, 307 U.S. 277, 280–281 (1939), to catalog criticism of *Evans*, and subsequently recognized, in *United States v. Will*, 449 U.S. 200, 227, and n. 31 (1980), that *O'Malley* had “undermine[d] the reasoning of *Evans*.” The Court's decision today simply recognizes what should be obvious: that *Evans* has not only been undermined, but has in fact collapsed.

II

My disagreement with the Court arises from its focus upon the issue of discrimination, which turns out to be dispositive with respect to the Medicare tax. The

federal judges challenged the constitutionality of certain legislative “freezes” that Congress had imposed upon earlier enacted Government-wide cost-of-living salary adjustments. The Court found a Compensation Clause violation in respect to the freeze for what was designated Year One (where Congress had rescinded an earlier-voted 4.8% salary increase). *Will*, 449 U.S., at 225–226. The Government points out that the *Will* Court “noted that Congress, later in that fiscal year, enacted a statutory increase in judges' salaries that exceeded the salaries that judges would have received” without the rescission. Brief for United States 41. And the Government adds that “it was unquestioned in *Will*” that the judges could not receive damages for the time subsequent to this later enactment. *Id.*, at 41–42.

The *Will* Year One example, however, shows only that, in the circumstances, and unlike the case before us, the later salary increase was related to the earlier salary diminishment. Regardless, the very fact that the matter was “unquestioned” in *Will* shows that it was not argued. See 449 U.S., at 206, n. 3 (noting that the judges' complaint sought relief for Year One's diminution only up to the moment of the subsequent salary increase). Hence, the Court did not decide the matter now before us.

We conclude that later statutory salary increases did not cure the preceding unconstitutional harm.

VI

Insofar as the Court of Appeals found the application of Medicare taxes to the salaries of judges taking office before 1983 unconstitutional, its judgment is reversed. Insofar as that court found the application of Social Security taxes to the salaries of judges taking office before 1984 unconstitutional, its judgment is affirmed. We also affirm the Court of Appeals' determination that the 1984 salary increase received by federal judges did not cure the Compensation Clause violation. The case is remanded for further proceedings consistent with this opinion.

It is so ordered.

JUSTICE STEVENS and JUSTICE O'CONNOR took no part in the consideration or decision of this case.

¹ I agree with the Court, see Part II, *ante*, that the law-of-the-case doctrine does not bar our consideration of the merits. I also join the Court in holding, see Part V, *ante*, that any constitutional violation was not remedied by subsequent salary increases.

Court holds “that the Compensation Clause does not forbid Congress to enact a law imposing a nondiscriminatory tax . . . upon judges, whether those judges were appointed before or after the tax law in question was enacted or took effect.” *Ante*, at 12. Since “the Medicare tax is just such a nondiscriminatory tax,” the Court concludes that “application of [that] tax law to federal judges is [c]onstitutional.” *Ante*, at 12–13.

But we are dealing here with a “Compensation Clause,” not a “Discrimination Clause.” See U.S. Const., Art III, Sec. 1 (“The Judges . . . shall, at stated Times, receive for their Services, a Compensation, which shall not be diminished during their Continuance in Office”). As we have said, “the Constitution makes no exceptions for ‘nondiscriminatory’ reductions” in judicial compensation, *Will, supra*, at 226. A reduction in compensation is a reduction in compensation, even if all federal employees are subjected to the same cut. The discrimination criterion that the Court uses would make sense if the only purpose of the Compensation Clause were to prevent invidious (and possibly coercive) action against judges. But as the Court acknowledges, the Clause “‘promote[s] the public weal’ . . . by helping to induce ‘learned’ men and women to ‘quit the lucrative pursuits’ of the private sector,” *ante*, at 9 (quoting *Evans, supra*, at 248; 1 J. Kent, Commentaries on American Law *294). That inducement would not exist if Congress could cut judicial salaries so long as it did not do so discriminatorily.

What the question comes down to, then, is (1) whether exemption from a certain tax can constitute part of a judge's “compensation,” and (2) if so, whether exemption from the Medicare tax was part of the judges' compensation here. The answer to the more general question seems to me obviously yes. Surely the term “compensation” refers to the entire “package” of benefits—not just cash, but retirement benefits, medical care, and exemption from taxation if that is part of the employment package. It is simply unreasonable to think than “\$150,000 a year tax-free” (if that was the bargain struck) is not higher compensation than “\$150,000 a year subject to taxes.” Ask the employees of the World Bank.

The more difficult question—though far from an insoluble one—is *when* an exemption from tax constitutes compensation. In most cases, the presence or absence of taxation upon wages, like the presence or absence of many other factors within the control of government—inflation, for example, or the rates charged by government-owned utilities, or import duties that increase consumer prices—affects the *value* of compensation, but is not an element of compensation itself. The Framers had this distinction well in mind. Hamilton, for example, wrote that as a result of “the fluctuations in the value of money,” “[i]t was . . . necessary to leave it to the discretion of the legislature to vary its provisions” for judicial compensation. The Federalist No. 79, p. 473 (C. Rossiter, ed. 1961); see also *Will*, *supra*, at 227 (the Constitution “placed faith in the integrity and sound judgment of the elected representatives to enact increases” in judicial salaries to account for inflation). Since Hamilton thought that the Compensation Clause “put it out of the power of [Congress] to change the condition of the individual [judge] for the worse,” The Federalist No. 79, at 473, he obviously believed that inflation does not diminish compensation as that term is used in the Constitution.

This distinction between Government action affecting compensation and Government action affecting the *value* of compensation was the basis for our statement in *O’Malley*, 307 U.S., at 282, that “[t]o subject [judges] to a general tax is merely to recognize that judges are also citizens, and that their particular function in government does not generate an immunity from sharing with their fellow citizens the material burden of the government. . . .” I agree with the Court, therefore, that *Evans* was wrongly decided—not, however, because in *Evans* there was no discrimination, but because in *Evans* the universal application of the tax *demonstrated* that the Government was not reducing the compensation of its judges but was acting as sovereign rather than employer, imposing a general tax.

But just as it is clear that a federal employee’s sharing of a tax-free status that all citizens enjoy is not compensation (and elimination of that tax-free status

not a reduction in compensation), so also it is clear that a tax-free status conditioned on federal employment *is* compensation, and its elimination a reduction. The Court apparently acknowledges that if a tax is *imposed* on the basis of federal employment (an income tax, for example, payable only by federal judges) it would constitute a *reduction* in compensation. It is impossible to understand why a tax that is *suspended* on the basis of federal employment (an exemption from federal income tax for federal judges) does not constitute the *conferral* of compensation—in which case its elimination is a *reduction*, whether or not federal judges end up being taxed just like other citizens. Only converting the Compensation Clause into a Discrimination Clause can explain a contrary conclusion.

And this, of course, is what has been achieved by the targeted extension of the Medicare tax to federal employees who were previously exempt. It may well be that, in some abstract sense, they are not being “discriminated against,” since they end up being taxed like other citizens; but this does not alter the fact that, since exemption from the tax was part of their employment package—since they had an employment expectation of a preferential exemption from taxation—their *compensation* was being reduced. One of the benefits of being a federal judge (or any federal employee) had, prior to 1982, been an exemption from the Medicare tax. This benefit Congress took away, much as a private employer might terminate a contractual commitment to pay Medicare taxes on behalf of its employees. The latter would clearly be a cut in compensation, and so is the former.² Had Congress simply imposed the Medicare tax on its

² As the Court explains, the purpose of the Medicare tax extension was to ensure that federal workers “bear a more equitable share of the costs of financing the benefits to which many of them eventually became entitled” by reason of their own or their spouses’ private-sector employment. *Ante*, at 2 (internal quotation marks and citation omitted). As with the Social Security tax, therefore, the Medicare tax aspect of this case does not present the situation in which a tax exemption has been eliminated in return for some other benefit, different in kind but equivalent in value. Cf. *Ante*, at 14 (“[P]articipation in Social Security as judges would benefit only a minority”).

own employees (including judges) at the time it introduced that tax for other working people, no benefit of federal employment would have been reduced, because, with respect to the newly introduced tax, none had ever existed. But an extension to federal employees of a tax from which they had previously been exempt *by reason of their employment status*, seems to me a flat-out reduction of federal employment compensation.

III

As should be clear from the above, though I agree with the Court that the extension of the Social Security tax to federal judges runs afoul of the Compensation Clause, I disagree with the Court’s grounding of this holding on the discriminatory manner in which the extension occurred. In this part of its opinion, however, the Court’s antidiscrimination rationale is slightly different from that which appeared in its discussion of the Medicare tax. There, the focus was on discrimination compared with ordinary citizens; here, the focus is on discrimination vis-a-vis other federal employees. (As the Court explains, federal judges, unlike nearly all other federal employees, were not given the opportunity to opt out of paying the tax). On my analysis, it would not matter if every federal employee had been made subject to the Social Security tax along with judges, so long as one of the previous entitlements of their federal employment had been exemption from that tax. Federal judges, unlike all other federal employees except the President, see Art. II, Sec. 1, cl. 7, cannot, consistent with the Constitution, have their compensation diminished. If this case involved salary cuts to pay for Social Security, rather than taxes to pay for Social Security, the irrelevance of whether other federal employees were covered by the operative legislation would be clear.

* * *

I join in the judgment that extension of the Social Security tax to sitting Article III judges was unconstitutional. I would affirm the Federal Circuit’s holding that extension of the Medicare tax was unconstitutional as well.

**SUPREME COURT OF THE
UNITED STATES**

No. 99–1978

UNITED STATES, PETITIONER v.
TERRY J. HATTER, JR., JUDGE,
UNITED STATES DISTRICT COURT
FOR THE CENTRAL DISTRICT OF
CALIFORNIA, ET AL.

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF
APPEALS FOR THE
FEDERAL CIRCUIT

May 21, 2001

JUSTICE THOMAS, concurring in the
judgment in part and dissenting in part.

I believe this Court was correct in
Evans v. Gore, 253 U.S. 245 (1920), when
it held that any tax that reduces a judge’s
net compensation violates Article III of
the Constitution. Accordingly, I would
affirm the judgment of the Court of Ap-
peals in its entirety.

Part III. Administrative, Procedural, and Miscellaneous

Proposed Audit Guidance for External Auditors of Qualified Intermediaries

Notice 2001-66

This notice requests comments on the attached proposed audit guidelines for qualified intermediaries (QI). QI's are a key component of the withholding and reporting regulations that became effective on January 1, 2001 (T.D. 8734, 1997-2 C.B. 109 and T.D. 8881, 2000-23 I.R.B. 1158).

I. BACKGROUND

Generally, a QI is a non-U.S. financial institution that has entered into a contractual agreement with the Internal Revenue Service (IRS). Under the agreement, the QI generally agrees to report annually certain aggregate information concerning the beneficial owners of U.S. source payments and to make any necessary tax payments to the IRS. Additionally, the QI agrees to engage an external auditor to verify that it is in compliance with the QI agreement. In return, the QI avoids the expense and burden of forwarding documentation with respect to each beneficial owner to a U.S. withholding agent in order to claim reductions in U.S. withholding tax. The QI also enjoys other significant benefits under the new rules, including the ability to rely on a collective refund procedure for its customers.

The IRS and Treasury have worked closely with the financial community in developing the QI system. The audit guidelines attached to this notice are being issued in proposed form specifically to continue the dialogue with the financial community on how to implement the audit procedures of the QI agreements in a way that minimizes costs to the QIs while preserving the compliance goals of the withholding regulations. The IRS and Treasury recognize that achieving these goals requires that the audit process preserves the cooperative nature and effectiveness of the QI system.

II. THE PROPOSED THREE PART QI AUDIT PROCESS

The guidelines attached to this notice reflect a three part audit process. As de-

scribed further below, whether a particular QI's audit will progress through all three parts generally will depend upon the results of each part. IRS expects that, if a QI demonstrates a satisfactory level of compliance with the QI agreement in the first part of the audit process, the QI will not be required to complete any further parts in the process during that audit cycle.

A. PART 1: Basic Fact Finding

Part 1 consists of basic fact finding. The external auditor performs the tasks detailed in the attached audit guidelines. From these fact finding activities, the auditor will develop a report of numerical results. The attached audit guidelines contain precise directions on what numerical information must be included in the auditor's report. The auditor will send a hard copy of this initial report to the IRS. The IRS intends to develop a standard electronic report form.

If the numerical results of a particular QI's audit demonstrate a high level of compliance with the QI agreement, then it is expected that the IRS generally will notify the QI that its audit is complete and that no additional steps need to be taken. If, however, the numerical results suggest that the QI has experienced some difficulties in meeting its obligations under the agreement, then the IRS will notify the QI that it is proceeding to Part 2 of the audit process.

B. PART 2: Follow Up Fact Finding

In Part 2 of the audit process, the IRS will contact the auditor and ask about certain numerical results in the auditor's report. If additional information is needed, the IRS will direct the auditor to perform additional procedures and to report on the results. The goal of this step of the audit process will be to identify the cause for the numerical results and to determine whether corrective actions are readily discernible.

For example, an audit report may show that the auditor was unable to associate beneficial owner information with a specified percentage of the QI's accounts. By discussing the facts with the auditor, the IRS may be able to determine that the

problem was attributable to deficient account opening procedures in one of the QI's branches. If the IRS is satisfied that the QI had taken corrective steps to ensure that the branch was appropriately opening new accounts, and if the QI has otherwise shown a high level of compliance with the QI agreement, then there would be no need to proceed to Part 3 of the audit process. Under other circumstances, however, the IRS may determine that further work must be done to resolve the issues raised in Part 1 of the audit process.

C. PART 3: Audit Meeting with QI

If the concerns arising from the numerical results reported in Part 1 of the audit process cannot be resolved by directed fact finding in Part 2, then the IRS will propose to meet with the QI to attempt mutually to clarify and resolve those concerns. This part is designed specifically to provide a forum where a productive dialogue between the IRS and the QI can occur. Treasury and the IRS continue to believe that the QI system, which allows the IRS's compliance goals to be met while minimizing the administrative burdens on financial institutions, is a critical component of the withholding regulations. Accordingly, the IRS will seek to develop mutually acceptable solutions to the issues that arise in the course of administering the QI agreements so that it will not become necessary to terminate a QI agreement.

III. Key Concepts for Comment in the Attached Audit Guidelines

The IRS and Treasury invite comments on all sections of both this Notice and the attached proposed audit guidelines. This section is intended to draw attention to particularly important aspects of the audit guidelines that are designed to lessen burdens on financial institutions serving as QIs.

A. Submission of Audit Plans.

Under the proposed audit guidelines, the submission of an audit plan to the IRS prior to performing the audit is not necessary if the external auditor plans to follow the audit guidelines. If, however,

the external auditor plans to modify or deviate from the audit guidelines, then an audit plan should be submitted to the IRS for prior approval. For example, the external auditor may propose to use multistage, cluster, stratification or some other sampling methodology in conducting its audit. In such cases, the external auditor should submit a written audit plan and should identify, and explain the reasons for, any proposed modifications or deviations from the audit guidelines.

B. Discretionary Waivers of External Audit.

The proposed audit guidelines allow QIs to request that the IRS waive the performance of an audit by an external auditor in three cases. In the first case, a QI may request a waiver of the external audit if it has received not more than \$250,000 in reportable payments during the year to be audited. Instead of an external audit in this case, the QI must submit copies of its Forms 1042 and 945, copies of the Forms 1042-S issued to it and filed by it, and copies of its Forms W-8IMY provided to its withholding agents, along with information about the number of its account holders of various classes.

In the second case, a QI may request a waiver of the external audit if it has made reportable payments to no more than 2000 direct and indirect account holders during the year to be audited. Instead of an external audit in this case, the QI must itself perform the audit procedures and report to the IRS in accordance with the audit guidelines. Statistical sampling will not be permitted in this case. The IRS will not agree to waive the external audit for the first audit year of the first term of the QI Agreement in this case. The IRS will not agree to waive the performance of an external audit for a Private Arrangement Intermediary (PAI).

In the third case, a QI may request a waiver of the external audit if it has a substantial and independent internal audit department and its internal audit department has audited the QI's compliance under the QI agreement for each of the three years preceding the year to be audited. Instead of an external audit in this case, the QI's internal audit department must perform the audit and report to the IRS in accordance with the audit guidelines. Statisti-

cal sampling will be permitted in this case.

Whether the IRS will waive the external audit in any case is discretionary. In the second and third cases, the IRS will not waive the external audit for more than one audit year during any one term of the QI agreement.

C. External Auditor's Reliance on Internal Auditors.

The proposed audit guidelines allow the external auditor to use a QI's internal audit staff and internal audit reports to any extent the external auditor chooses. Nevertheless, the external auditor remains personally responsible for the conduct of the audit. The external auditor must disclose in the audit report specifically how and when it has used internal audit staff and reports. Further, the external auditor must certify that the use of the internal audit personnel and reports has not affected the accuracy of the external auditor's report.

D. Projection of Underwithholding.

The QI agreement provides that if statistical sampling has been used and the auditor determines that underwithholding has occurred with respect to the sampled accounts, the IRS will determine the total amount of underwithheld tax by projecting the underwithholding over the entire population of similar accounts.

Under the proposed audit guidelines, if the auditor uses a sample and has found that underwithholding has occurred with respect to an account in the sample, the auditor must report the underwithholding in the report for step 1 of the audit. In step 2 of the audit, the IRS would direct the external auditor to perform any additional procedures necessary to collect any information required to determine whether it is appropriate to project the underwithholding and any information required to make a projection. The IRS will employ a projection method that is consistent with the sampling methodology used. In step 3 of the audit, the QI may address whether projection is appropriate and may propose a projection using another amount of underwithholding based on a more accurate population, a more accurate projection technique, or an examination of all similar accounts.

IV. Comments.

Written comments must be received by December 12, 2001. Send comments to CC:DOM:CORP:R (NOT-151112-01), Room 5228, Internal Revenue Service, Ben Franklin Station, Washington, DC 20224. Alternatively, comments may be hand delivered between the hours of 8:00 AM and 5:00 PM to: CC:DOM:CORP:R (NOT-151112-01), Courier's Desk, Internal Revenue Service, 1111 Constitution Ave. NW, Washington, DC.

Contact Information

For further information regarding this Notice, contact Carl Cooper or Laurie Hatten-Boyd of the Office of the Associate Chief Counsel (International), Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224. Mr. Cooper and Ms. Hatten-Boyd may be contacted by telephone at 202-622-3840 (not a toll-free call).

APPENDIX

(PROPOSED) GUIDANCE

FOR EXTERNAL AUDITORS OF QUALIFIED INTERMEDIARIES

Section 4 of Rev. Proc. 2000-12 (2000-4 I.R.B. 387, 388) provides the final text of the Qualified Intermediary Agreement ("QI Agreement") between the Internal Revenue Service ("IRS") and a qualified intermediary ("QI"). Section 10 of the QI Agreement provides external audit procedures. In section 10, the IRS agrees not to conduct an on-site audit of the QI provided the QI engages an external auditor to conduct an audit in accordance with the procedures detailed therein. Under those procedures, the external auditor examines the QI to verify whether it is in compliance with the QI Agreement and makes a report to the IRS. Section 10 of the QI Agreement is reproduced below in bolded text for reference. Following each paragraph of section 10, procedural guidance on audit issues is provided under the heading Audit Guidance numbered to correspond to the QI Agreement. The audit guidance under sections 10.01 to 10.03 includes procedures that a QI may follow to request an IRS audit or a waiver of audit. Section 10.03(A), (B), (C), and (D) describe Part 1 of the audit process. This section in-

cludes the procedures that an external auditor should follow in examining the QI and the information to be included in the external auditor's report to the IRS. Section 10.04 provides guidance on the use of statistical sampling and projection of underwithholding. Section 10.05 provides further guidance on the form, content and submission of the external auditor's report. Section 10.06 provides guidance on Parts 2 and 3 of the audit process. The audit guidance does not amend, modify, or interpret the QI Agreement.

QI Agreement Sec. 10.01. In General. Unless QI requests an IRS audit in lieu of an external audit, the IRS agrees not to conduct an on-site audit of QI, or any PAI with which QI has an agreement, with respect to withholding and reporting obligations covered by this Agreement provided that an external auditor designated in Appendix B of this Agreement conducts an audit of QI, and any PAI, in accordance with this section 10. QI shall permit the external auditor to have access to all relevant records of QI for purposes of performing the external audit, including information regarding specific account holders. QI shall permit the IRS to communicate directly with the external auditor and to review the audit procedures followed by the external auditor. QI represents that there are no legal prohibitions that prevent the external auditor from examining any information relevant to the external audit to be performed under this section 10 and that there are no legal prohibitions that prevent the IRS from communicating directly with the auditor. QI shall permit the IRS to examine the external auditor's work papers and reports. However, the external auditor is not required to divulge the identity of QI's account holders to the IRS.

Audit Guidance Sec. 10.01:

10.01.1. *IRS Audit.* A QI that is not prohibited by law from disclosing account holder information may request an IRS onsite audit instead of an external audit. To request an IRS audit, the QI must submit a written request to the IRS before March 31 of the year following the specific year to be audited ("audit year").

The QI must send the request to the following address:

Internal Revenue Service
LMSB:FS:QI
290 Broadway
New York, NY 10007-1867
USA

If the IRS agrees to conduct an audit of the QI, the IRS will send the QI a written response within 90 days of the date the IRS received the request. In some cases, the IRS will conduct an audit by correspondence. For instance, in the case of a QI that has made reportable payments to no more than 50 accounts covered by the QI Agreement, the IRS may conduct an audit by correspondence. For purposes of this guidance, "accounts covered by the QI Agreement" are accounts maintained by the QI for its direct account holders (which include intermediaries and flow-through entities) to which the QI has made reportable payments during the audit year from the QI's accounts with withholding agents that the QI has designated as QI accounts.

10.01.2. *External Audit Waiver (\$250,000 Threshold).* A QI may request that the IRS waive the performance of the audit by an external auditor for an audit year if the QI has received reportable payments during that year that do not exceed \$250,000. To calculate the \$250,000 threshold, the QI must aggregate all reportable payments (including payments beneficially owned by the QI) made to its accounts with withholding agents that the QI has designated as QI accounts. The QI must submit its request for a waiver to the IRS in accordance with Audit Guidance 10.01.1 (AG10.01.1).

The QI should include in its request:

- (a) Copies (for the audit year) of its Forms 1042 and 945, the Forms 1042-S issued to it, the Forms 1042-S and 1099 issued by it, and the Forms W-8IMY (including summaries of withholding statements) provided by it to its withholding agents;
- (b) A reconciliation of the Forms 1042-S issued to the QI and the Forms 1042-S issued by the QI; and
- (c) A statement made under penalties of perjury by a person named as a responsible party for performance in the

QI's application for a QI Agreement ("responsible party") that:

1. States
 - (i) The number of the QI's direct account holders during the audit year;
 - (ii) The number of the QI's indirect account holders during the audit year; and
 - (iii) Within each category, the number of account holders that were U.S. exempt recipients, U.S. non-exempt recipients, intermediaries, flow-through entities, and undocumented account holders;
- (2) States the total amount of any underwithholding or collective refund for the audit year;
- (3) States that no event of default under section 11 of the QI Agreement has occurred during the audit year;
- (4) States that the QI does not refer account holders to an affiliated entity with the effect of circumventing the \$250,000 threshold; and
- (5) Certifies that the QI was in compliance with the QI Agreement during the audit year.

The IRS may contact the QI to request additional information. If the IRS agrees to waive the performance of the audit for the audit year, the IRS will send the QI a written response within 90 days of the date the IRS received the request. The IRS will not agree to waive the performance of an audit for a Private Arrangement Intermediary ("PAI").

10.01.3. *External Audit Waiver (2000 Account Holder Threshold).* A QI may request that the IRS waive the performance of the audit by an external auditor for an audit year if, during the audit year, the QI has made reportable payments to no more than 2000 direct and indirect account holders covered by the QI Agreement. The QI must submit its request for a waiver to the IRS in accordance with AG 10.01.1. The QI must include in its request a statement, made under penalties of perjury by the responsible party, that states:

- (a) The number of account holders to which the QI has made such payments;

- (b) The aggregate amount of reportable payments (including payments beneficially owned by the QI) made to its accounts with withholding agents that the QI has designated as QI accounts;
- (c) The QI does not refer account holders to an affiliated entity with the effect of circumventing the 2000 account holder threshold; and
- (d) That, in lieu of the external audit, the QI itself will apply the procedures set forth in section 10 of the QI Agreement. In doing so, the QI agrees to examine each account holder and to submit a report to the IRS signed by the responsible party.

The IRS may contact the QI to request additional information. The QI must agree that its performance of the audit will be governed in all respects by section 10 of the QI Agreement as if the persons conducting the audit were the external auditor referred to in that section. The IRS will not permit the use of statistical sampling by the QI. The IRS will not agree to waive the external audit for more than one audit year during any one term of the QI Agreement. If the IRS agrees to waive the performance of the audit for the audit year, the IRS will send the QI a written response within 90 days of the date the IRS receives the request. The IRS will not agree to waive the performance of an audit for a PAI. The IRS will not agree to waive the external audit for the first audit year of the first term of the QI Agreement.

10.01.4. *External Audit Waiver (Annual Internal Audits)*. A QI may request that the IRS waive the performance of the audit by an external auditor for an audit year if the QI maintains a substantial and independent internal audit staff, and the QI's internal auditors have conducted an audit of the QI's compliance with the QI Agreement each year for the three years preceding the audit year. The QI must submit its request for a waiver to the IRS in accordance with AG 10.01.1. The QI must include in its request a statement, made under penalties of perjury by the responsible party, that states:

- (a) The number of direct account holders and the number of indirect account holders to which the QI has made such payments;

- (b) The aggregate amount of reportable payments (including payments beneficially owned by the QI) made to its accounts with withholding agents that the QI has designated as QI accounts;
- (c) How the internal audit staff is organized, including position descriptions, the number of individuals in each position, the names of the individual or individuals with overall responsibility for internal audit, the routine functions of the internal auditors within the QI, and the persons to whom the internal auditors report;
- (d) In brief summaries, the procedures performed, the findings, and the conclusions or recommendations of each annual audit of the QI's compliance with the QI Agreement conducted by the QI's internal auditors in each of the three years preceding the audit year; and
- (e) That, in lieu of the external audit, the QI itself will apply the procedures set forth in section 10 of the QI Agreement to those accounts.

The IRS may contact the QI to request additional information. The QI must agree that its performance of the audit will be governed in all respects by section 10 of the QI Agreement as if the persons conducting the audit were the external auditor referred to in that section. The IRS will not agree to waive the external audit for more than one audit year during any one term of the QI Agreement. If the IRS agrees to waive the performance of the audit for the audit year, the IRS will send the QI a written response within 90 days of the date the IRS receives the request. The IRS will not agree to waive the performance of an audit for a PAI.

QI Agreement Sec. 10.02. Designation of External Auditor. QI's external auditor must be one of the auditors listed in Appendix B of this Agreement, unless QI and the IRS agree, prior to the audit, to substitute another auditor. QI shall not propose an external auditor unless it has a reasonable belief that the auditor is subject to laws, regulations, or rules that impose sanctions for failure to exercise its independence and to perform the audit competently. The IRS has the right to reject a proposed external auditor, or to revoke its acceptance of an external auditor, if the IRS,

in its sole discretion, reasonably believes that the auditor is not independent or cannot perform an effective audit under this Agreement.

Audit Guidance Sec. 10.02:

10.02.1. *Auditor Approval.* To obtain assurance that an external auditor will be acceptable to the IRS, the QI or the external auditor may submit a written request explaining the qualifications of the external auditor to the IRS at any time. The QI or the external auditor should send the request to the address provided in AG 10.01.1. The IRS will send the QI or the external auditor a written response within 90 days of the date the IRS receives the request.

10.02.2. *Auditor Independence.* A QI and its external auditor must disclose to the IRS any circumstances that compromise or reasonably appear to compromise the external auditor's independence or ability to perform an effective audit. To make a disclosure, the QI or the external auditor must submit a written statement explaining the circumstances and any steps taken to address them as soon as such circumstances are discovered. The disclosure must be sent to the address provided in AG 10.01.1. If the IRS determines that the external auditor is not acceptable, it will send the QI and the external auditor a written notice to that effect within 90 days of the date the IRS receives the disclosure.

QI Agreement Sec. 10.03. Timing and Scope of External Audits. QI shall have the external auditor conduct an audit of the second full calendar year and the fifth full calendar year that this Agreement is in effect, subject to section 10.06 of this Agreement. The external auditor shall verify whether QI is in compliance with this Agreement by conducting an audit that meets the requirements of this section 10.03. The external auditor shall verify whether QI is in compliance with its QI agreement by providing a report to the IRS. The report must be received by the IRS, at the address set forth in section 12.06 of this Agreement, no later than June 30 of the year following the year being audited. The IRS may, however, upon request by the external auditor, extend the due date of the audit report

upon good cause. The report must disclose that the external auditor has, at a minimum, performed the following checks listed in this paragraph 10.03, and set forth how each of those checks was performed and the results of the checks. QI's (or a PAI's) external auditor is encouraged to contact the IRS at the address set forth in section 12.06 of this Agreement and submit an audit plan (which includes, if relevant, the extent to which the external auditor proposes to rely on QI's internal audit procedures) prior to performing the audit so that the audit may be conducted in the most efficient and least costly manner possible.

Audit Guidance Sec. 10.03:

10.03.1. *Specifications of Audit Report.* For guidance on the form and contents of the external auditor's report, submitting the report to the IRS, the due date of the report and extensions of the due date, see AG 10.05.

10.03.2. *Submission of Audit Plan.* Submission of an audit plan to the IRS prior to performing the audit is not necessary unless the external auditor plans to modify or deviate from the procedures described in AG 10.03 and 10.04. In such circumstances, the external auditor should submit a written plan, identifying and explaining the reasons for any planned modifications or deviations from those procedures, prior to performing the audit. The external auditor should submit the audit plan to the address provided in AG 10.01.1. The IRS will send the external auditor a written response within 90 days of the date the IRS receives the audit plan.

10.03.3. *Use of Internal Audit.* The external auditor is required to perform the audit itself. The external auditor may use the QI's internal audit personnel and internal audit reports to any extent the external auditor chooses to do so. In that case, the external auditor remains responsible for the conduct of the audit as if the external auditor had personally performed the audit. In its report to the IRS, the external auditor must disclose specifically when and how it has used the QI's internal audit personnel and reports in conducting the audit and must certify that the use of the internal audit personnel and re-

ports has not affected the accuracy of the external auditor's report.

10.03.4. *Use of Copies.* In conducting the audit, the external auditor may use copies of any account records or written materials provided by the QI. Nevertheless, the QI must permit the external auditor to have access to the complete and unaltered account holder records in the original, if the external auditor deems it necessary to examine originals.

QI Agreement 10.03(A). Documentation. The external auditor must—
(1) Verify that QI has training materials, manuals, and directives that instruct the appropriate QI employees how to request, collect, review, and maintain documentation in accordance with this Agreement;

Audit Guidance 10.03(A)(1):

10.03(A)(1).1. *Review of Documentation Training.* The external auditor must:

Step 1: Identify the QI's employees that are responsible for opening and maintaining customer accounts.

Step 2: Collect any written training materials, manuals, and directives used by those employees.

Step 3: Inspect the written training materials, manuals, and directives to determine whether they contain instructions specific to accounts covered by the QI Agreement on how to request, collect, review, and maintain documentation.

10.03(A)(1).2. *Documentation Training Report.* The external auditor must specifically report:

Report 1: Whether the QI has written training materials, manuals, and directives that contain instructions specific to accounts covered by the QI Agreement on how to request, collect, review, and maintain customer documentation.

QI Agreement Sec. 10.03(A)(2). Review QI's account opening procedures and interview QI's employees, to determine if appropriate documentation is requested from account holders and, if obtained, that it is reviewed and maintained in accordance with this Agreement;

Audit Guidelines 10.03(A)(2)

10.03(A)(2).1. *Review of Account Opening Procedures.* The external auditor must:

Step 1: Identify the QI employees responsible for opening and maintaining customer accounts and select representative employees for interview.

Step 2: Ask the selected employees how accounts covered by the QI Agreement are opened, what documentation is requested, how the documentation is obtained, and how the documentation is reviewed and maintained.

10.03(A)(2).2. *Account Opening Procedures Report.* The external auditor must specifically report:

Report 1: The number of employees interviewed.

Report 2: The number of employee responses that indicate that Forms W-8 and documents listed in the Attachment to the QI Agreement are not routinely requested, reviewed, cross checked against other account information, or maintained in accordance with section 5.12 of the QI Agreement.

QI Agreement Sec. 10.03(A)(3). Verify that QI follows procedures designed to inform account holders that claim a reduced rate of withholding under an income tax treaty about any applicable limitation on benefits procedures;

Audit Guidance 10.03(A)(3):

10.03(A)(3).1. *Review Limitation on Benefits (LOB) Procedure.* The external auditor must:

Step 1: Ask the QI employees selected for interview under AG 10.03(A)(2) Step 1 how account holders that are not individuals claim a reduced rate of withholding under an income tax treaty.

10.03(A)(3).2. *LOB Procedure Report.* The external auditor must specifically report:

Report 1: The number of employee responses that indicate that such customers are not informed about any applicable limitation on benefits provisions.

QI Agreement 10.03(A)(4). Review QI's accounts, using a valid sample of accounts for which treaty benefits are claimed, to ensure that QI is obtaining the treaty statements required by section 5.03(B);

Audit Guidance 10.03(A)(4):

10.03(A)(4).1. *Review of Treaty Statements.* The external auditor must:

Step 1: Identify all accounts covered by the QI Agreement that are held by direct account holders that are not U.S. non-exempt recipients, or select a valid sample of such accounts in accordance with AG 10.04.

Step 2: From the accounts identified or selected in Step 1, segregate the accounts for which treaty benefits are claimed.

Step 3: From the accounts for which treaty benefits are claimed, segregate the accounts for which documentary evidence has been obtained.

Step 4: From the accounts for which documentary evidence has been obtained, segregate those accounts held by account holders that are not individuals or governments.

Step 5: For the accounts segregated in Step 4, inspect each account holder's documentation to determine whether it contains a valid treaty statement described in section 5.03(B) of the QI Agreement. A valid treaty statement must be signed by the beneficial owner. A treaty statement may be incorporated into another document that is signed by the beneficial owner.

Step 6: For the accounts segregated in Step 4, identify:

- (a) All accounts covered by the QI Agreement held by intermediaries or flow through entities for which recipient specific re-

porting is required under section 8.02(B) and (C) or section 8.04 of the QI Agreement.

- (b) The number in Step 6(a) that are intermediaries.
- (c) The number in Step 6(a) that are flow through entities
- (d) The number of indirect account holders holding through intermediaries that are direct account holders; and
- (e) The number of indirect account holders holding through each flow through entity that is a direct account holder.

Step 7: (a) For purposes of Step 7 and the following sections, the external auditor must identify the indirect account holders for which recipient specific reporting is required or select a valid sample of such account holders in accordance with AG 10.04. From the indirect account holders identified or selected, segregate the indirect account holders for which treaty benefits are claimed.

- (b) From the indirect account holders segregated in (a), segregate the indirect account holders for which documentary evidence has been obtained.
- (c) From the indirect account holders segregated in (b), segregate indirect account holders that are not individuals or governments.
- (d) For the indirect account holders segregated in (c), inspect each indirect account holder's documentation to determine whether it contains a valid treaty statement described in section 5.03(B) of the QI Agreement.

10.03(A)(4).2. *Treaty Statements Report.* The external auditor must specifically report:

Report 1: The number of accounts determined under each of Steps 1, 2, 3, and 4.

Report 2: The number of accounts segregated in Step 4 that do not contain a valid treaty statement

described in section 5.03(B) of the QI Agreement.

Report 3: The number of indirect account holders determined under Step 6(a) through (e).

Report 4: The number of indirect account holders identified, selected (if sampling is used), and segregated under Step 7 (a) through (c).

Report 5: The number of indirect account holders whose documentation does not contain a valid treaty statement described in section 5.03(B) of the QI Agreement.

QI Agreement Sec. 10.03(A)(5). Review information, using a valid sample, contained in account holder files to determine if the documentation validity standards of section 5.10 of this Agreement are being met. For example, the external auditor must verify that changes in account holder information (e.g., a change of address to a U.S. address or change of account holder status from foreign to U.S.) are being conveyed to QI's withholding agent, or, if QI assumes primary NRA withholding responsibility or primary Form 1099 reporting and backup withholding responsibility, that QI is applying the appropriate withholding rate;

Audit Guidance 10.03(A)(5):

10.03(A)(5).1. *Review of Documentation Validity (Foreign Persons and U.S. Exempt Recipients).* The external auditor must:

Step 1: Identify all accounts covered by the QI Agreement that are held by direct account holders that are not U.S. non-exempt recipients, or use the same sample selected in AG 10.03(A)(4).1 Step 1.

Step 2: Sort those accounts according to whether they contain the following types of documentation:

- (a) Form W-8BEN;
- (b) Form W-8EXP;
- (c) Form W-8ECI;
- (d) Form W-8IMY;
- (e) Form W-9;
- (f) Documentary Evidence; and
- (g) no documentation.

Step 3: FORM W-8BEN:

- (a) For accounts documented with a Form W-8BEN, inspect Part I of the Form W-8BEN. Determine that the following lines are completed and consistent with each other:
 - (i) Line 1 (name of individual or organization that is the beneficial owner);
 - (ii) Line 2 (country of incorporation or organization), for non-individuals;
 - (iii) Line 3 (type of beneficial owner);
 - (iv) Line 4 (permanent residence address, including country) A permanent residence address cannot be a P.O. Box, in-care-of address or an address at a financial institution, including a hold mail address (except when the beneficial owner is a financial institution); and
 - (v) Signature and date.
 - (A) Determine that December 31 of the audit year was within three full calendar years following the year of signature; and
 - (B) Determine that the certifications attested under penalties of perjury have not been modified.
- (b) For a Form W-8BEN for which the beneficial owner has claimed treaty benefits, inspect Part II of the Form W-8BEN. Determine that the following lines are completed and consistent with each other and with Part I of the Form:
 - (i) Line 9a (residence certification, including name of country); and
 - (ii) Line 9c (section 894 and LOB certification), but only for non-individuals.

- Step 4: FORM W-8EXP.** For accounts documented with Form W-8EXP, inspect Form W-8EXP. Determine that the following lines are completed and consistent with each other:
- (a) Line 1 (name of organization);

- (b) Line 2 (country of incorporation or organization);
- (c) Line 3 (type of entity);
- (d) Line 4 (permanent residence address, including country). A permanent residence address cannot be a P.O. Box, in-care-of address or an address at a financial institution, including a hold mail address (except when the beneficial owner is a financial institution);
- (e) Either:
 - (i) Line 9a and 9b or 9c; or
 - (ii) Line 10 (and organization is designated by executive order under 22 U.S.C. 288 through 288(f)); or
 - (iii) Line 11; or
 - (iv) Line 12a (including date) or 12b (including attached opinion from U.S. counsel), and, for section 501(c)(3) organizations, Line 12c (including affidavit) or 12d, and Line 6; or
 - (v) Line 13; and
- (f) Signature and date.
 - (i) Determine that the certifications attested under penalties of perjury have not been modified.

- Step 5: FORM W-8ECI.** For accounts documented with Form W-8ECI, inspect the Form W-8ECI. Determine that the following lines are completed and consistent with each other:
- (a) Line 1 (name of organization);
 - (b) Line 2 (country of incorporation or organization);
 - (c) Line 3 (type of entity);
 - (d) Line 4 (permanent residence address, including country). A permanent residence address cannot be a P.O. Box, in-care-of address, or an address at a financial institution, including a hold mail address (except when the beneficial owner is a financial institution);
 - (e) Line 5 (business address in the United States);
 - (f) Line 6 (U.S. taxpayer identification number);
 - (g) Line 9 (list of items of income that are effectively connected with the conduct of a trade or

- business in the United States); and
- (h) Signature and date.
 - (i) Determine that December 31 of the audit year was within three full calendar years following the year of signature; and
 - (ii) Determine that the certifications attested under penalties of perjury have not been modified.

- Step 6: FORM W-8IMY.** For accounts documented with Form W-8IMY, inspect the Form W-8IMY. Determine that the following lines are completed and consistent with each other:

- (a) Line 1 (name of individual or organization);
- (b) Line 2 (country of incorporation or organization), for non-individuals;
- (c) Line 3 (type of entity);
- (d) Line 4 (permanent residence address, including country). A permanent residence address cannot be a P.O. Box, in-care-of address or an address at a financial institution, including a hold mail address (except when the beneficial owner is a financial institution).
- (e) Either:
 - (i) Line 9a and Line 6 (QI-EIN);
 - (ii) Line 10a;
 - (iii) Line 11 and Line 6 (EIN), and Line 12 or Line 13;
 - (iv) Line 14 and Line 6; or
 - (v) Line 15 (and, if line 3 (nonwithholding foreign grantor trust) is checked, Line 6 (EIN)); and
- (f) Signature and date.
 - (i) Determine that the certifications attested under penalties of perjury have not been modified.

- Step 7: FORM W-9.** For accounts documented with Form W-9, inspect the Form W-9. Determine that the following lines are completed and consistent with each other:
- (a) Name;
 - (b) U.S. taxpayer identification number;

- (c) Part II (For U.S. payees exempt from backup withholding); and
- (d) Signature and date.
 - (i) Determine that the certifications attested under penalties of perjury have not been modified.

Step 8: DOCUMENTARY EVIDENCE. For accounts documented with documentary evidence, inspect the documentary evidence. Determine:

- (a) Whether the documentary evidence is one of the types listed in the applicable Attachment to the QI Agreement,
- (b) Whether it appears to be in proper form when compared to documents of the same type listed in the Attachment,
- (c) Whether it:
 - (i) Supports the account holder's foreign status and, for an account holder that claims treaty benefits, supports the account holder's residence in the treaty country, or
 - (ii) Supports the account holder's status as a U.S. exempt recipient.
- (d) In the case of an international organization, whether the organization is designated by executive order under 22 U.S.C. 288 through 288(f).
- (e) In the case of a foreign government or foreign central bank of issue, whether the documentary evidence supports the account holder's status as such.

Step 9: For each account determined to be documented under Steps 3 through 8, examine the account opening statement, any other account documents or memoranda and any correspondence associated with the account (for purposes of this section, "the account holder's file"). Determine:

- (a) Whether the identifying information in the documentation matches the identifying information in the account holder's file (taking into account any updated information that links the identifying information in

- the documentation to the identifying information in the account holder's file),
- (b) Whether, in the case of an account documented with documentary evidence, the documentary evidence and the account holder's file contains only: an address at a financial institution, including a hold mail instruction (except when the financial institution is the beneficial owner), an in-care-of address, or a P.O. Box, and if so, whether the QI has satisfied the additional requirements of section 5.10(B)(2)(i) of the QI Agreement.
- (c) Whether the documentation or the account holder's file shows a U.S. mailing or residence address for the account holder or standing instructions to pay from the account to a U.S. address or to an account maintained in the United States, and if so, whether:
 - (i) The account holder is a U.S. person, or
 - (ii) In the case of documentary evidence, the QI has satisfied the additional requirements of section 5.10(B)(2)(i), (ii), and (iii) of the QI Agreement or, in the case of Forms W-8, the QI has satisfied the additional requirements of section 1.1441-7(b)(5) of the regulations.
- (d) For accounts where the beneficial owner has claimed treaty benefits, whether the documentation or the account holder's file shows a residence address or mailing address, or a P.O. Box, in-care-of address or an address at a financial institution, including a hold mail instruction (except when the financial institution is the beneficial owner), that is not in the applicable treaty country, or standing instructions to pay from the account to an address outside the treaty country or to an account maintained outside the treaty country, and if so, whether:

- (i) In the case of documentary evidence, the QI has satisfied the additional requirements of section 5.10(B)(3) of the QI Agreement; or
- (ii) In the case of Forms W-8, the QI has satisfied the additional requirements of section 1.1441-7(b)(6) of the regulations.
- (e) Include in the category of accounts with no documentation (AG 10.03(A)(5).1 Step 2(g)) all accounts:
 - (i) That are not documented with Forms W-8BEN, W-8EXP, W-8IMY, W-8ECI, W-9 or documentary evidence that is listed in the applicable Attachment to the QI Agreement, and
 - (ii) That are documented with Forms W-8 or documentary evidence that is inadequate after applying the additional requirements of AG 10.03(A)(5).1 Step 9(b)-(d).

Step 10: (a) Identify all indirect account holders for which recipient specific reporting is required under section 8.02(B) and (C) or section 8.04 of the QI Agreement, or use the same sample of indirect account holders selected under AG 10.03(A)(4).1 Step 7.

- (b) From those indirect account holders, segregate the indirect account holders that are not U.S. non-exempt recipients.
- (c) Inspect the documentation for each indirect account holder segregated in Step 10(b) to determine whether the documentation validity standards of section 5.03(C) of the QI Agreement are satisfied by performing the procedures under AG 10.03(A)(5) with the following modifications:
 - (i) Part II of the Form W-8BEN is not complete unless line 9b and line 6 are completed, except in the case of a claim of treaty benefits for income from a marketable security.
 - (ii) Documentary evidence establishing entitlement to

treaty benefits must be documentary evidence described in section 5.03(A)(3) of the QI Agreement. Also, except in the case of income from a marketable security, a TIN is required.

(iii) Documentary evidence for purposes other than establishing entitlement to treaty benefits must be documentary evidence described in Treas. Reg. 1.1441-1(c)(17).

Step 11: For indirect account holders, the external auditor must apply Steps 1 through 9.

10.03(A)(5).2. *Documentation Validity Report (Foreign Persons and U.S. Exempt Recipients)*. The external auditor must specifically report:

Report 1: The number of accounts identified or selected under Step 1.

Report 2: The number of accounts segregated under Step 2.

Report 3: The number of Forms W-8BEN inspected under Step 3(a) and the number of Forms W-8BEN that did not satisfy the criteria under that section.

Report 4: The number of Forms W-8BEN inspected under Step 3(b) and the number of Forms W-8BEN that did not satisfy the criteria under that section.

Report 5: The number of Forms W-8EXP inspected under Step 4 and the number of Forms W-8EXP that did not satisfy the criteria under that section.

Report 6: The number of Forms W-8ECI inspected under Step 5 and the number of Forms W-8ECI that did not satisfy the criteria under that section.

Report 7: The number of Forms W-8IMY inspected under Step 6 and the number of Forms W-8IMY that did not satisfy the criteria under that section.

Report 8: The number of Forms W-9 inspected under Step 7 and the

number of Forms W-9 that did not satisfy the criteria under that section.

Report 9: The number of accounts:

- (a) Documented with documentary evidence inspected under Step 8;
- (b) Reviewed under Step 8 that did not satisfy criteria (a) or (b) of that section;
- (c) Reviewed under Step 8 that satisfy the criteria of either section (c)(i) or (ii);
- (d) Reviewed under Step 8 that did not satisfy the criteria of either (c)(i) or (ii); and
- (e) Described in each of (d) and (e) of Step 8 and the number of accounts that did not satisfy the criteria of (d) and (e) of Step 8.

Report 10: The number of accounts:

- (a) That did not satisfy the criteria of Step 9(a);
- (b) Described in Step 9(b) and the number of accounts that did not satisfy the additional criteria of that step;
- (c) Described in Step 9(c), the number of accounts described in (c)(i) of that step, and the number of accounts that did not satisfy (c)(ii) of that step; and
- (d) Described in Step 9(d) and the number of accounts that did not satisfy the criteria of (d)(i) or (ii) of that step.

Report 11: The number of accounts described in each of (i) and (ii) of Step 9(e).

Report 12: For indirect account holders, the external auditor must separately complete Report 1 through 11.

QI Agreement Sec. 10.03(A)(6). Review accounts, using a valid sample of U.S. non-exempt recipient account holders, to determine if QI is obtaining Forms W-9 from those customers whose identity is not prohibited by law from disclosure, and that QI is transmitting those forms to a withholding agent to the extent QI does not assume primary Form 1099 reporting and backup withholding responsibility with respect to

reportable amounts and, if applicable, designated broker proceeds;

Audit Guidance 10.03(A)(6):

10.03(A)(6).1. *Review of Documentation Validity (Disclosed U.S. Non-exempt Recipients)* The external auditor must:

Step 1: Identify all accounts covered by the QI Agreement that are held by direct account holders that are U.S. non-exempt recipients, or select a valid sample of such accounts in accordance with AG 10.04.

Step 2: From those accounts, segregate the accounts of those U.S. non-exempt recipients whose identity is not prohibited by law from disclosure, including the accounts of U.S. non-exempt recipients that have waived the prohibitions against disclosure.

Step 3: Obtain copies of the QI's Forms W-8IMY and inspect them to determine whether the QI has assumed primary Form 1099 and backup withholding responsibility. From the accounts segregated in Step 2, segregate the accounts of U.S. non-exempt recipients for which the QI has not assumed primary Form 1099 reporting and backup withholding responsibility.

Step 4: From the accounts segregated in Step 3, segregate the accounts documented with Form W-9 and determine that each Form W-9 satisfies the criteria of AG 10.03(A)(5).1 Step 7.

Step 5: From the accounts segregated in Step 3, segregate the accounts that are not documented with Form W-9 and the accounts for which the Forms W-9 did not satisfy the criteria of AG 10.03(A)(5).1 Step 7.

Step 6: Obtain the withholding statements associated with QI's Forms W-8IMY.

Step 7: For each Form W-9 that satisfies the criteria of AG 10.03(A)(5).1 Step 7, match the name and TIN on the Form W-9 to the name and TIN on the withholding statement.

Step 8: For each account segregated in Step 5, match the name, and (if provided) address, and TIN of the U.S. non-exempt recipient to the name, address, and TIN on the withholding statement.

Step 9: (a) Identify all accounts covered by the QI Agreement for which recipient specific reporting is required under section 8.02(B) and (C) or section 8.04 of the QI Agreement.

- (b) Identify the indirect account holders holding through those accounts, or use the same sample selected under AG 10.03(A)(4).1 Step 7.
- (c) Segregate the indirect account holders that are U.S. non-exempt recipients.
- (d) Apply Steps 2 through 8.

10.03(A)(6).2. *Documentation Validity (U.S. Non-exempt Recipients) Report.* The external auditor must specifically report:

Report 1: The number of accounts segregated under each of Steps 1, 2, 3, 4, and 5.

Report 2: The number of accounts that did not satisfy the criteria of Steps 7 and 8.

Report 3: For indirect account holders, the external auditor must report:

- (a) The number of indirect account holders identified and segregated under Step 9;
- (b) The number of indirect account holders identified and segregated under Steps 2 through 5; and
- (c) The number of indirect account holders that did not satisfy the criteria of Steps 7 and 8.

QI Agreement Sec. 10.03(A)(7). Review accounts, using a valid sample of U.S. non-exempt recipient account holders whose identity and account information is prohibited by law, including by contract, from disclosure, to verify that—

(i) Such accounts exist in only rare and unusual circumstances (and detailing in the audit report the nature of such circumstances); and

(ii) The procedures of section 6.04 have been, and are being, followed.

Audit Guidance 10.03(A)(7):

10.03(A)(7).1. *Account Review of U.S. Non-exempt Recipients (Disclosure Prohibited).* The external auditor must:

Step 1: Identify all accounts covered by the QI Agreement that are held by direct account holders that are U.S. non-exempt recipients, or use the same sample selected for AG 10.03(A)(6).

Step 2: From those accounts, segregate the accounts of those U.S. non-exempt recipients whose identity is prohibited by law from disclosure, excluding the accounts of U.S. non-exempt recipients that have waived the prohibitions against disclosure.

Step 3: From the accounts segregated in Step 2, segregate the accounts opened by U.S. non-exempt recipients on or after January 1, 2001.

Step 4: Obtain a letter from the responsible party explaining why the accounts in section 10.07(A)(7).1 Step 2 exist and how the procedures of section 6.04 of the QI Agreement have been and are being applied.

10.03(A)(7).2. *Account Review of U.S. Non-exempt Recipients (Disclosure Prohibited) Report.* The external auditor must specifically:

Report 1: Report the number of accounts segregated under Steps 1, 2, and 3; and

Report 2: Include a copy of the letter obtained under Step 4.

QI Agreement Sec. 10.03(A)(8). Review QI's agreements with its PAIs to ensure that the obligations imposed on the PAIs are identical to the obligations imposed on QI under this Agreement, except as otherwise provided in section 4.02.

Audit Guidance 10.03(A)(8):

10.03(A)(8).1. *Review PAI Obligations.* The external auditor must:

Step 1: Obtain copies of the QI Agreement and all PAI agreements.

Step 2: Inspect each PAI agreement to determine whether:

- (a) The PAI agreement covers all offices of the PAI located in a country listed in Appendix A of the QI Agreement;
- (b) The PAI agreement provides that the QI include all reportable payments made by the PAI in the QI's Forms 945 and 1099 and 1042 and 1042-S;
- (c) The PAI agreement requires the PAI to provide the QI with all information necessary for the QI to meet its obligations under the QI Agreement;
- (d) There are not any provisions limiting the PAI's liability for underwithholding or reporting due to the PAI's failure to perform its obligations under the PAI agreement;
- (e) The PAI agreement requires the PAI to disclose U.S. non-exempt recipients to the same extent as the QI Agreement;
- (f) The PAI agreement permits the PAI to assume primary withholding responsibility or primary Form 1099 reporting and backup withholding responsibility;
- (g) The PAI is subject to audit procedures that are identical to those applicable to the QI under the QI Agreement and that the PAI's designated auditor is listed in Appendix B of the QI Agreement or has been approved by the IRS for that PAI; and
- (h) The PAI is subject to all other obligations of the QI under the QI Agreement.

Step 3: Obtain a copy of the notice identifying each PAI filed by the QI with the IRS described in section 4.01(B) of the QI Agreement and determine that the date of filing for each notice precedes the date of the first payment received by the PAI from the QI pursuant to the PAI agreement.

Step 4: Obtain a copy of the PAI's W-8IMY provided to the QI and determine that it satisfies the criteria of AG 10.03(A)(5).1 Step 6.

10.03(A)(8).2. *PAI Obligations Report.* The external auditor must specifically report:

Report 1: The number of PAI agreements;

Report 2: The number of PAI agreements that did not satisfy the criteria of each of Step 2(a) through (h); and

Report 3: The number of PAI agreements that did not satisfy the criteria of Step 3.

Report 4: The number of Forms W-8IMY obtained in Step 4 and the number of Forms W-8IMY that did not satisfy the criteria of Step 6.

QI Agreement Sec. 10.03(A)(9). State in its external audit report if the auditor is aware that QI is in material violation or is under investigation for violation of any of the know-your-customer rules, practices, or procedures applicable to the offices audited.

Audit Guidance 10.03(A)(9):

10.03(A)(9).1. *Knowledge of KYC Investigations.* The external auditor must:

Step 1: Obtain a letter signed by the responsible party and by the QI's legal counsel stating whether either is aware that the QI is in material violation or is under investigation for violation of any of the know-your-customer rules, practices, or procedures applicable to all branches of the QI located in countries named in the Attachments to the QI Agreement.

10.03(A)(9).2. *KYC Investigations Report.* The external auditor must specifically report:

Report 1: Whether, based on the information in the letter described in Step 1 and on its own information, the external auditor is aware of any such material violations or investigations and, if so, identify them.

Report 2: The external auditor must attach to its report:

(a) A copy of the letter described in Step 1.

QI Agreement Sec. 10.03(A)(10). State in its external audit report if the auditor is aware that QI removes U.S. non-exempt recipients from accounts covered by this Agreement for the purpose of circumventing the Form 1099 reporting and backup withholding provisions of this Agreement.

Audit Guidance 10.03(A)(10):

10.03(A)(10).1. *Review for Removal of U.S. Non-exempt Recipients.* The external auditor must:

Step 1: Identify all accounts covered by the QI Agreement that are held by direct account holders that are U.S. non-exempt recipients, or use the sample selected in AG 10.03(A)(6).1 Step 1.

Step 2: Inspect account closing records to determine whether the account was closed during the audit year.

Step 3: Inspect account transfer records to determine whether any assets have been transferred to another account held by the same account holder during the audit year.

10.03(A)(10).2. *Removal of U.S. Non-exempt Recipients Report.* The external auditor must specifically report:

Report 1: The number of accounts covered by the QI Agreement held by U.S. non-exempt recipients that were closed during the audit year.

Report 2: Whether the external auditor is aware of any accounts with the QI not covered by the QI Agreement held by the same U.S. non-exempt recipients that were opened during the audit year, and if so, the number of such accounts.

Report 3: Whether the external auditor is aware of any transfers of assets from an account covered by the QI Agreement held by a U.S. non-exempt recipient to another account with the QI not covered by the QI Agreement held by the same U.S. non-exempt re-

ipient, and if so, the number of accounts to which such transfers were made.

Report 4: Whether the external auditor is aware that the QI removes U.S. non-exempt recipients from accounts covered by the QI Agreement for the purpose of circumventing the Form 1099 reporting and backup withholding provisions of the QI Agreement.

QI Agreement Sec. 10.03(B)(1). Withholding Rate Pools. The external auditor must—

(1) Verify that QI has training materials, manuals, and directives that instruct the appropriate QI employees how to determine withholding rate pools based on documentation and the presumption rules;

Audit Guidance 10.03(B)(1):

10.03(B)(1).1. *Review of Withholding Rate Pool Training Materials.* The external auditor must:

Step 1: Identify the QI's employees that are responsible for determining withholding rate pools.

Step 2: Collect any written training materials, manuals, and directives used by those employees.

Step 3: Inspect the written training materials, manuals, and directives to determine whether they contain specific instructions on how to determine withholding rate pools based on documentation and the presumption rules.

10.03(B)(1).2. *Withholding Rate Pool Training Materials Report.* The external auditor must specifically report:

Report 1: Whether the QI has written training materials, manuals, and directives that contain specific instructions on how to determine withholding rate pools based on documentation and the presumption rules.

QI Agreement Sec. 10.03(B)(2). Interview employees responsible for determining withholding rate pools to ascertain if they are adequately trained to

determine those pools and that they follow adequate procedures for determining those pools;

Audit Guidance 10.03(B)(2):

10.03(B)(2).1. *Review of Personnel Training (Withholding Rate Pool).* The external auditor must:

Step 1: Identify the QI's employees that are responsible for determining withholding rate pools and select representative employees for interview.

Step 2: Ask the selected employees whether they have received any formal or informal training on determining withholding rate pools and if so, ask the selected employees to describe the training, when it occurred, and how much time was devoted to it.

Step 3: Ask the selected employees how an account is assigned to withholding rate pools.

10.03(B)(2).2. *Personnel Training (Withholding Rate Pool) Report.* The external auditor must report:

Report 1: The number of employees interviewed.

Report 2: The number of employee responses that indicate that the employee has not received training on how to determine withholding rate pools.

Report 3: The number of employee responses that indicate that accounts are assigned to withholding rate pools without routinely referring to documentation, presumptions, the type of income earned, and the withholding rate applied.

QI Agreement Sec. 10.03(B)(3). Review QI's procedures for preparing the withholding statements associated with QI's Forms W-8IMY and verify that the withholding statements provided to withholding agents convey complete and correct information on a timely basis;

Audit Guidance 10.03(B)(3):

10.03(B)(3).1. *Review of Withholding Statements.* The external auditor must:

Step 1: Identify the QI's employees that are responsible for preparing withholding statements and providing them to withholding agents, and select representative employees for interview.

Step 2: Ask the selected employees how withholding statements are prepared and provided to withholding agents.

Step 3: Obtain copies of the withholding statements provided to withholding agents and records of payments from the withholding agents to the QI.

Step 4: Inspect the withholding statements to determine whether they are consistent with the payment records.

Step 5: Inspect the withholding statements to determine whether the withholding statement information was updated and provided to the withholding agent before the withholding agent made payments.

10.03(B)(3).2. *Withholding Statement Report.* The external auditor must report:

Report 1: The number of employees interviewed.

Report 2: The number of employee responses that indicate that withholding statement information was not routinely reviewed, updated and provided to the withholding agent before the withholding agent made payments.

Report 3: The number of payments with respect to which the withholding statements were inconsistent.

Report 4: The number of payments with respect to which the withholding statement information was not updated or provided to the withholding agent before payment.

QI Agreement Sec. 10.03(B)(4). Perform test checks, using a valid sample of account holders assigned to each withholding rate pool, and cross check that assignment against the documen-

tation provided by, or presumption rules that apply to, the account holder, the type of income earned, and the withholding rate applied;

Audit Guidance:

10.03(B)(4).1. *Review Withholding Rate Pool Classification.* The external auditor must:

Step 1: Identify all accounts covered by the QI Agreement that are held by direct account holders that are not U.S. non-exempt recipients, or use the same sample selected under AG 10.03(A)(4).1 Step 1.

Step 2: Obtain copies of the QI's Forms W-8IMY and inspect them to determine whether the QI has assumed primary NRA withholding responsibility. For accounts covered by the QI Agreement for which the QI has not assumed such responsibility, the external auditor must perform the procedures described below.

Step 3: Obtain:

(a) The account statements and records that show the investment and the type of income earned and the amounts of withholding; and

(b) The account records that show how the QI has classified the type of income and withholding rate for purposes of its withholding rate pools.

Step 4: (a) Based on the records described in Step 3(a), classify the accounts according to the type of income paid to each account. An account to which more than one type of income has been paid must be placed into multiple income classifications.

(b) Based on the documentation for the account (after the determinations under AG 10.03(A)(4) and (5) have been made) and applicable presumptions under section 5.13 of the QI Agreement, determine the withholding rate and further classify the accounts within an income classification according to withholding rate. An account

within an income classification to which more than one withholding rate has been applied must be placed into multiple withholding rate classifications.

Step 5: Determine whether the classifications under Step 4(a) and (b) match the QI's classifications in the account records described in Step 3(b).

Step 6: (a) Identify all accounts covered by the QI Agreement for which recipient specific reporting is required under section 8.02(B) and (C) or section 8.04 of the QI Agreement;
(b) Identify the indirect account holders holding through those accounts, or use the same sample selected under AG 10.03(A)(4).1 Step 7.
(c) Segregate the indirect account holders that are not U.S. non-exempt recipients.
(d) Apply Steps 2 through 5 to those indirect account holders.

10.03(B)(4).2. *Withholding Rate Pool Classification Report*. The external auditor must specifically report:

Report 1: The number of accounts identified or selected as a sample in Step 1.

Report 2: The number of accounts in Report 1 classified under Step 4(a) and (b).

Report 3: The number of accounts in Report 1 for which the QI's classifications do not match the account records under Step 5.

Report 4: For indirect account holders,
(a) The number of indirect account holders under Step 6(a) through (c); and
(b) The number of indirect account holders under Step 4(a) and (b) and Step 5.

QI Agreement Sec. 10.03(B)(5). Perform test checks, using a valid sample of accounts of U.S. non-exempt recipients, to verify that appropriate withholding rate pools are established for U.S. non-exempt recipients; and

Audit Guidance 10.03(B)(5):

10.03(B)(5).1. *Review of Withholding Rate Pool Classification (U.S. Non-exempt Recipients)*. The external auditor must:

Step 1: Identify all accounts covered by the QI Agreement that are held by direct account holders that are U.S. non-exempt recipients, or use the same sample selected under AG 10.03(A)(6).1 Step 1.

Step 2: From those accounts, segregate the accounts of those U.S. non-exempt recipients whose identity is not prohibited by law from disclosure, including the accounts of U.S. non-exempt recipients that have waived the prohibitions against disclosure.

Step 3: Obtain copies of the QI's Forms W-8IMY and inspect them to determine whether the QI has assumed primary Form 1099 and backup withholding responsibility. From the accounts segregated in Step 2, segregate the accounts of U.S. non-exempt recipients for which the QI has not assumed primary Form 1099 reporting and backup withholding responsibility.

Step 4: Obtain:
(a) The account statements and records that show the investment and the type of income earned and the amounts backup withheld (if any); and
(b) The withholding statements associated with the Forms W-8IMY.

Step 5: Based on the records described in Step 4(a), classify the pools within each account according to the type of reportable payment made to each account. The external auditor must apply this Step 5 and Step 6 whether or not the QI is using the alternative procedure contained in section 6.03(B) of the QI Agreement.

Step 6: Determine whether the classifications and amounts of income and amounts backup withheld (if any) under Step 5 match classifications and amounts in the with-

holding statements described in Step 4(b).

Step 7: For indirect account holders:

(a) Identify all accounts covered by the QI Agreement for which recipient specific reporting is required under section 8.02(B) and (C) or section 8.04 of the QI Agreement;
(b) Identify the indirect account holders holding through those accounts, or use the same sample selected under AG 10.03(A)(4).1 Step 7.
(c) From the indirect account holders identified or selected in (b), segregate the indirect account holders that are U.S. non-exempt recipients.
(d) Apply Steps 2 through 6 to the indirect account holders segregated in (c).

10.03(B)(5).2. *Withholding Rate Pool Classification (U.S. Non-exempt Recipient) Report*. The external auditor must specifically report:

Report 1: The number of accounts segregated under Steps 1, 2, and 3.

Report 2: The number of accounts for which the classifications and amounts do not match the classifications and amounts in the QI's withholding statements.

Report 3: For indirect account holders,
(a) The number of indirect account holders under Step 7(a) through (c);
(b) The number of indirect account holders under Step 2; and
(c) The number of indirect account holders for which the classifications and amounts do not match the classifications and amounts in the QI's withholding statements.

QI Agreement Sec. 10.03(B)(6). Verify, if QI is using the alternative procedure for U.S. non-exempt recipients contained in section 6.03(B) of this Agreement, that QI is providing sufficient and timely information to withholding agents that allocates reportable payments to U.S. non-exempt recipients.

Audit Guidance 10.03(B)(6):

10.03(B)(6).1. *Review of Alternative Procedure.* The external auditor must:

Step 1: Inspect the withholding statements associated with the Forms W-8IMY to determine whether the allocation information for each account was provided to the withholding agent no later than January 15 of the year following the year of payment.

10.03(B)(6).2. *Alternative Procedure Report.* The external auditor must specifically report:

Report 1: The number of accounts for which allocation information was not provided to the withholding agent by January 15 of the year following the year of payment.

QI Agreement Sec. 10.03(C)(1). Withholding Responsibilities. The external auditor must—

(1) To the extent QI has assumed primary NRA withholding responsibility, perform test checks, using a valid sample of foreign account holders, to verify that QI is withholding the proper amounts;

Audit Guidance 10.03(C)(1):

10.03(C)(1).1. *Review of Withholding (NRA Withholding Assumed).* The external auditor must:

Step 1: Identify all accounts covered by the QI Agreement that are held by direct account holders that are not U.S. non-exempt recipients, or use the same sample selected under AG 10.03(A)(4).1 Step 1.

Step 2: Obtain copies of the QI's Forms W-8IMY and inspect them to determine whether the QI has assumed primary NRA withholding responsibility. For accounts covered by the QI Agreement for which the QI has assumed such responsibility, the external auditor must perform the procedures described below.

Step 3: Obtain the account statements and records that show the investment

and the type of income earned and the amounts of withholding.

Step 4: (a) Based on the records described in Step 3, classify the accounts according to the type of income paid to each account. An account to which more than one type of income has been paid must be placed into multiple income classifications.

(b) Based on the documentation for the account (after the determinations under AG 10.03(A)(4) and (5) have been made), determine the withholding rate and further classify the accounts within an income classification according to withholding rate. An account within an income classification to which more than one withholding rate has been applied must be placed into multiple withholding rate classifications.

Step 5: For each account, determine the amount (if any) by which the amount of withholding based on the classifications under Step 4(a) and Step 4(b) exceeds the amount withheld by the QI.

Step 6: (a) Identify all accounts covered by the QI Agreement for which recipient specific reporting is required under section 8.02(B) and (C) or section 8.04 of the QI Agreement;

(b) Identify the indirect account holders holding through those accounts, or use the same sample selected under AG 10.03(A)(4).1 Step 7.

(c) From the indirect account holders identified or selected in (c), segregate the indirect account holders that are not U.S. non-exempt recipients.

(d) Obtain copies of the QI's Forms W-8IMY and inspect them to determine whether the QI has assumed primary NRA withholding. For accounts covered by the QI Agreement for which the QI has assumed such responsibility, the external auditor must perform the procedures described below.

(e) Complete Steps 4(a) through (c) and Step 5.

10.03(C)(1).2. *Withholding (NRA Withholding Assumed) Report.* The external auditor must report:

Report 1: The amount of underwithholding for each account examined within each withholding rate classification in Step 1.

Report 2: The amount of underwithholding for each indirect account holder examined within each withholding rate classification.

QI Agreement 10.03(C)(2). To the extent QI has not assumed primary NRA withholding responsibility, verify that QI has fulfilled its responsibilities under section 3.02 of this Agreement;

Audit Guidance 10.03(C)(2):

10.03(C)(2).1. *Review of Responsibilities under Section 3.02.* The external auditor must:

Step 1: For each account required to be reported under AG 10.03(B)(4).2 Report 3 and each indirect account holder required to be reported under AG 10.03(B)(4).2 Report 4(b), determine the amount (if any) by which the amount of withholding based on the classifications under AG 10.03(B)(4).1 Step 4(a) and Step 4(b) exceeds the amount withheld.

10.03(C)(2).2. *Responsibilities under Section 3.02 Report.* The external auditor must report:

Report 1: The amount of underwithholding for each account and each indirect account holder within each withholding classification.

QI Agreement 10.03(C)(3). To the extent QI has assumed primary Form 1099 reporting and backup withholding responsibility, perform test checks using a valid sample of U.S. non-exempt recipient account holders to verify that QI backup withheld when required;

Audit Guidance 10.03(C)(3):

10.03(C)(3).1. *Review of Backup Withholding (Responsibilities Assumed)*. The external auditor must:

Step 1: Identify all accounts covered by the QI Agreement that are held by direct account holders that are U.S. non-exempt recipients, or use the same sample selected under AG 10.03(A)(6).1 Step 1.

Step 2: From the accounts identified or selected in Step 1, segregate the accounts of those U.S. non-exempt recipients whose identity is not prohibited by law from disclosure, including the accounts of U.S. non-exempt recipients that have waived the prohibitions against disclosure.

Step 3: Obtain copies of the QI's Forms W-8IMY and inspect them to determine whether the QI has assumed primary Form 1099 and backup withholding responsibility. From the accounts segregated in Step 2, segregate the accounts of U.S. non-exempt recipients for which the QI has assumed primary Form 1099 reporting and backup withholding responsibility.

Step 4: Obtain the account statements and records that show the investment and the type of income earned and the amounts backup withheld (if any).

Step 5: Based on the records described in AG 10.03(A)(6).1, determine whether account holder's file contains the account holder's TIN.

Step 6: If the account holder's file does not contain the account holder's TIN, determine whether the QI imposed backup withholding on reportable payments at the correct rate.

Step 7: (a) Identify all accounts covered by the QI Agreement for which recipient specific reporting is required under section 8.02(B) and (C) or section 8.04 of the QI Agreement;

(b) Identify the indirect account holders holding through those accounts, or use the same sam-

ple selected under AG 10.03(A)(4).1 Step 7;

(c) From the indirect account holders in (b), segregate the indirect account holders that are U.S. non-exempt recipients.

(d) Apply Steps 2 through 6 to those indirect account holders.

10.03(B)(5).2. *Backup Withholding Report (Responsibilities Assumed)*. The external auditor must specifically report:

Report 1: The amount of underwithholding for each account and each indirect account holder that does not contain the account holder's TIN.

QI Agreement Sec. 10.03(C)(4). To the extent QI has not assumed primary Form 1099 reporting and backup withholding responsibility, perform test checks using a valid sample of U.S. non-exempt account holders to verify that QI has fulfilled its backup withholding responsibilities under sections 3.04, 3.05, and 3.06 of this Agreement;

Audit Guidance 10.03(C)(4):

10.03(C)(4).1. *Backup Withholding Review (Responsibilities Not Assumed)*. The external auditor must:

Step 1: For each account required to be reported under AG 10.03(B)(5).2 Report 2 and each indirect account holder required to be reported under AG 10.03(B)(5).2 Report 3(c), determine whether backup withholding was imposed at the correct amount.

10.03(C)(4).2. *Backup Withholding Report (Responsibilities Not Assumed)* The external auditor must report:

Report 1: The amount of underwithholding for each account and each indirect account holder for which backup withholding is required.

QI Agreement Sec. 10.03(C)(5). Review the accounts of U.S. non-exempt recipient account holders whose identity is prohibited by law, including by contract, from disclosure and verify that QI or another payor is backup withholding on reportable payments made to such account holders;

Audit Guidance 10.03(C)(5):

10.03(C)(5).1. *Review of Backup Withholding on Reportable Payments (Disclosure Prohibited)*. The external auditor must:

Step 1: For each account required to be reported under AG 10.03(A)(7).2 Report 2, determine whether backup withholding was imposed at the correct amount.

10.03(C)(5).2. *Backup Withholding on Reportable Payments (Disclosure Prohibited) Report*. The external auditor must report:

Report 1: The amount of underwithholding for each account for which backup withholding is required.

QI Agreement Sec. 10.03(C)(6). Review a valid sample of accounts of U.S. non-exempt recipient account holders and determine if assets that generate or could generate reportable payments are held in an account of any U.S. non-exempt recipient account holders whose identity is prohibited by law, including by contract, from disclosure, and ascertain the reason why such assets have not been disposed of or the account holder disclosed;

Audit Guidance 10.03(C)(6):

10.03(C)(6).1. *Review of Assets Held by U.S. Non-exempt Recipients (Disclosure Prohibited)*. The external auditor must:

Step 1: For each account required to be reported under AG 10.03(A)(7).2 Report 2, obtain a letter from the responsible party explaining the reason why assets that generate or could generate reportable payments have not been disposed of or the account holder disclosed.

10.03(C)(6).2. *Assets Held by U.S. Non-exempt Recipients (Disclosure Prohibited) Report*. The external auditor must:

Report 1: Include a copy of the letter obtained in Step 1 with its report.

QI Agreement Sec. 10.03(C)(7). Verify that amounts withheld were timely deposited in accordance with section 3.08 of this Agreement.

Audit Guidance 10.03(C)(7):

10.03(C)(7).1. *Review of Timely Deposits.* The external auditor must:

Step 1: Obtain the QI's records of payments covered by the QI Agreement, the QI's Form 1042 and the QI's records of tax deposits.

Step 2: Determine that the payment dates timely correspond with the deposit dates for any required deposits.

10.03(C)(7).2. *Timely Deposits Report.* The external auditor must report:

Report 1: Any payment dates that do not timely correspond with deposit dates.

QI Agreement Sec. 10.03(D)(1). Return Filing and Information Reporting. The external auditor must—

(1) Obtain copies of original and amended Forms 1042 and Forms 945, and any schedules, statements, or attachments required to be filed with those forms, and determine whether the amounts of income, taxes, and other information reported on those forms are accurate by—

(i) Reviewing work papers;

(ii) Reviewing Forms W-8IMY, together with the associated withholding statements, that QI has provided to withholding agents;

(iii) Reviewing copies of Forms 1042-S that withholding agents have provided QI;

(iv) Reviewing account statements from withholding agents;

(v) Reviewing correspondence between QI and withholding agents; and

(vi) Interviewing personnel responsible for preparing the Forms 1042 and 945 and the work papers used to prepare those forms.

Audit Guidance 10.03(D)(1):

10.03(D)(1).1. *Review of Forms 1042 and 945.* The external auditor must:

Step 1: Obtain copies of:

- a. The QI's Forms W-8IMY and associated withholding statements, Forms 1042 and 945,

and the Forms 1042-S issued to the QI and the Forms 1042-S filed by the QI (for PAI's, obtain the reporting pool information provided to its QI); and

- b. The copies of the QI's records of payments from withholding agents and of payments to the QI's reporting pools, other QI's and withholding foreign partnerships and trusts, other recipients for which recipient specific reporting is required under section 8.02 of the QI Agreement, U.S. non-exempt recipients, and U.S. exempt recipients as a class.

Step 2: Reconcile the amounts reported paid to the QI on the Forms 1042-S issued to the QI, the amounts reported paid by the QI on the Forms 1042-S filed by the QI, the amounts shown paid by the QI to U.S. non-exempt recipients on its withholding statements and in the QI's records of payments, and the amounts shown paid by the QI to U.S. exempt recipients as a class in the QI's records of payments, and the amounts reported on the QI's Forms 1042 and 945.

10.03(D)(1).2. *Forms 1042 and 945 Report.* The external auditor must report:

- Report 1: (a) The aggregate amount reported paid to the QI on the Forms 1042-S issued to the QI;
- (b) The aggregate amount reported paid by the QI on Forms 1042-S to each reporting pool;
- (c) The aggregate amount reported paid by the QI on Forms 1042-S to other QI's as a class;
- (d) The aggregate amount reported paid by the QI on Forms 1042-S to indirect account holders;
- (e) The aggregate amount shown paid by the QI to U.S. non-exempt recipients as a class;
- (f) The aggregate amount shown paid by the QI to U.S. exempt recipients as a class;

(g) The total amounts withheld by the QI; and

(h) The total amounts withheld by others.

Report 2: The aggregate amount of any adjustments under section 9 of the QI agreement incorporated in each amount in Report 1.

Report 3: The aggregate amount of any other adjustments that were incorporated in the amounts reported under Report 1 in performing the reconciliation under Step 2.

Report 4: Attach a copy of the QI's Form 1042.

QI Agreement Sec. 10.03(D)(2). Obtain copies of original and corrected Forms 1042-S and Forms 1099 together with the work papers used to prepare those forms and determine whether the amounts reported on those forms are accurate by—

(i) Reviewing the Forms 1042-S received from withholding agents;

(ii) Reviewing the Forms W-8IMY, and the associated withholding statements, that QI has provided withholding agents;

(iii) Reviewing a valid sample of account statements issued by QI to account holders; and

(iv) Interviewing QI's personnel responsible for preparing the Forms 1042-S and, if applicable, Forms 1099, and the work papers used to prepare those forms.

Audit Guidance 10.03(D)(2):

10.03(D)(2).1. *Review of Forms 1042-S and 1099.* The external auditor must:

Step 1: Obtain copies of:

- (a) The QI's records of payments from withholding agents and the QI's records of payments to the QI's reporting pools and to any other QIs (or PAIs) contained in the sample selected for AG 10.03(A)(4), and
- (b) The Forms 1042-S filed by the QI for each reporting pool and any such QIs.

Step 2: Match the QI's records of payments to the amounts reported for each reporting pool and any QI's described in Step 1(a) on the QI's Forms 1042-S.

Step 3: Identify:

- (a) All accounts covered by the QI Agreement for which recipient specific reporting is required under section 8.02(B) and (C) or section 8.04 of the QI Agreement; and
- (b) The indirect account holders holding through those accounts, or use the same sample selected under AG 10.03(A)(4).1 Step 7.

Step 4: Obtain copies of:

- (a) The Forms 1042-S and Forms 1099 filed by the QI for each indirect account holder;
- (b) The Forms W-8IMY and associated withholding statements applicable to each indirect account holder;
- (c) The QI's records of payments to each indirect account holder; and
- (d) The documentation for each indirect account holder.

Step 5: Match the QI's records of payments to the amounts reported for each indirect account holder on the QI's Forms 1042-S and 1099.

Step 6: (a) In the case of a QI that assumed primary Form 1099 and backup withholding responsibility, identify all accounts covered by the QI Agreement that are held by U.S. non-exempt recipients, or use the same sample as in AG 10.03(A)(6).1 Step 1.
(b) Match the QI's records of payments to the amounts reported on each Form 1099 filed by the QI.

10.03(D)(2).2. *Forms 1042-S and 1099 Report.* The external auditor must report:

Report 1: For each pool or QI for which the amounts paid and the amounts reported do not match, the amounts of income reported on each Form 1042-S under

Step 2, and the amounts paid to each pool or QI.

Report 2: The number of:

- (a) Nonqualified intermediaries and flow through entities that are direct account holders under Step 3(a);
- (b) Indirect account holders under Step 3(b);

Report 3: The number of indirect account holders for which the payments made do not match the payments reported on Forms 1042-S and on Forms 1099, and for those account holders the amounts reported on each form and the amounts paid to each indirect account holder.

Report 4: The number of non-exempt recipients for which the payments made do not match the payments reported on Forms 1099, and for those accounts the amounts reported on each form and the amounts paid to each non-exempt recipient.

***QI Agreement Sec. 10.03(D)(3).* Thoroughly review the statements attached to amended Forms 1042 filed to claim a refund, ascertain their veracity, and determine the causes of any overwithholding reported and ensure QI did not issue Forms 1042-S to persons whom it included as part of its collective credit or refund.**

Audit Guidance 10.03(D)(3):

10.03(D)(3).1. *Review of Refunds.* The external auditor must:

Step 1: Obtain:

- (a) The QI's amended Form 1042 (including the attached statements), the Forms 1042-S filed by the QI, and the Forms 1042-S issued to the QI;
- (b) The QI's records of payments from withholding agents and the QI's records of payments to the QI's reporting pools; and
- (c) The QI's records of payments to the account holders who received a refund of overwithholding from the QI.

Step 2: Inspect the QI's records of payments to determine whether overwithholding occurred and the amount of the overwithholding.

Step 3: Match the amount of income, withholding, and overwithholding with the QI's Form 1042.

Step 4: Identify the reporting pool or pools to which the overwithholding is attributable and the amount of overwithholding attributable to each pool.

Step 5: Identify the account holders who received a refund of the overwithholding from the QI.

Step 6: Identify all Forms 1042-S filed by the QI on a recipient specific basis.

Step 7: Match the account holders identified under Step 5 with the Forms 1042-S identified under Step 6.

10.03(D)(3).2. *Refund Report.* The external auditor must report:

Report 1: The total amount of overwithholding under Step 2.

Report 2: The amounts of overwithholding by each pool under Step 4.

Report 3: The number of account holders identified under Step 5.

Report 4: The number of account holders that do not match with Forms 1042-S under Step 7.

***QI Agreement Sec. 10.03(D)(4).* Determine, in the case of collective credits or refunds, that QI repaid the appropriate account holders prior to requesting a collective refund or credit.**

Audit Guidance 10.03(D)(4):

10.03(D)(4).1. *Review of Account Holder Repayment Prior to Refund.* The external auditor must:

Step 1: Obtain:

- (a) The QI's amended Form 1042 (including attached statements); and
- (b) The QI's records of payments to the account holders who received a refund of overwithholding from the QI.

Step 2: Inspect the QI's Form 1042 and records of payments to determine that the dates of payments of overwithholding made to each account holder were prior to the date of filing the Form 1042.

10.03(D)(4).2. *Account Holder Repayment Prior to Refund Report:* The external auditor must report:

Report 1: The amount of overwithholding paid to each account holder that occurred after the date of filing the Form 1042.

QI Agreement Sec. 10.03(E). Change in Circumstances. The external auditor must verify that in the course of the audit it has not discovered any significant change in circumstances, as described in section 11.03(A), (D), or (E) of this Agreement.

Audit Guidance 10.03(E):

10.03(E).1. *Review of Change in Circumstance.* The external auditor must:

Step 1: Obtain a letter signed by the responsible party and by the QI's legal counsel stating:

- (a) Whether there has been an acquisition of all, or substantially all, of the QI's assets in any transaction in which the QI is not the surviving legal entity;
- (b) Any material changes in the know-your-customer rules and procedures set forth in the Attachments to the QI Agreement; and
- (c) Any significant changes in the QI's business practices that affect the QI's ability to meet its obligations under the QI Agreement.

10.03(E).2. *Change in Circumstance Report.* The external auditor must report a change in circumstances by:

Report 1: Attaching a copy of the letter under Step 1.

QI Agreement Sec. 10.04. Use of Statistical Sampling. If the external auditor is required to make a determination based on a valid sample of accounts, it shall use a statistical sampling whenever an examination of all of accounts within a particular class of accounts would be prohibitive in terms of time and expense. If it is reasonable to examine all accounts in connection with a particular issue, statistical sampling techniques shall not be used. If statistical sampling techniques are required, the external auditor must determine a sample size that provides a 95 percent confidence level. If statistical sampling has been used and the auditor determines that underwithholding has occurred with respect to the sampled accounts, the IRS will determine the total amount of underwithheld tax by projecting the underwithholding over the entire population of similar accounts. For this purpose, QI agrees to provide the IRS with the information (e.g., number of accounts and amounts) required to project the underwithholding. QI shall either report and pay, in accordance with section 9.06 of this Agreement, the underwithheld tax determined under the IRS projection or propose another amount of underwithholding based on a more accurate population, a more accurate projection technique, or an examination of all similar accounts. If the IRS does not agree with the amount proposed by QI, the IRS shall assess a tax

by making a return under section 6020 of the Code.

Audit Guidance 10.04:

10.04.1. *When to Use Statistical Sampling.* The external auditor is permitted to select three statistical samples for use in performing the procedures in AG 10.03. These are the samples permitted to be selected in:

- (a) AG 10.03(A)(4).1 Step 1 (a sample of all accounts covered by the QI Agreement that are held by direct account holders that are not U.S. non-exempt recipients);
- (b) AG 10.03(A)(6).1 Step 1 (a sample of all accounts covered by the QI Agreement that are held by direct account holders that are U.S. non-exempt recipients); and
- (c) AG 10.03(A)(4).1 Step 7 (a sample of the indirect account holders for which recipient specific reporting is required).

The external auditor may always elect to conduct a 100 percent review instead of selecting a statistical sample. The statistical sampling methodology used in these guidelines cannot be used for any other tax purpose.

10.04.2. *Sample Size.* The external auditor is permitted to select a sample only if there are more than 50 accounts from which to select a sample in 10.04.1(a) or (b) or more than 50 indirect account holders from which to select a sample in 10.04.1(c).

10.04.3. *Sample Formula.* The external auditor must determine the sample size by using the following formula:

$$\text{Sample Size} = \frac{\frac{t^2 P Q}{d^2}}{1 + \frac{1}{N} \left(\frac{t^2 P Q}{d^2} - 1 \right)}$$

where $t=1.96$ (confidence coefficient at 95 percent two sided)

$P=5$ percent (error rate)

$Q=1-P$

$d=2$ percent (precision level)

N =total population

The sample size will not exceed 456 (as determined by the formula above) or 50 percent of the population, whichever is smaller. In no event may the sample size be lower than 50.

10.04.4. *Number Generator.* The external auditor must select the sample by using a random number generator.

10.04.5. *Records of Sampling Methodology.* The external auditor is required to record its statistical sampling procedures and to maintain the ability to reconstruct the sample.

10.04.6. *Alternative Sampling Methods.* Multistage, cluster, stratification or other sampling methodology may be used with the consent of the IRS. The sample size may be adjusted to achieve a 5 percent error rate, a 2 percent precision level and a 95 percent two sided confidence level. See AG 10.03.2 (Submission of Audit Plan).

10.04.7. *Projection.* If the external auditor has used a sample and has determined that underwithholding under AG 10.03(C)(1), (2), (3), (4), or (5) has occurred, then the IRS will determine the total amount of underwithheld tax by projecting the underwithholding over the entire population of similar accounts using a projection method that is consistent with the sampling method used. For example, if a simple unrestricted random sample as provided in these guidelines has been used, then the IRS may determine the total amount of underwithheld tax by projecting the underwithholding over the entire population of similar accounts as follows:

- (a) Dividing the amount of underwithholding for the sample by the number of accounts (or indirect account holders) in the sample; and
- (b) Multiplying the result in (a) by the total number of accounts in the population.
- (c) If the external auditor has used a sample and has determined

that overwithholding has occurred, the QI may not project the amount of overwithholding in order to claim a refund. For samples of direct account holders, the IRS will offset any underwithholding in the sample against any overwithholding in the sample, provided that the QI enters into a closing agreement (Form 906) that QI will not file a claim for refund for any overwithholding that the external auditor has discovered.

- (d) The IRS will determine whether it is appropriate to project an amount of underwithholding when the facts show that:
 - (i) The amount is the consequence of an identified error; and
 - (ii) The error was not repeated throughout the population over which it would be projected.
- (e) The QI may propose that it is not appropriate to project an amount of underwithholding when the QI shows that:
 - (i) The underwithholding was the consequence of an identified error,
 - (ii) The QI has corrected the error in the sample in which it was discovered,
 - (iii) The QI has corrected the error throughout the population from which the sample was drawn,
 - (iv) The QI has established safeguards to prevent repetition of the error in the future, and
 - (v) As a consequence of the correction, the facts as corrected show that there was actually no underwithholding during the audit year. (Penalties and interest may nevertheless be imposed.)

The QI may also propose an alternative projected underwithholding tax adjustment based on facts and circumstances. See Audit meeting

in AG 10.06 Step 3 for procedures for making such proposals.

Sec. 10.05. External Auditor's Report. Upon completion of the audit of QI and any PAI, the external auditor shall issue a report, or reports, of audit findings directly to the IRS by sending the original report to the IRS at the address set forth in section 12.06 of this Agreement by June 30 following the calendar year being audited, or if that date falls on a Saturday or Sunday, the next U.S. business day. The report must be in writing, in English, and currency amounts must be stated in U.S. dollars. The report must fully describe the scope of the audit, the methodologies (including sampling techniques) used to determine whether QI is in compliance with the provisions of this Agreement, and the result of each such determination. The report must also specifically address each of the items in section 10.03 of this Agreement.

Audit Guidance 10.05:

10.05.1. *Auditor's Report Requirements.* The external auditor's report must:

- (a) List the external auditor's name, address, contact person and contact person's telephone number.
- (b) List the QI's name, address, QI-EIN, responsible party and responsible party's telephone number.
- (c) List each procedure required under these Audit Guidelines in the order listed in the Audit Guidelines with a notation that the procedure was performed.
- (d) Identify the audit year.
- (e) List, under each procedure, the items required to be reported under these Audit Guidelines in the order listed in the Audit Guidelines.
- (f) Include any items required to be attached to the report as Appendix 1. These items should be cross-referenced in the report with footnotes.
- (g) Include any information that requires a narrative response and any other information that the external auditor wishes to include as Appendix 2. These

items should be cross-referenced in the report with footnotes.

- (h) Contain a certification signed by the external auditor that the required procedures have been competently performed and that the information reported is accurate and complete.

10.05.2. *Electronic Report.* The IRS intends to develop a standard electronic report form. For audit reports due after the publication date of that form, the external auditor must also complete that form and send it to the IRS in the manner required by the form.

10.05.3. *Report Due Dates.* The external auditor must send the hard copy audit report to the IRS at the address set forth in section 12.06 of the QI Agreement by June 30 of the year following the audit year. The external auditor and the QI may jointly request an extension of the due date of the report by submitting a request for extension in writing signed by the external auditor and by the QI's responsible party to the IRS at the address in AG 10.01.1 by June 30 of the year following the audit year. The request should state the date to which the extension is requested, explain the reason for the extension and include telephone numbers for the external auditor's contact person and the QI's responsible party. The IRS will send the external auditor and the QI a written response as soon as practicable after receiving the request.

Sec. 10.06. Expanding Scope and Timing of External Audit. Upon review of the external auditor's report, the IRS may request, and QI must permit, the external auditor to perform additional audit procedures, or to expand the external audit to cover some or all of the calendar years for which the period of limitations for assessment of taxes has not expired. In addition, the IRS may

request, and QI agrees to permit, the external auditor to perform an audit for one or more calendar years not scheduled for audit under section 10.03 of this Agreement.

Audit Guidance 10.06:

10.06.1 *IRS Review of Audit Report.* Within 90 days after the IRS receives the external auditor's report, the IRS will review the report and, if the IRS determines that no further action is necessary, then the IRS will send a written notice to the QI and the external auditor informing them of this determination.

10.06.2. *Audit Part 2: IRS Directed Procedures.* The IRS may determine that additional fact finding is necessary. In such cases, the IRS will contact the external auditor and the QI by telephone or in writing within 90 days after the IRS receives the external auditor's report. The IRS will direct the external auditor to perform specific audit procedures and to report in writing the results of those procedures. The IRS directed procedures may include instructing the external auditor to forward to the IRS certain of the external auditor's work papers and reports or instructing the external auditor to perform specific procedures (or perform an audit in accordance with these Audit Guidelines) for the audit year or for years other than the audit year. The IRS will stipulate a due date not more than 90 days from the date of its instructions to the external auditor for the external auditor's report on the results of any IRS directed procedures. The external auditor may request an extension of the due date in accordance with AG 10.05 at any time before the due date. Within 90 days after receiving the external auditor's report on the results of the initial IRS directed procedures, the IRS will contact the external auditor and the QI. If the IRS determines that additional fact finding is necessary, then the IRS may direct the external auditor to perform further addi-

tional procedures under this section until the IRS determines that the facts have been sufficiently developed. If the IRS determines that the audit is complete, the IRS will notify the external auditor and the QI in writing of the completion of the audit and of any actions that it will take as a result of the audit.

10.06.3. *Audit Part 3: Audit Meeting.* At any time after the external auditor has submitted its report on the initial IRS directed procedures and before the IRS notifies the QI and the external auditor of the completion of the audit, either the IRS or the QI may request an audit meeting between the IRS and the QI to accelerate fact finding, and to clarify and resolve concerns. To request and schedule a meeting, the IRS will contact the QI's responsible party by telephone or in writing, and the QI may contact the IRS at the address in AG 10.01 by telephone or in writing. The IRS will meet with the QI within 90 days of the date the IRS receives or makes the request, or at such other time as the IRS and the QI may agree. If the IRS and the QI agree, the employees of the external auditor who are acting in the capacity of external auditors under the QI Agreement may attend the audit meeting in that capacity, and other employees of the same firm may attend in other capacities. The IRS may continue to direct the external auditor to perform specific audit procedures under AG 10.06.2 without regard to whether an audit meeting has been scheduled or held. After the first audit meeting, either the IRS or the QI may request further audit meetings at any time before the IRS notifies the external auditor and the QI of the completion of the audit.

Part IV. Items of General Interest

Reporting Elective Deferral Catch-up Contributions on the 2002 Form W-2

Announcement 2001-93

Purpose

This is to advise employers how to report elective deferral catch-up contributions beginning after December 31, 2001.

Statutory Change

The Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) added section 414(v) to the Internal Revenue Code of 1986. For 2002, section 414(v) enables applicable employer plans to allow eligible participants who are age 50 or over to make additional elective deferrals, *i.e.*, “catch-up” contributions.

Reporting on Form W-2

For 2002, employers are required to report participants’ elective pension deferrals on Form W-2 in box 12 using Codes D through H and S. For employees’ qualified catch-up contributions after 2001, employers must report the elective deferral catch-up contributions in the totals reported for Codes D through H and S.

Reporting on Form 5498

The reporting of catch-up contributions will be addressed in the 2002 Instructions for Forms 1099-R and 5498. No major changes are anticipated.

Saver’s Tax Credit for Contributions by Individuals to Employer Retirement Plans and IRAs

Announcement 2001-106

This announcement describes the new “saver’s credit,” an income tax credit that is available to eligible taxpayers who contribute to a retirement plan or IRA. This announcement includes a sample notice that employers can give to employees explaining the credit.

Q-1: What is the saver’s credit?

A-1: The saver’s credit is a nonrefundable income tax credit for certain taxpayers with adjusted gross income that does not exceed \$50,000. It is equal to a specified percentage of certain employee contributions made to an employer-sponsored retirement plan or of certain individual or spousal contributions to an individual retirement arrangement (IRA) for taxable years beginning after December 31, 2001, and before January 1, 2007. The saver’s credit is contained in § 25B of the Internal Revenue Code, which was added by section 618 of the Economic Growth and Tax Relief Reconciliation Act of 2001.

Q-2: Who is eligible for the saver’s credit?

A-2: Taxpayers who are age 18 or over before the end of their taxable year, other than full-time students or persons claimed as dependents on another taxpayer’s return, are eligible for the credit.

For this purpose, students include individuals who, during some part of each of five months during the year, are (a) enrolled at a school that has a regular teaching staff, course of study, and regularly enrolled body of students in attendance, or (b) taking an on-farm training course given by such a school or a state, county, or local government. A student is a full-time student if he or she is enrolled for the number of hours or courses the school considers to be full-time.

Q-3: What is the maximum annual contribution eligible for the saver’s credit?

A-3: \$2,000 per year.

Q-4: Is the amount of the annual contribution eligible for the saver’s credit ever reduced?

A-4: Yes. The amount of any contribution eligible for the saver’s credit is reduced by the amount of any taxable distribution received by the taxpayer (or by the taxpayer’s spouse if the taxpayer filed jointly with that spouse both for the year during which a distribution was made and the year for which the credit is taken) from any plan described in A-5 below during the testing period. The testing pe-

riod consists of the year for which the credit is claimed, the period after the end of that year and before the due date (with extensions) for filing the taxpayer’s return for that year, and the two taxable years that precede the year for which the credit is claimed. In the case of a distribution from a Roth IRA, this reduction applies to any such distribution, whether or not taxable, that is not rolled over. An amount does not count as a distribution for purposes of the reduction rule if the distribution is a return of a contribution to an IRA (including a Roth IRA) made during the tax year and (1) the distribution is made before the due date (including extensions) of the individual’s tax return for that year, (2) no deduction is taken with respect to the contribution, and (3) the distribution includes any income attributable to the contribution.

For example, if an individual contributes \$3,000 to a 401(k) plan during 2002, but had taken a \$500 IRA withdrawal during that year and a \$900 IRA withdrawal during 2001 and neither of these withdrawals was rolled over, the amount of that individual’s 2002 plan contribution eligible for the credit is \$1,600 (\$3,000 - \$500 - \$900), instead of the \$2,000 that would have been eligible for the credit if no withdrawals had been taken.

Q-5: What types of contributions are eligible for the saver’s credit?

A-5: Salary reduction contributions to the following arrangements are eligible for the credit: a 401(k) plan (including a SIMPLE 401(k)), a section 403(b) annuity, an eligible deferred compensation plan of a state or local government (a “governmental 457 plan”), a SIMPLE IRA plan, or a salary reduction SEP. The saver’s credit is also available for voluntary after-tax employee contributions to a tax-qualified retirement plan or section 403(b) annuity. For purposes of the credit, an employee contribution will be “voluntary” as long as it is not required as a condition of employment. Finally, the saver’s credit is available for contributions to a traditional or Roth IRA.

An amount contributed to an individual’s IRA is not a contribution eligible for the

saver's credit if (1) the amount is distributed to the individual before the due date (including extensions) of the individual's tax return for the year in which the contribution was made, (2) no deduction is taken with respect to the contribution,

and (3) the distribution includes any income attributable to the contribution.

Q-6: What is the saver's credit rate?

A-6: The saver's credit rate is based on the taxpayer's adjusted gross income for

the taxable year for which the credit is claimed, as follows:

Adjusted Gross Income			
Married filing joint	Head of household	All other filers	Credit
\$0-\$30,000	\$0-\$22,500	\$0-\$15,000	50% of contribution
\$30,001-\$32,500	\$22,501-\$24,375	\$15,001-\$16,250	20% of contribution
\$32,501-\$50,000	\$24,376-\$37,500	\$16,251-\$25,000	10% of contribution
Over \$50,000	Over \$37,500	Over \$25,000	credit not available

For example, a taxpayer whose filing status is single with adjusted gross income of \$15,000 may be entitled to a credit equal to 50% of his or her contributions (up to \$2,000 of contributions) to a plan described in A-5 above.

Q-7: Does the saver's credit affect an eligible individual's entitlement to any deduction or exclusion that would otherwise apply to the contribution?

A-7: No. Eligible individuals entitled to deduct IRA contributions or to exclude plan contributions from gross income will be able to deduct or exclude those amounts and also claim the saver's credit.

Q-8: Can a taxpayer use the saver's credit to offset both an alternative minimum tax liability and a regular income tax liability?

A-8: Yes.

Q-9: For married taxpayers filing jointly, do contributions by or for either or both spouses give rise to the saver's credit?

A-9: Yes, contributions by or for either or both spouses, up to \$2,000 per year for each spouse, can give rise to the saver's credit.

Q-10: Are salary reduction and after-tax employee contributions that are eligible for the saver's credit taken into account in the ADP and ACP nondiscrimination tests of §§ 401(k) and (m) of the Internal Revenue Code?

A-10: Yes. Salary reduction contributions to a 401(k) plan, whether or not those contributions give rise to the saver's credit, are taken into account in the nondiscrimination test for salary

reduction contributions (the ADP test) for plans subject to that test. Also, voluntary after-tax employee contributions to a qualified plan, whether or not those contributions give rise to the saver's credit, are taken into account in the nondiscrimination test for employee after-tax contributions (the ACP test) for plans subject to that test.

Q-11: Can an individual claim the saver's credit for an amount contributed to a plan pursuant to automatic enrollment?

A-11: Yes. Any amount that is treated as an elective contribution on behalf of an eligible individual to an employer plan described in A-5 above can give rise to the saver's credit.

Q-12: Can an individual take a projected saver's credit into account in figuring the allowable number of withholding allowances on Form W-4?

A-12: Yes. For information on converting credits into withholding allowances, see IRS Publication 919, "How Do I Adjust My Withholding?"

Q-13: Is there a sample notice that employers can use to help explain the saver's credit to employees?

A-13: Yes. Employers are encouraged to tell their employees about the credit. Employers can inform employees in any way they choose, including use of the notice set out below.

Drafting Information

The principal author of this announcement is Roger Kuehnle of the Employee

Plans, Tax Exempt and Government Entities Division. For further information regarding this announcement, 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 9:30 p.m. Eastern Time, Monday through Friday. Mr. Kuehnle may be reached at (202) 283-9888 (not a toll-free number).

Notice to Employees Regarding Saver's Credit:

This notice explains how you may be able to pay less tax by contributing to [insert name of employer's plan] (the "Plan") or to an individual retirement arrangement ("IRA").

Beginning in 2002, if you make contributions to the Plan or to an IRA, you may be eligible for a tax credit, called the "saver's credit." This credit could reduce the federal income tax you pay dollar-for-dollar. The amount of the credit you can get is based on the contributions you make and your credit rate. The credit rate can be as low as 10% or as high as 50%, depending on your adjusted gross income — the lower your income, the higher the credit rate. The credit rate also depends on your filing status. See the tables at the end of this notice to determine your credit rate.

The maximum contribution taken into account for the credit for an individual is \$2,000. If you are married filing jointly, the maximum contribution taken into account for the credit is \$2,000 each for you and your spouse.

The credit is available to you if you:

- are 18 or older,
- are not a full-time student,
- are not claimed as a dependent on someone else's return, and
- have adjusted gross income (shown on your tax return for the year of the credit) that does not exceed:

\$50,000 if you are married filing jointly,

\$37,500 if you are a head of household with a qualifying person, or

\$25,000 if you are single or married filing separately.

Example: Susan and John are married and file their federal income tax return jointly. For 2002, their adjusted gross income would have been \$34,000 if they had not made any retirement contributions. During 2002, Susan elected to have \$2,000 contributed to her employer's 401(k) plan. John made a deductible contribution of \$2,000 to an IRA for 2002. As a result of these contributions, their 2002 adjusted gross income is \$30,000. If their Federal income tax would have been \$3,000 (after applying any other credits to

which they are entitled) without having made any retirement contributions, then their federal income tax as a result of making the \$4,000 retirement contributions will be only \$400 after application of the saver's credit and other tax benefits for the retirement contributions. Thus, by saving \$4,000 for their retirement, Susan and John have also reduced their taxes by \$2,600.

The annual contribution eligible for the credit may have to be reduced by any taxable distributions from a retirement plan or IRA that you or your spouse receive during the year you claim the credit, during the 2 preceding years, or during the period after the end of the year for which you claim the credit and before the due date for filing your return for that year. A distribution from a Roth IRA that is not rolled over is taken into account for this reduction, even if the distribution is not taxable. After these reductions, the maximum annual contribution eligible for the credit per person is \$2,000.

Example: Mark's adjusted gross income for 2002 is low enough for him to be eli-

gible for the credit that year and he defers \$3,000 of his pay to his employer's 401(k) plan during 2002. During 2001, Mark took a \$400 hardship withdrawal from his employer's plan and during 2002 he takes an \$800 IRA withdrawal. Mark's 2002 saver's credit will be based on contributions of \$1,800 (\$3,000 - \$400 - \$800).

The amount of your saver's credit will not change the amount of your refundable tax credits. A refundable tax credit, such as the earned income credit or the refundable amount of your child tax credit, is an amount that you would receive as a refund even if you did not otherwise owe any taxes.

The amount of your saver's credit in any year cannot exceed the amount of tax that you would otherwise pay (not counting any refundable credits or the adoption credit) in any year. If your tax liability is reduced to zero because of other nonrefundable credits, such as the Hope Scholarship Credit, then you will not be entitled to the saver's credit.

CREDIT RATES

If your income tax filing status is "married filing joint"

and your adjusted gross income is:

\$0-\$30,000
\$30,001-\$32,500
\$32,501-\$50,000
Over \$50,000

Your saver's credit rate is:

50% of contribution
20% of contribution
10% of contribution
credit not available

If your income tax filing status is "head of household"

and your adjusted gross income is:

\$0-\$22,500
\$22,501-\$24,375
\$24,376-\$37,500
Over \$37,500

Your saver's credit rate is:

50% of contribution
20% of contribution
10% of contribution
credit not available

If your income tax filing status is "single," "married filing separate," or "qualifying widow(er)"

and your adjusted gross income is:

\$0-\$15,000
\$15,001-\$16,250
\$16,251-\$25,000
Over \$25,000

Your saver's credit rate is:

50% of contribution
20% of contribution
10% of contribution
credit not available

Information Reporting Program Call Site Update

Announcement 2001-107

IRS Martinsburg Computing Center (MCC) Information Reporting Program Call Site Now Has a Toll-Free Telephone Number

The Call Site is located at IRS/MCC and operates in conjunction with the Information Reporting Program. The Call Site provides service to the payer community (financial institutions, employers, and other transmitters of information returns).

The Information Reporting Program Call Site answers both magnetic media and tax law questions relating to the filing of information returns (Forms 1096, 1098, 1099, 5498, 8027, W-2G, and W-4). The Call Site also answers magnetic media questions related to Forms 1042-S, and tax law and paper filing related questions about Forms W-2 and W-3, as well as handling inquiries dealing with backup withholding and reasonable cause requirements due to missing and incorrect taxpayer identification numbers.

The Call Site accepts calls from all areas of the country. **The new toll-free number is 866-455-7438.** Payers and transmitters may still use the original telephone number, which is **304-263-8700** or Telecommunications Device for the Deaf (TDD) **304-267-3367.** These are toll calls. *The Call Site can also be reached via email at mccirp@irs.gov.* Hours of operation for the Call Site are Monday through Friday, 8:30 a.m. to 4:30 p.m. Eastern time. The Call Site is in operation throughout the year to handle the questions of payers, transmitters, and employers. Due to the high demand for assistance at the end of January and February, it is advisable to call as soon as possible to avoid these peak filing seasons.

Foundations Status of Certain Organizations

Announcement 2001-108

The following organizations have failed to establish or have been unable to maintain their status as public charities

or as operating foundations. Accordingly, grantors and contributors may not, after this date, rely on previous rulings or designations in the Cumulative List of Organizations (Publication 78), or on the presumption arising from the filing of notices under section 508(b) of the Code. This listing does *not* indicate that the organizations have lost their status as organizations described in section 501(c)(3), eligible to receive deductible contributions.

Former Public Charities. The following organizations (which have been treated as organizations that are not private foundations described in section 509(a) of the Code) are now classified as private foundations:

A-1 Universal Care, Inc., Hempstead, NY
Albany-El Cerrito Access, El Cerrito, CA
Alliance for Youth Services Project, Inc., Long Beach, CA
Amateur Baseball Association of Texas, Inc., Houston, TX
Ambassador Baptist Church of Houston, Houston, TX
American Friends of Children of Chernobyl, Inc., New York, NY
American Samoan Medical Team, Inc., Las Vegas, NV
Amigas-Assisting Mexicans in Gaining Academic Success, Houston, TX
Amos York Ministries, Inc., Houston, TX
Asian-American Culture Center, Houston, TX
Asociacion Boliviana De Houston, Inc., Houston, TX
Balance Ministries, Houston, TX
Barrett Station Youth Enrichment Project, Inc., Crosby, TX
Bay Area School Reform Collaborative, San Francisco, CA
Bevcomm Internet Technology, Davis, CA
Binghampton Revitalization Association, Inc., Memphis, TN
Brazos River Preservation Society, Sugar Land, TX
Cape Cod Discovery Museum, Inc., Dennisport, MA
Capital District Field of Dreams, Inc., Albany, NY
Caregivers Empowered, Houston, TX
Caring Neighbor Services, Inc., Jersey City, NJ
Center for Value Inquiry, St. Paul, MN
Child and Adult Development Center of Houston, Inc., Houston, TX

Children of God Ministries-Childheart Ministries International, Dallas, TX
Christ Outreach Center, Marion, OH
C.I.E.L.O. Project/Radio Ranch, Olympia, WA
Citrus 20-20, Inc., Homosassa, FL
Citywide Youth Basketball League of Houston, Inc., Houston, TX
Clinton School Committee for Curriculum Advancement, Clinton, MT
Clyde Drexler Foundation, Inc., Houston, TX
Common Sense Forum, Inc., Milwaukee, WI
Community Advocacy Foundation, Fresno, CA
Community Housing and Development Fund, Torrance, CA
Community Housing and Redevelopment Trust, Inc., Homestead, FL
Creative Arts Institute, Port Hadlock, WA
Darley Park Community Association, Inc., Baltimore, MD
Desert Arts Unlimited, Lakeview, OR
Devoted Care Home, Inc., Missouri City, TX
Dunamis Connection, Inc., Brookshire, TX
Earning by Learning Stanislaus, Modesto, CA
Emmaus Ministries, Yakima, WA
Enchanted Womanhood, Inc., Baytown, TX
Encore Theatre, Houston, TX
Environmental Exchange, Inc., Forest Hills, NY
Falmouth Youth Basketball Association, Falmouth, ME
Families for Effective Autism Treatment, Inc., Minnetonka, MN
Faye and A.J. Wolf Foundation, Houston, TX
Federation of African American Contractors, Oakland, CA
Fort Bend Cultural Arts Council, Missouri City, TX
Frank Steele Foundation, Inc., Geary, OK
Fraternal Organization, Killeen, TX
Friends of Arch, Inc., New Hyde Park, NY
Friends of the Paragon Carousel, Inc., Hull, MA
GLT Foundation, Omaha, NE
Golden Shadow Associates, St. Charles, MO
Goose Creek Navy Community Foundation, Inc., Baytown, TX

Greater Houston Academic Challenge, Inc., Houston, TX
 Greg Crawford Ministries, Inc., Huffman, TX
 Heavenly Acres Foundation, Hugo, OK
 Hematology-Oncology Assistance Resource Coalition, Kingwood, TX
 Hidalgo Coordination, Inc., Lordsburg, NM
 Highland Belle Booster Club, Inc., Dallas, TX
 Highland Park Dance Theater Company, Fresno, CA
 Hmong Foundation, Inc., Milwaukee, WI
 Home Growth Program & Associates, Inc., Sacramento, CA
 Hospice Lights Foundation, Inc., New Freedom, PA
 Houston Pride Band, Inc., Houston, TX
 Houston Roundup, Houston, TX
 Human Focus, Daly City, CA
 Hyde Park Foundation, Houston, TX
 Independent Heights Baptist Pastors and Ministers Alliance, Inc., Houston, TX
 Intellidebt Corp., Garland, TX
 International Marinelife Alliance, Inc., Honolulu, HI
 Jackson Hole Community Radio, Incorporated, Jackson, WY
 Jackson Park Preservation Corporation, Chicago, IL
 Jafria Council USA, Inc., Corona, NY
 James M. Tirella Memorial Foundation for the Arts, New York, NY
 James River Blues Society, Lynchburg, VA
 Jehovah Jirah Outreach Ministries, Inc., Winston-Salem, NC
 John F. and Annie M. Hurley Howells Family Foundation, Inc., Salt Lake City, UT
 Jojo Community Vocational and Rehabilitation Services, Denver, CO
 Jude-25 Christian Stewardship Fund, Inc., Palm Desert, CA
 Kansas Alliance of Alcohol and Other Drug Services, Inc., Abilene, KS
 Kenner Housing Authority Resident Association, Kenner, LA
 Korean Civic Alliance, Incorporated, Bronx, NY
 Laguna Hills Aquatics, Cathedral City, CA
 Les Amis, St. Louis, MO
 Light Club 8, Incorporated, Coral Springs, FL
 Little Brothers & Little Sisters Program, Inc., Visalia, CA
 Lucky Community Improvement Club, McMinnville, TN
 Lyric Theatre, Ltd., Weehawken, NJ
 Madison Township Volunteer Fire Department, Inc., Greencastle, IN
 Main Thing Ministries, Houston, TX
 Mark Williams Charities, Houston, TX
 Masters Watchmen Ministry, Inc., Augusta, GA
 Mat Rats, Inc., Hillsboro, OR
 Metropolitan Children Services, Inc., Matteson, IL
 Michigan Legal Foundation, Midland, MI
 Mind Body and Science Institute, San Antonio, TX
 Mountain View Resident Council, Big Stone Gap, VA
 Muslim American Youth, Inc., Lindenhurst, NY
 Na Kokua Ministries Haai, Inc., Home Fellowship Church of Jesus, Honolulu, HI
 National Collegiate Exposure Program, Houston, TX
 Navajo Scouting Organization, St. Michaels, AZ
 Needham Ministries, Incorporated, Houston, TX
 Netday, Irvine, CA
 Neurosurgical Peruvian American Foundation, Huntington Beach, CA
 New Century Development, Inc., McComb, MS
 New Hope Outreach Ministries, Incorporated, Lexington, NC
 Newburgh Housing Authority's Outreach Development Corp., Newburgh, NY
 NWLRC Legends Rowing Club, Everett, WA
 Ohitare Global for Family & Youth, Tacoma, WA
 Options of Ohio, Inc., Dellroy, OH
 Orange Area Boxing Club, Inc., Orange, TX
 Outrage, Inc., Houston, TX
 Palm Beach County Alzheimers Care Association, Inc., Boca Raton, FL
 Parental Alcohol-Drug Services, Alameda, CA
 Path of Life, Inc., Houston, TX
 Pathways to Freedom, Inc., Brentwood, TN
 Perry N. Finley Foundation, Ltd., Boston, MA
 Pleasant Hill Community Development Corporation, Houston, TX
 Porter County Railroad Educational & Historical Fund, Valparaiso, IN
 Prehospital Advisory Board, Moline, IL
 Prevention Intervention Program, Plano, TX
 Pulaski Court Residents Association of Garfield, Inc., Garfield, NJ
 Quality Connections, Inc., Seminole, OK
 Rainbow Tribe Institution Foundation, Inc., Albany, NY
 Reach Me, Inc., Houston, TX
 Recovery Campuses of Texas Caring for the Indigent, Galveston, TX
 Responsibility is Ours Trio, Houston, TX
 Richmond Historic Preservation Committee, Richmond, TX
 Rolla Area Lutheran for Life Organization, Rolla, MO
 Rophe Ministries, Philadelphia, PA
 Roseberg Roughnecks Football Club, Rosenberg, TX
 Roz House of New Found Hope, Chicago, IL
 Russell Community, Corporation, Washington, DC
 Salt of the Earth A New Jersey Non-Profit Corporation, Bagota, NJ
 Samskriti Society for Indian Performing Arts, Incorporated, Houston, TX
 San Francisco Italian Athletic Club Foundation, San Francisco, CA
 San Gabriel-Pomona Valleys Cocaine Anonymous, Arcadia, CA
 Save Our Shores, Dickinson, TX
 Senior Assistance Fund Elite, Houston, TX
 Seymour Community School Scholarship Trust, Seymour, WI
 Sharp Ministries International, Inc., Oklahoma City, OK
 Social Assistance and Fundamental Education, Inc.-SAFE, Houston, TX
 Societe Italiana Di Cultura, Chicago, IL
 Soul Ministries, Inc., La Marque, TX
 Southeast Texas Area Emissions Reduction Credit Organization, Port Arthur, TX
 Southwestern Illinois Business Council, Inc., East St. Louis, IL
 Space America Foundation for Education, Inc., Houston, TX
 Springfield Eagles Charity, Inc., Springfield, OH
 St. Stephen Christian Center, Houston, TX
 Story Center, A Historical Museum and Cultural Center, Ames, IA
 Success, Inc., Carpinteria, CA

Success of Minority Students, Inc.,
Catskill, NY
Sweeny Historical Society, Inc.,
Sweeny, TX
Teen Life Community Action Group,
Pfafftown, NC
Teenage Incentive Program, Inc.,
Houston, TX
Texas Raptor & Wildlife Rehab &
Education Center, Inc., Houston, TX
Thai Association of San Diego County,
Excondido, CA
Three Corners Counseling Center,
Concord, CA
Timberlawn Psychiatric Research
Foundation, Inc., Greensboro, NC
Tomball Njotc Booster Club,
Tomball, TX
Tournament Teams, Inc., Katy, TX
Tri-County Revitalization
Industrialization Pac-People Again,
Ellicott, MD

Trinity Gardens Integral Forces, Inc.,
Houston, TX
Upstate Alive 95, Inc., Greenville, SC
USA Joshinmon Shorin-Ryu Karate-Do
Federation, Houston, TX
Vision Entertainment, Inc., Dallas, TX
Volunteers for Increased Public Safety,
La Quinta, CA
Watts Home, Inc., Beaumont, TX
Wings for Wildlife, Denver, CO
Wolf Laurel Historical Society,
Mars Hill, NC
Yorkshire Village Resident Council, Inc.,
Houston, TX
Ziggurratt Christian Ministries,
Richland, WA

If an organization listed above sub-
mits information that warrants the re-
newal of its classification as a public
charity or as a private operating founda-
tion, the Internal Revenue Service will

issue a ruling or determination letter
with the revised classification as to
foundation status. Grantors and contrib-
utors may thereafter rely upon such rul-
ing or determination letter as provided
in section 1.509(a)-7 of the Income Tax
Regulations. It is not the practice of the
Service to announce such revised classi-
fication of foundation status in the Inter-
nal Revenue Bulletin.

Definition of Terms

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

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

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

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

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it ap-

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

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

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

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

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

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

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

Abbreviations

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

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

E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign Corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.

PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statements of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

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