Bulletin No. 1996–10
March 4, 1996

HIGHLIGHTS OF THIS ISSUE

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

INCOME TAX

Rev. Rul. 96–13, page 19.

Election in respect of losses attributable to a disaster. This ruling lists the areas declared by the President to qualify as major disaster areas under the Disaster Relief and Emergency Assistance Act since the publication of Rev. Rul. 95–17.

T.D. 8648, page 23.

Final regulations under sections 358, 1032, and 1502 of the Code provide rules for adjusting the basis of a controlling corporation in the stock of a controlled corporation as the result of certain triangular reorganizations involving the stock of the controlling corporation.

T.D. 8650, page 5.

Final regulations under section 162 of the Code relating to the disallowance of deductions for employee remuneration in excess of $1,000,000.

EE–106–82, page 31.

Proposed regulations under section 72 of the Code relating to loans made from a qualified employer plan to plan participants or beneficiaries.

ADMINISTRATIVE

Notice 96–12, page 29.

Mark to market for dealers in securities; related parties as customers. This notice describes guidance expected to be issued in proposed regulations concerning whether a taxpayer's transactions with related parties, including members of its consolidated group, may be transactions with customers for purposes of section 475 of the Code.

Notice 96–13, page 29.

Certain payments from the Presidential Election Campaign Fund. This notice announces a change that will be made to the Presidential Election Campaign Fund regulations for certain payments made to Presidential primary candidates from that Fund.

Finding Lists begin on page 40.
Announcement Relating to Court Decisions, on page 4.
Announcement of Disbarments and Suspensions begins on page 37.
Index for January and February begins on page 42.

Mission of the Service

The purpose of the Internal Revenue Service is to collect the proper amount of tax revenue at the least cost; serve the public by continually improving the quality of our products and services; and perform in a manner warranting the highest degree of public confidence in our integrity, efficiency and fairness.

Statement of Principles of Internal Revenue Tax Administration

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

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

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

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

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

Introduction

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

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

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

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

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.

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

Part II.—Treaties and Tax Legislation.

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

Part III.—Administrative, Procedural, and Miscellanous.

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

Part IV.—Items of General Interest.

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

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

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

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

Announcement Relating to Court Decisions

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

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

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

The recommendation in every Action on Decision will be summarized as acquiescence, acquiescence in result only, or nonacquiescence. Both ''acquiescence'' and ''acquiescence in result only'' mean that the Service accepts the holding of the court in a case and that the Service will follow it in disposing of cases with the same controlling facts. However, ''acquiescence'' indicates neither approval nor disapproval of the reasons assigned by the court for its conclusions; whereas, ''acquiescence in result only'' indicates disagreement or concern with some or all of those reasons. Nonacquiescence signifies that, although no further review was sought, the Service does not agree with the holding of the court and, generally, will not follow the decision in disposing of cases involving other taxpayers. In reference to an opinion of a circuit court of appeals, a nonacquiescence indicates that the Service will not follow the holding on a nationwide basis. However, the Service will recognize the precedential impact of the opinion on cases arising within the venue of the deciding circuit.

The announcements published in the weekly Internal Revenue Bulletins are consolidated semiannually and annually. The semiannual consolidation appears in the first Bulletin for July and in the Cumulative Bulletin for the first half of the year, and the annual consolidation appears in the first Bulletin for the following January and in the Cumulative Bulletin for the last half of the year.

The Commissioner ACQUIESCE in the following decisions:

William H. and Patricia Adair v. Commissioner,[1] T.C. Memo. 1995 – 493

The Commissioner does NOT ACQUIESCE in the following decisions:

Estate of Goree v. Commissioner,[2] T.C. 1994 – 331

Robert B. and Eleanor Risman v. Commissioner,[3] 100 T.C. 191 (1993)

Anthony Teong-Chan and Rosanna W. Gaw v. Commissioner,[4] 45 F.3d 461 (D.C. Cir. 1995)

---

[1]Acquiescence relating to whether petitioner who performed services for the North Atlantic Treaty Organization as a transferee transferred and paid by the U.S. Department of the Army was entitled to the foreign earned income exclusion under section 911 of the Code.

[2]Nonacquiescence relating to whether under *Estate of Bosch v. Commissioner,* 387 U.S. 456 (1967), the Tax Court erred in applying an appellate standard of review to a lower state court factual determination instead of reviewing the question *de novo*.

[3]Nonacquiescence relating to whether a remittance forwarded to the Service with a Form 4868 constitutes a payment of tax or a deposit in the nature of a cash bond for purposes of the period of limitations for seeking a refund of such remittance.

[4]Nonacquiescence relating to when the period for filing a Tax Court petition begins to run if the notice of deficiency is mailed to the taxpayers' last known address and the Service knows or should know the taxpayers will not receive the noice at their last known address.

Section 162.—Trade or Business Expenses

26 CFR 1.162–27: Certain employee remuneration in excess of $1,000,000.

T.D. 8650

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Disallowance of Deductions for Employee Remuneration in Excess of $1,000,000

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the disallowance of deductions for employee remuneration in excess of $1,000,000. The regulations provide guidance to taxpayers that are subject to section 162(m), which was added to the Code by the Omnibus Budget Reconciliation Act of 1993.

DATES: January 1, 1994.

For dates of applicability, see §1.162–27(j).

FOR FURTHER INFORMATION CONTACT: Robert Misner or Charles T. Deliee at (202) 622-6060 (not a toll free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1466. Responses to these collections of information are required to obtain a tax deduction for performance-based compensation in excess of $1 million.

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

The estimated average annual burden per respondent is 50 hours.

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

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

Background

Under section 162(m) of the Internal Revenue Code, a publicly held corporation is denied a deduction for compensation paid to its ''covered employees'' to the extent the compensation exceeds $1,000,000 if the compensation would otherwise be deductible in a taxable year beginning on or after January 1, 1994.

On December 20, 1993, proposed regulations under section 162(m) (the 1993 proposed regulations) were published in the Federal Register (58 FR 66310 [EE–61–93, 1994–1 C.B. 775]). Amendments to the proposed regulations (the 1994 amendments) were published in the Federal Register on December 2, 1994 (59 FR 61844 [EE–61–93, 1994–2 C.B. 853]). Public hearings were held on May 9, 1994, and August 11, 1995. After consideration of the comments that were received in response to the notices of proposed rulemaking and at the hearings, the IRS and Treasury adopt the proposed regulations as amended and revised by this Treasury decision.

Explanation of Provisions

A. *Overview of Provisions*

As noted above, section 162(m) provides that a publicly held corporation is denied a deduction for compensation paid to a ''covered employee'' to the extent the compensation exceeds $1,000,000. A ''covered employee'' includes the chief executive officer (CEO), as well as any other individual whose compensation is required to be reported to the Securities and Exchange Commission by reason of that individual being among the four highest compensated officers for the taxable year (other than the CEO), as of the end of the corporation's taxable year.

''Performance-based compensation'' and certain other compensation is not subject to the deduction limitation of section 162(m). Performance-based compensation is remuneration payable solely on account of the attainment of one or more performance goals, but only if: (1) the goals are determined by a compensation committee of the board of directors consisting solely of two or more outside directors; (2) the material terms under which the compensation is to be paid are disclosed to the shareholders and approved by a majority in a separate vote before payment is made; and (3) before any payment is made, the compensation committee certifies that the performance goals and any other material terms have been satisfied.

Compensation is also excluded from the deduction limitation of section 162(m) if it is paid under a binding written contract that was in existence on February 17, 1993. In addition, in accordance with the legislative history, the proposed regulations exempt from the limitation compensation that is paid under an arrangement that existed before the corporation became publicly held, to the extent that the arrangement is disclosed in the initial public offering.

B. *Discussion of Comments*

Comments that relate to the application of the proposed regulations and the responses to the comments, including an explanation of the revisions reflected in the final regulations, are summarized below.

Dividend Equivalents Paid on Stock Options

Under the proposed regulations, the performance-based exception to the deduction limitation generally is applied on a grant-by-grant basis. If the facts and circumstances indicate, however, that the employee would receive all or part of the compensation regardless of whether the performance goal is attained, the compensation is not performance based. For example, where payment under a nonperformance based bonus is contingent upon the failure to attain the performance goals under an otherwise performance-based bonus, neither bonus arrangement will be considered performance based. The proposed regulations provide that whether dividends (which generally are not performance based) on restricted stock are payable before attainment of the performance goal, will not affect the determination of whether the restricted stock is performance based. The proposed regulations also provide, however, that if the amount of any compensation the employee will receive under a stock option is not based solely on an increase in the value of the stock after the date of grant (for example, an option granted with an exercise price that is less than the fair market value of the stock as of the date of grant), none of the compensation attributable to the grant will be performance based.

Commentators raised the question of whether nonperformance-based dividend equivalents that are paid with respect to a granted but unexercised stock option irrespective of whether the option is exercised will cause the compensation paid upon the exercise of the option to be nonperformance based. Section 1.162–27(e)(2)(vi) of the final regulations provides that such dividend equivalents will not cause the compensation paid upon the exercise of the option to be nonperformance based, provided that the payment of the dividend equivalents is not conditioned upon the employee exercising the option. If the payment of the dividend equivalent is conditioned upon the employee exercising the option, the dividend effectively reduces the exercise price of the option, thereby causing the option to be nonperformance based upon its exercise.

Bonus Pools

Section 1.162–27(e)(2)(ii) of the proposed regulations provides that a preestablished performance goal must state, in terms of an objective formula or standard, the method for computing the amount of compensation payable to the employee if the goal is attained. A formula or standard is objective if a third party having knowledge of the relevant performance results could calculate the amount to be paid to the employee.

Section 1.162–27(e)(2)(iii) prohibits discretion to increase the amount of compensation to be paid under the preestablished performance goal, but permits the compensation committee to reduce or eliminate the compensation that is due upon attainment of the goal.

Examples 7 and 8 under §1.162–27-(e)(2)(vii) of the proposed regulations illustrated the application of these rules to bonus pools. In Example 7, the amount of the bonus pool was determined under an objective formula. However, because the compensation committee retained the discretion to determine the fraction of the bonus pool that each covered employee would receive, the compensation that any individual could receive was not determined under an objective formula and, therefore, the bonus plan did not satisfy the requirements of paragraph (e)(2). In Example 8, the compensation for any individual was determined under an objective formula because each employee’s share of the bonus pool was specified and because, notwithstanding the compensation committee’s ability to reduce the compensation payable to each individual employee, a reduction in one employee’s bonus would not result in an increase in the amount of any other employee’s bonus.

Several commentators have indicated that, in some cases where compensation committees have stated the amount payable to each individual under a bonus pool plan as a percentage of the bonus pool, the total of these percentages has exceeded 100 percent of the pool. The use of such overlapping percentages is inconsistent with §1.162–27(e)(2), as illustrated by both Example 7 and Example 8. As noted, Example 8 states that negative discretion will not cause the bonus plan to fail to satisfy the requirements of paragraph (e)(2), ‘‘provided that a reduction in the amount of one employee’s bonus does not result in an increase in the amount of any other employee’s bonus.’’ Where the total of the percentages payable under a bonus pool plan exceeds 100 percent, it is impossible to award each individual the stated percentage, and this necessary exercise of negative discretion with respect to one or more employees means that it is impossible for a third party, with knowledge of the relevant performance results, to calculate the amount to be paid to each employee. Further, a reduction in at least some employees’ bonuses will result in an increase in the amount available to pay other employees’ bonuses.

Accordingly, §1.162–27(e)(2)(iii) is amended to state more clearly that, when the compensation to be paid to each employee is stated in terms of a percentage of a bonus pool, the sum of the individual percentages for all participants in the pool cannot exceed 100 percent. In addition, the principle stated in Example 8, that the exercise of negative discretion with respect to one employee cannot increase the amount payable to another employee, is incorporated in paragraph (e)(2)(iii). Example 8 is also revised to more clearly illustrate this rule.

Although the IRS and Treasury believe that the changes made merely clarify the proposed regulations, it is recognized that others have interpreted the language of the proposed regulations differently. Therefore, under §1.162–27(j)(2)(iv), this clarified rule will not be applied to any compensation paid before January 1, 2001, under a bonus pool based on performance in any period that began before December 20, 1995.

Outside Directors

Section 1.162–27(e)(3)(vi) provides that a director is not precluded from being an outside director solely because he or she is a former officer of a corporation that previously was an affiliated corporation of the publicly held corporation. The regulation is revised to clarify that a former officer of either a spun off or liquidated corporation, that formerly was a member of the affiliated group, is not precluded from serving on the compensation committee of the publicly held member of the affiliated group.

Companies that Become Publicly Held Without an Initial Public Offering

Under §1.162–27(f), the $1 million deduction limit does not apply to any compensation plan or agreement that existed before the corporation became publicly held to the extent that the plan or agreement was disclosed in the prospectus accompanying the initial public offering (IPO). This exception may be relied on until the earliest of: (1) the expiration of the plan or agreement, (2) the material modification of the plan or agreement, (3) the issuance of all stock and other compensation that has been allocated under the plan, or (4) the first shareholder meeting at which directors will be elected that occurs after the close of the third calendar year following the calendar year in which the IPO occurs.

Commentators have asked whether this rule applies to corporations that become publicly held without an IPO.

As indicated in the legislative history accompanying Code section 162(m), the prospectus that accompanies the IPO provides an opportunity to disclose the terms of the plan or agreement to the potential shareholders, and the subsequent purchase of the stock with that knowledge may be viewed as tantamount to a favorable vote on the compensation arrangement. When a corporation becomes publicly held without an IPO, there is no comparable alternative means of satisfying the requirements of section 162(m)(4)(C)(ii). On the other hand, because there is no requirement for privately held corporations to comply with section 162(m), the IRS and Treasury recognize the need for a transition rule for plans and agreements that are in existence when a privately held corporation becomes publicly held without an IPO.

Accordingly, §1.162–27(f)(1) is revised to provide relief for privately held corporations that become publicly held without an IPO. Under the transition rule for these corporations, the reliance period in §1.162–27(f)(2) lapses upon the first meeting of shareholders at which directors are to be elected that occurs after the close of the first calendar year following the calendar year in which the corporation becomes publicly held.

Written Binding Contracts

Section 1.162–27(h)(1) provides the transition rules for compensation payable under a written binding contract that was in effect on February 17, 1993. Under those rules, a written binding contract that is terminable or cancelable by the corporation after February 17, 1993, without the employee's consent is treated as a new contract as of the date that any such termination or cancelation, if made, would be effective. The proposed regulations further provide that, if the terms of a contract provide that the contract will be terminated or canceled as of a certain date unless either the corporation or the employee elects to renew within 30 days of that date, the contract is treated as renewed by the corporation as of that date.

Commentators have suggested that these regulations clarify the outcome where a corporation will remain bound by the terms of a contract beyond a certain date at the sole discretion of the employee. For example, if a contract that is in effect on February 17, 1993, provides that the employee has the sole discretion to extend or renew the terms beyond its stated expiration, without the consent of the corporation, a question arises whether the contract will be considered a pre-February 17, 1993 written binding contract after the employee chooses to extend.

Generally, the question of whether the terms of a contract are binding is determined under state law. The IRS and Treasury believe that the rules for determining whether a contract is binding should be applied based on whether the corporation is bound by the terms of the contract. Thus, if a contract provides the employee with the right to extend or renew its terms without the consent of the corporation, and the corporation is legally obligated to pay the agreed-upon compensation to the employee if the employee chooses to extend or renew the contract, the contract will be considered binding on the corporation. Accordingly, a new sentence has been added to §1.162–27(h)(1)(i) to clarify that, if the corporation will remain legally obligated by the terms of a contract beyond a certain date at the sole discretion of the employee, the contract will not be treated as a new contract as of that date if the employee exercises the discretion.

Awards Based on a Percentage of Salary

The 1994 amendments modified §1.162–27(e)(2)(iii) to provide that, if the terms of an objective formula or standard fail to preclude discretion merely because the amount of compensation to be paid upon attainment of the performance goal is based, in whole or in part, on a percentage of salary or base pay, the objective formula or standard will not be considered discretionary (and thus §1.162–27(e)(2)(iii) will not be violated) if the maximum dollar amount to be paid is fixed at the time the performance goal is established. The final regulations clarify that a maximum dollar amount need not be specified under this provision if, at the time the performance goal is established, the dollar amount of salary or base pay is fixed. In such a case, the use of salary or base pay does not cause the formula to fail to preclude discretion to increase compensation.

The 1994 amendments made a corresponding amendment with respect to salary-based formulas to the shareholder disclosure rules in §1.162–27(e)(4)(i). However, the shareholder disclosure amendment was not explicitly limited to formulas that would otherwise be discretionary. The final regulations clarify that the shareholder disclosure rule relating to salary-based formulas applies only to those formulas that would otherwise be discretionary.

In addition, the final regulations provide transition relief with respect to the 1994 amendment of the shareholder disclosure requirement relating to salary-based formulas. New §1.162–27(j)(2)(v) provides that this disclosure requirement applies only to plans approved by shareholders after April 30, 1995.

In the case of a preestablished performance goal that was established prior to the publication of the 1994 amendments, a corporation could, of course, rely upon a reasonable good faith interpretation of the statutory provisions to determine that the performance goal was stated in terms of an objective formula, to the extent the issue to which the interpretation relates was not covered by the 1993 regulations. An award made pursuant to such a performance goal would not fail to be performance based merely because the award was made after the publication of the 1994 amendments.

Stock-Based Compensation

The 1993 proposed regulations provided transition relief for previously approved plans and agreements that did not satisfy the written binding contract requirement as of February 17, 1993, but that were approved by shareholders before December 20, 1993. See §1.162–27(h)(3)(iii). The transition relief applied to compensation paid prior to the expiration of a reliance period. In response to comments on the 1993 proposed regulations, the 1994 amendments expanded this relief to encompass compensation paid after the reliance period with respect to the exercise of stock options and stock appreciation rights, and the substantial vesting of restricted property, provided that the stock option, stock appreciation right, or restricted property was granted during the reliance period. Similar relief provisions were also included in new transition rules added by the 1994 amendments. (See §§1.162–27(f)(3), (f)(4), (j)(2)(ii), and (j)(2)(iii) of the final regulations.)

Commentators have asked that the relief provided in the 1994 amendments for stock options, stock appreciation rights, and restricted property be extended even further to cover other stock-based compensation and deferred compensation in general. After careful consideration of the comments received, the IRS and Treasury have concluded that there is not adequate justification for a further expansion of the 1994 expansion of the prior regulatory transition relief for previously approved plans and agreements, or the other similar relief provisions added in 1994.

Subsidiaries That Become Separate Publicly Held Corporations

Section 1.162–27(f)(4) of the proposed regulations contains special rules for subsidiaries that become separate publicly held corporations. A transition rule set forth in §1.162–27(i)(2)(iii) of the proposed regulations specified delayed effective dates for these special rules. However, commentators indicated that the regulation were not explicit as to which rules applied prior to the delayed effective dates.

The final regulations clarify that compensation paid prior to the delayed effective dates by a subsidiary that becomes a separate publicly held corporation will not be subject to the $1 million deduction limit if the conditions of the transition rule are satisfied. (This transition rule and all other effective date provisions have been moved from paragraph (i) to paragraph (j) of the final regulations. Paragraph (i) is reserved.)

Special Analysis

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

Drafting Information

The principal authors of these regulations are Charles T. Deliee and Robert Misner, Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations), Internal Revenue Service. However, other personnel from IRS and the Treasury Department participated in their development.

* * * * * *

Adoption of Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.162–27 is added to read as follows:

§1.162–27 Certain employee remuneration in excess of $1,000,000

(a) *Scope*. This section provides rules for the application of the $1 million deduction limit under section 162(m) of the Internal Revenue Code. Paragraph (b) of this section provides the general rule limiting deductions under section 162(m). Paragraph (c) of this section provides definitions of generally applicable terms. Paragraph (d) of this section provides an exception from the deduction limit for compensation payable on a commission basis. Paragraph (e) of this section provides an exception for qualified performance-based compensation. Paragraphs (f) and (g) of this section provide special rules for corporations that become publicly held corporations and payments that are subject to section 280G, respectively. Paragraph (h) of this section provides transition rules, including the rules for contracts that are grandfathered and not subject to section 162(m). Paragraph (j) of this section contains the effective date provisions. For rules concerning the deductibility of compensation for services that are not covered by section 162(m) and this section, see section 162(a)(1) and §1.162–7. This section is not determinative as to whether compensation meets the requirements of section 162(a)(1).

(b) *Limitation on deduction*. Section 162(m) precludes a deduction under chapter 1 of the Internal Revenue Code by any publicly held corporation for compensation paid to any covered employee to the extent that the compensation for the taxable year exceeds $1,000,000.

(c) *Definitions*—(1) *Publicly held corporation*—(i) *General rule*. A *publicly held corporation* means any corporation issuing any class of common equity securities required to be registered under section 12 of the Exchange Act. A corporation is not considered publicly held if the registration of its equity securities is voluntary. For purposes of this section, whether a corporation is publicly held is determined based solely on whether, as of the last day of its taxable year, the corporation is subject to the reporting obligations of section 12 of the Exchange Act.

(ii) *Affiliated groups*. A publicly held corporation includes an affiliated group of corporations, as defined in section 1504 (determined without regard to section 1504(b)). For purposes of this section, however, an affiliated group of corporations does not include any subsidiary that is itself a publicly held corporation. Such a publicly held subsidiary, and its subsidiaries (if any), are separately subject to this section. If a covered employee is paid compensation in a taxable year by more than one member of an affiliated group, compensation paid by each member of the affiliated group is aggregated with compensation paid to the covered employee by all other members of the group. Any amount disallowed as a deduction by this section must be prorated among the payor corporations in proportion to the amount of compensation paid to the covered employee by each such corporation in the taxable year.

(2) *Covered employee*—(i) *General rule*. A *covered employee* means any individual who, on the last day of the taxable year, is—

(A) The chief executive officer of the corporation or is acting in such capacity; or

(B) Among the four highest compensated officers (other than the chief executive officer).

(ii) *Application of rules of the Securities and Exchange Commission*. Whether an individual is the chief executive officer described in paragraph (c)(2)(i)(A) of this section or an officer described in paragraph (c)(2)(i)(B) of this section is determined pursuant to the executive compensation disclosure rules under the Exchange Act.

(3) *Compensation*—(i) *In general*. For purposes of the deduction limitation described in paragraph (b) of this section, *compensation* means the aggregate amount allowable as a deduction under chapter 1 of the Internal Revenue Code for the taxable year (determined without regard to section 162(m)) for remuneration for services performed by a covered employee, whether or not the services were performed during the taxable year.

(ii) *Exceptions. Compensation* does not include—

(A) Remuneration covered in section 3121(a)(1) through section 3121(a)(5)(D) (concerning remuneration that is not treated as *wages* for purposes of the Federal Insurance Contributions Act); and

(B) Remuneration consisting of any benefit provided to or on behalf of an employee if, at the time the benefit is provided, it is reasonable to believe that the employee will be able to exclude it from gross income. In addition, compensation does not include salary reduction contributions described in section 3121(v)(1).

(4) *Compensation Committee*. The *compensation committee* means the committee of directors (including any subcommittee of directors) of the publicly held corporation that has the authority to establish and administer performance goals described in paragraph (e)(2) of this section, and to certify that performance goals are attained, as described in paragraph (e)(5) of this section. A committee of directors is not treated as failing to have the authority to establish performance goals merely because the goals are ratified by the board of directors of the publicly held corporation or, if applicable, any other committee of the board of directors. See paragraph (e)(3) of this section for rules concerning the composition of the compensation committee.

(5) *Exchange Act*. The *Exchange Act* means the Securities Exchange Act of 1934.

(6) *Examples*. This paragraph (c) may be illustrated by the following examples:

Example 1. Corporation X is a publicly held corporation with a July 1 to June 30 fiscal year. For Corporation X's taxable year ending on June 30, 1995, Corporation X pays compensation of $2,000,000 to A, an employee. However, A's compensation is not required to be reported to shareholders under the executive compensation disclosure rules of the Exchange Act because A is neither the chief executive officer nor one of the four highest compensated officers employed on the last day of the taxable year. A's compensation is not subject to the deduction limitation of paragraph (b) of this section.

Example 2. C, a covered employee, performs services and receives compensation from Corporations X, Y, and Z, members of an affiliated group of corporations. Corporation X, the parent corporation, is a publicly held corporation. The total compensation paid to C from all affiliated group members is $3,000,000 for the taxable year, of which Corporation X pays $1,500,000; Corporation Y pays $900,000; and Corporation Z pays $600,000. Because the compensation paid by all affiliated group members is aggregated for purposes of section 162(m), $2,000,000 of the aggregate compensation paid is nondeductible. Corporations X, Y, and Z each are treated as paying a ratable portion of the nondeductible compensation. Thus, two thirds of each corporation's payment will be nondeductible. Corporation X has a nondeductible compensation expense of $1,000,000 ($1,500,000 × $2,000,000/$3,000,000). Corporation Y has a nondeductible compensation expense of $600,000 ($900,000 × $2,000,000/$3,000,000). Corporation Z has a nondeductible compensation expense of $400,000 ($600,000 × $2,000,000/$3,000,000).

Example 3. Corporation W, a calendar year taxpayer, has total assets equal to or exceeding $5 million and a class of equity security held of record by 500 or more persons on December 31, 1994. However, under the Exchange Act, Corporation W is not required to file a registration statement with respect to that security until April 30, 1995. Thus, Corporation W is not a publicly held corporation on December 31, 1994, but is a publicly held corporation on December 31, 1995.

Example 4. The facts are the same as in *Example 3*, except that on December 15, 1996, Corporation W files with the Securities and Exchange Commission to disclose that Corporation W is no longer required to be registered under section 12 of the Exchange Act and to terminate its registration of securities under that provision. Because Corporation W is no longer subject to Exchange Act reporting obligations as of December 31, 1996, Corporation W is not a publicly held corporation for taxable year 1996, even though the registration of Corporation W's securities does not terminate until 90 days after Corporation W files with the Securities and Exchange Commission.

(d) *Exception for compensation paid on a commission basis*. The deduction limit in paragraph (b) of this section shall not apply to any compensation paid on a commission basis. For this purpose, compensation is paid on a commission basis if the facts and circumstances show that it is paid solely on account of income generated directly by the individual performance of the individual to whom the compensation is paid. Compensation does not fail to be attributable directly to the individual merely because support services, such as secretarial or research services, are utilized in generating the income. However, if compensation is paid on account of broader performance standards, such as income produced by a business unit of the corporation, the compensation does not qualify for the exception provided under this paragraph (d).

(e) *Exception for qualified performance-based compensation*—

(1) *In general*. The deduction limit in paragraph (b) of this section does not apply to qualified performance-based compensation. Qualified performance-based compensation is compensation that meets all of the requirements of paragraphs (e)(2) through (e)(5) of this section.

(2) *Performance goal requirement*—(i) *Preestablished goal*. Qualified performance-based compensation must be paid solely on account of the attainment of one or more preestablished, objective performance goals. A performance goal is considered preestablished if it is established in writing by the compensation committee not later than 90 days after the commencement of the period of service to which the performance goal relates, provided that the outcome is substantially uncertain at the time the compensation committee actually establishes the goal. However, in no event will a performance goal be considered to be preestablished if it is established after 25 percent of the period of service (as scheduled in good faith at the time the goal is established) has elapsed. A

performance goal is objective if a third party having knowledge of the relevant facts could determine whether the goal is met. Performance goals can be based on one or more business criteria that apply to the individual, a business unit, or the corporation as a whole. Such business criteria could include, for example, stock price, market share, sales, earnings per share, return on equity, or costs. A performance goal need not, however, be based upon an increase or positive result under a business criterion and could include, for example, maintaining the status quo or limiting economic losses (measured, in each case, by reference to a specific business criterion). A performance goal does not include the mere continued employment of the covered employee. Thus, a vesting provision based solely on continued employment would not constitute a performance goal. See paragraph (e)(2)(vi) of this section for rules on compensation that is based on an increase in the price of stock.

(ii) *Objective compensation formula*. A preestablished performance goal must state, in terms of an objective formula or standard, the method for computing the amount of compensation payable to the employee if the goal is attained. A formula or standard is objective if a third party having knowledge of the relevant performance results could calculate the amount to be paid to the employee. In addition, a formula or standard must specify the individual employees or class of employees to which it applies.

(iii) *Discretion*.

(A) The terms of an objective formula or standard must preclude discretion to increase the amount of compensation payable that would otherwise be due upon attainment of the goal. A performance goal is not discretionary for purposes of this paragraph (e)(2)(iii) merely because the compensation committee reduces or eliminates the compensation or other economic benefit that was due upon attainment of the goal. However, the exercise of negative discretion with respect to one employee is not permitted to result in an increase in the amount payable to another employee. Thus, for example, in the case of a bonus pool, if the amount payable to each employee is stated in terms of a percentage of the pool, the sum of these individual percentages of the pool is not permitted to exceed 100 percent. If the terms of an objective formula or standard fail to preclude discretion to increase the amount of compensation merely because the amount of compensation to be paid upon attainment of the performance goal is based, in whole or in part, on a percentage of salary or base pay and the dollar amount of the salary or base pay is not fixed at the time the performance goal is established, then the objective formula or standard will not be considered discretionary for purposes of this paragraph (e)(2)(iii) if the maximum dollar amount to be paid is fixed at that time.

(B) If compensation is payable upon or after the attainment of a performance goal, and a change is made to accelerate the payment of compensation to an earlier date after the attainment of the goal, the change will be treated as an increase in the amount of compensation, unless the amount of compensation paid is discounted to reasonably reflect the time value of money. If compensation is payable upon or after the attainment of a performance goal, and a change is made to defer the payment of compensation to a later date, any amount paid in excess of the amount that was originally owed to the employee will not be treated as an increase in the amount of compensation if the additional amount is based either on a reasonable rate of interest or on one or more predetermined actual investments (whether or not assets associated with the amount originally owed are actually invested therein) such that the amount payable by the employer at the later date will be based on the actual rate of return of a specific investment (including any decrease as well as any increase in the value of an investment). If compensation is payable in the form of property, a change in the timing of the transfer of that property after the attainment of the goal will not be treated as an increase in the amount of compensation for purposes of this paragraph (e)(2)(iii). Thus, for example, if the terms of a stock grant provide for stock to be transferred after the attainment of a performance goal and the transfer of the stock also is subject to a vesting schedule, a change in the vesting schedule that either accelerates or defers the transfer of stock will not be treated as an increase in the amount of compensation payable under the performance goal.

(C) Compensation attributable to a stock option, stock appreciation right, or other stock-based compensation does not fail to satisfy the requirements of this paragraph (e)(2) to the extent that a change in the grant or award is made to reflect a change in corporate capitalization, such as a stock split or dividend, or a corporate transaction, such as any merger of a corporation into another corporation, any consolidation of two or more corporations into another corporation, any separation of a corporation (including a spinoff or other distribution of stock or property by a corporation), any reorganization of a corporation (whether or not such reorganization comes within the definition of such term in section 368), or any partial or complete liquidation by a corporation.

(iv) *Grant-by-grant determination*. The determination of whether compensation satisfies the requirements of this paragraph (e)(2) generally shall be made on a grant-by-grant basis. Thus, for example, whether compensation attributable to a stock option grant satisfies the requirements of this paragraph (e)(2) generally is determined on the basis of the particular grant made and without regard to the terms of any other option grant, or other grant of compensation, to the same or another employee. As a further example, except as provided in paragraph (e)(2)(vi), whether a grant of restricted stock or other stock-based compensation satisfies the requirements of this paragraph (e)(2) is determined without regard to whether dividends, dividend equivalents, or other similar distributions with respect to stock, on such stock-based compensation are payable prior to the attainment of the performance goal. Dividends, dividend equivalents, or other similar distributions with respect to stock that are treated as separate grants under this paragraph (e)(2)(iv) are not performance-based compensation unless they separately satisfy the requirements of this paragraph (e)(2).

(v) *Compensation contingent upon attainment of performance goal*. Compensation does not satisfy the requirements of this paragraph (e)(2) if the facts and circumstances indicate that the employee would receive all or part of the compensation regardless of whether the performance goal is attained. Thus, if the payment of compensation under a grant or award is only nominally or partially contingent on attaining a performance goal, none of the compensation payable under the grant or award will be considered performance-based. For example, if an employee is entitled to a bonus under either of two arrangements, where payment under a nonperformance-based arrangement is contingent upon the failure to attain the performance goals under an otherwise performance-based arrangement, then neither arrangement provides for compensation that satisfies the requirements of this paragraph (e)(2). Compensation does not fail to be qualified performance-based compensation merely because the plan allows the compensation to be payable upon death, disability, or change of ownership or control, although compensation actually paid on account of those events prior to the attainment of the performance goal would not satisfy the requirements of this paragraph (e)(2). As an exception to the general rule set forth in the first sentence of paragraph (e)(2)(iv) of this section, the facts-and-circumstances determination referred to in the first sentence of this paragraph (e)(2)(v) is made taking into account all plans, arrangements, and agreements that provide for compensation to the employee.

(vi) *Application of requirements to stock options and stock appreciation rights*—(A) *In general*. Compensation attributable to a stock option or a stock appreciation right is deemed to satisfy the requirements of this paragraph (e)(2) if the grant or award is made by the compensation committee; the plan under which the option or right is granted states the maximum number of shares with respect to which options or rights may be granted during a specified period to any employee; and, under the terms of the option or right, the amount of compensation the employee could receive is based solely on an increase in the value of the stock after the date of the grant or award. Conversely, if the amount of compensation the employee will receive under the grant or award is not based solely on an increase in the value of the stock after the date of grant or award (*e.g.*, in the case of restricted stock, or an option that is granted with an exercise price that is less than the fair market value of the stock as of the date of grant), none of the compensation attributable to the grant or award is qualified performance-based compensation because it does not satisfy the requirement of this paragraph (e)(2)(vi)(A). Whether a stock option grant is based solely on an increase in the value of the stock after the date of grant is determined without regard to any dividend equivalent that may be payable, provided that payment of the dividend equivalent is not made contingent on the exercise of the option. The rule that the compensation attributable to a stock option or stock appreciation right must be based solely on an increase in the value of the stock after the date of grant or award does not apply if the grant or award is made on account of, or if the vesting or exercisability of the grant or award is contingent on, the attainment of a performance goal that satisfies the requirements of this paragraph (e)(2).

(B) *Cancellation and repricing*. Compensation attributable to a stock option or stock appreciation right does not satisfy the requirements of this paragraph (e)(2) to the extent that the number of options granted exceeds the maximum number of shares for which options may be granted to the employee as specified in the plan. If an option is canceled, the canceled option continues to be counted against the maximum number of shares for which options may be granted to the employee under the plan. If, after grant, the exercise price of an option is reduced, the transaction is treated as a cancellation of the option and a grant of a new option. In such case, both the option that is deemed to be canceled and the option that is deemed to be granted reduce the maximum number of shares for which options may be granted to the employee under the plan. This paragraph (e)(2)(vi)(B) also applies in the case of a stock appreciation right where, after the award is made, the base amount on which stock appreciation is calculated is reduced to reflect a reduction in the fair market value of stock.

(vii) *Examples*. This paragraph (e)(2) may be illustrated by the following examples:

Example 1. No later than 90 days after the start of a fiscal year, but while the outcome is substantially uncertain, Corporation S establishes a bonus plan under which A, the chief executive officer, will receive a cash bonus of $500,000, if year-end corporate sales are increased by at least 5 percent. The compensation committee retains the right, if the performance goal is met, to reduce the bonus payment to A if, in its judgment, other subjective factors warrant a reduction. The bonus will meet the requirements of this paragraph (e)(2).

Example 2. The facts are the same as in *Example 1*, except that the bonus is based on a percentage of Corporation S's total sales for the fiscal year. Because Corporation S is virtually certain to have some sales for the fiscal year, the outcome of the performance goal is not substantially uncertain, and therefore the bonus does not meet the requirements of this paragraph (e)(2).

Example 3. The facts are the same as in *Example 1*, except that the bonus is based on a percentage of Corporation S's total profits for the fiscal year. Although some sales are virtually certain for virtually all public companies, it is substantially uncertain whether a company will have profits for a specified future period even if the company has a history of profitability. Therefore, the bonus will meet the requirements of this paragraph (e)(2).

Example 4. B is the general counsel of Corporation R, which is engaged in patent litigation with Corporation S. Representatives of Corporation S have informally indicated to Corporation R a willingness to settle the litigation for $50,000,000. Subsequently, the compensation committee of Corporation R agrees to pay B a bonus if B obtains a formal settlement for at least $50,000,000. The bonus to B does not meet the requirement of this paragraph (e)(2) because the performance goal was not established at a time when the outcome was substantially uncertain.

Example 5. Corporation S, a public utility, adopts a bonus plan for selected salaried employees that will pay a bonus at the end of a 3-year period of $750,000 each if, at the end of the 3 years, the price of S stock has increased by 10 percent. The plan also provides that the 10-percent goal will automatically adjust upward or downward by the percentage change in a published utilities index. Thus, for example, if the published utilities index shows a net increase of 5 percent over a 3-year period, then the salaried employees would receive a bonus only if Corporation S stock has increased by 15 percent. Conversely, if the published utilities index shows a net decrease of 5 percent over a 3-year period, then the salaried employees would receive a bonus if Corporation S stock has increased by 5 percent. Because these automatic adjustments in the performance goal are preestablished, the bonus meets the requirement of this paragraph (e)(2), notwithstanding the potential changes in the performance goal.

Example 6. The facts are the same as in *Example 5*, except that the bonus plan provides that, at the end of the 3-year period, a bonus of $750,000 will be paid to each salaried employee if either the price of Corporation S stock has increased by 10 percent or the earnings per share on Corporation S stock have increased by 5 percent. If both the earnings-per-share goal and the stock-price goal are preestablished, the compensation committee's discretion to choose to pay a bonus under either of the two goals does not cause any bonus paid under the plan to fail to meet the requirement of this paragraph (e)(2) because each goal independently meets the requirements of this paragraph (e)(2). The choice to pay under either of the two goals is tantamount to the discretion to choose not to pay under one of the goals, as provided in paragraph (e)(2)(iii) of this section.

Example 7. Corporation U establishes a bonus plan under which a specified class of employees will participate in a bonus pool if certain preestablished performance goals are attained. The amount of the bonus pool is determined under an objective formula. Under the terms of the bonus plan, the compensation committee retains the discretion to determine the fraction of the bonus pool that each employee may receive.

The bonus plan does not satisfy the requirements of this paragraph (e)(2). Although the aggregate amount of the bonus plan is determined under an objective formula, a third party could not determine the amount that any individual could receive under the plan.

Example 8. The facts are the same as in *Example 7*, except that the bonus plan provides that a specified share of the bonus pool is payable to each employee, and the total of these shares does not exceed 100% of the pool. The bonus plan satisfies the requirements of this paragraph (e)(2). In addition, the bonus plan will satisfy the requirements of this paragraph (e)(2) even if the compensation committee retains the discretion to reduce the compensation payable to any individual employee, provided that a reduction in the amount of one employee's bonus does not result in an increase in the amount of any other employee's bonus.

Example 9. Corporation V establishes a stock option plan for salaried employees. The terms of the stock option plan specify that no salaried employee shall receive options for more than 100,000 shares over any 3-year period. The compensation committee grants options for 50,000 shares to each of several salaried employees. The exercise price of each option is equal to or greater than the fair market value at the time of each grant. Compensation attributable to the exercise of the options satisfies the requirements of this paragraph (e)(2). If, however, the terms of the options provide that the exercise price is less than fair market value at the date of grant, no compensation attributable to the exercise of those options satisfies the requirements of this paragraph (e)(2) unless issuance or exercise of the options was contingent upon the attainment of a preestablished performance goal that satisfies this paragraph (e)(2).

Example 10. The facts are the same as in *Example 9*, except that, within the same 3-year grant period, the fair market value of Corporation V stock is significantly less than the exercise price of the options. The compensation committee reprices those options to that lower current fair market value of Corporation V stock. The repricing of the options for 50,000 shares held by each salaried employee is treated as the grant of new options for an additional 50,000 shares to each employee. Thus, each of the salaried employees is treated as having received grants for 100,000 shares. Consequently, if any additional options are granted to those employees during the 3-year period, compensation attributable to the exercise of those additional options would not satisfy the requirements of this paragraph (e)(2). The results would be the same if the compensation committee canceled the outstanding options and issued new options to the same employees that were exercisable at the fair market value of Corporation V stock on the date of reissue.

Example 11. Corporation W maintains a plan under which each participating employee may receive incentive stock options, nonqualified stock options, stock appreciation rights, or grants of restricted Corporation W stock. The plan specifies that each participating employee may receive options, stock appreciation rights, restricted stock, or any combination of each, for no more than 20,000 shares over the life of the plan. The plan provides that stock options may be granted with an exercise price of less than, equal to, or greater than fair market value on the date of grant. Options granted with an exercise price equal to, or greater than, fair market value on the date of grant do not fail to meet the requirements of this paragraph (e)(2) merely because the compensation committee has the discretion to determine the types of awards (*i.e.*, options, rights, or restricted stock) to be granted to each employee or the discretion to issue options or make other compensation awards under the plan that would not meet the requirements of this paragraph (e)(2). Whether an option granted under the plan satisfies the requirements of this paragraph (e)(2) is determined on the basis of the specific terms of the option and without regard to other options or awards under the plan.

Example 12. Corporation X maintains a plan under which stock appreciation rights may be awarded to key employees. The plan permits the compensation committee to make awards under which the amount of compensation payable to the employee is equal to the increase in the stock price plus a percentage ''gross up'' intended to offset the tax liability of the employee. In addition, the plan permits the compensation committee to make awards under which the amount of compensation payable to the employee is equal to the increase in the stock price, based on the highest price, which is defined as the highest price paid for Corporation X stock (or offered in a tender offer or other arms-length offer) during the 90 days preceding exercise. Compensation attributable to awards under the plan satisfies the requirements of paragraph (e)(2)(vi) of this section, provided that the terms of the plan specify the maximum number of shares for which awards may be made.

Example 13. Corporation W adopts a plan under which a bonus will be paid to the CEO only if there is a 10% increase in earnings per share during the performance period. The plan provides that earnings per share will be calculated without regard to any change in accounting standards that may be required by the Financial Accounting Standards Board after the goal is established. After the goal is established, such a change in accounting standards occurs. Corporation W's reported earnings, for purposes of determining earnings per share under the plan, are adjusted pursuant to this plan provision to factor out this change in standards. This adjustment will not be considered an exercise of impermissible discretion because it is made pursuant to the plan provision.

Example 14. Corporation X adopts a performance-based incentive pay plan with a four-year performance period. Bonuses under the plan are scheduled to be paid in the first year after the end of the performance period (year 5). However, in the second year of the performance period, the compensation committee determines that any bonuses payable in year 5 will instead, for bona fide business reasons, be paid in year 10. The compensation committee also determines that any compensation that would have been payable in year 5 will be adjusted to reflect the delay in payment. The adjustment will be based on the greater of the future rate of return of a specified mutual fund that invests in blue chip stocks or of a specified venture capital investment over the five-year deferral period. Each of these investments, considered by itself, is a predetermined actual investment because it is based on the future rate of return of an actual investment. However, the adjustment in this case is not based on predetermined actual investments within the meaning of paragraph (e)(2)(iii)(B) of this section because the amount payable by Corporation X in year 10 will be based on the greater of the two investment returns and, thus, will not be based on the actual rate of return on either specific investment.

Example 15. The facts are the same as in *Example 14*, except that the increase will be based on Moody's Average Corporate Bond Yield over the five-year deferral period. Because this index reflects a reasonable rate of interest, the increase in the compensation payable that is based on the index's rate of return is not considered an impermissible increase in the amount of compensation payable under the formula.

Example 16. The facts are the same as in *Example 14*, except that the increase will be based on the rate of return for the Standard & Poor's 500 Index. This index does not measure interest rates and thus does not represent a reasonable rate of interest. In addition, this index does not represent an actual investment. Therefore, any additional compensation payable based on the rate of return of this index will result in an impermissible increase in the amount payable under the formula. If, in contrast, the increase were based on the rate of return of an existing mutual fund that is invested in a manner that seeks to approximate the Standard & Poor's 500 Index, the increase would be based on a predetermined actual investment within the meaning of paragraph (e)(2)(iii)(B) of this section and thus would not result in an impermissible increase in the amount payable under the formula.

(3) *Outside directors*—(i) *General rule*. The performance goal under which compensation is paid must be established by a compensation committee comprised solely of two or more outside directors. A director is an outside director if the director—

(A) Is not a current employee of the publicly held corporation;

(B) Is not a former employee of the publicly held corporation who receives compensation for prior services (other than benefits under a tax-qualified retirement plan) during the taxable year;

(C) Has not been an officer of the publicly held corporation; and

(D) Does not receive remuneration from the publicly held corporation, either directly or indirectly, in any capacity other than as a director. For this purpose, remuneration includes any payment in exchange for goods or services.

(ii) *Remuneration received*. For purposes of this paragraph (e)(3), remuneration is received, directly or indirectly, by a director in each of the following circumstances:

(A) If remuneration is paid, directly or indirectly, to the director personally or to an entity in which the director has a beneficial ownership interest of greater than 50 percent. For this purpose, remuneration is considered paid when actually paid (and throughout the remainder of that taxable year of the corporation) and, if earlier, throughout the period when a contract or agreement to pay remuneration is outstanding.

(B) If remuneration, other than *de minimis* remuneration, was paid by the publicly held corporation in its preceding taxable year to an entity in which the director has a beneficial ownership interest of at least 5 percent but not more than 50 percent. For this purpose, remuneration is considered paid when actually paid or, if earlier, when the publicly held corporation becomes liable to pay it.

(C) If remuneration, other than *de minimis* remuneration, was paid by the publicly held corporation in its preceding taxable year to an entity by which the director is employed or self-employed other than as a director. For this purpose, remuneration is considered paid when actually paid or, if earlier, when the publicly held corporation becomes liable to pay it.

(iii) *De minimis remuneration*—(A) *In general*. For purposes of paragraphs (e)(3)(ii)(B) and (C) of this section, remuneration that was paid by the publicly held corporation in its preceding taxable year to an entity is *de minimis* if payments to the entity did not exceed 5 percent of the gross revenue of the entity for its taxable year ending with or within that preceding taxable year of the publicly held corporation.

(B) *Remuneration for personal services and substantial owners*. Notwithstanding paragraph (e)(3)(iii)(A) of this section, remuneration in excess of $60,000 is not *de minimis* if the remuneration is paid to an entity described in paragraph (e)(3)(ii)(B) of this section, or is paid for personal services to an entity described in paragraph (e)(3)(ii)(C) of this section.

(iv) *Remuneration for personal services*. For purposes of paragraph (e)(3)(iii)(B) of this section, remuneration from a publicly held corporation is for personal services if—

(A) The remuneration is paid to an entity for personal or professional services, consisting of legal, accounting, investment banking, and management consulting services (and other similar services that may be specified by the Commissioner in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin), performed for the publicly held corporation, and the remuneration is not for services that are incidental to the purchase of goods or to the purchase of services that are not personal services; and

(B) The director performs significant services (whether or not as an employee) for the corporation, division, or similar organization (within the entity) that actually provides the services described in paragraph (e)(3)(iv)(A) of this section to the publicly held corporation, or more than 50 percent of the entity's gross revenues (for the entity's preceding taxable year) are derived from that corporation, subsidiary, or similar organization.

(v) *Entity defined*. For purposes of this paragraph (e)(3), entity means an organization that is a sole proprietorship, trust, estate, partnership, or corporation. The term also includes an affiliated group of corporations as defined in section 1504 (determined without regard to section 1504(b)) and a group of organizations that would be an affiliated group but for the fact that one or more of the organizations are not incorporated. However, the aggregation rules referred to in the preceding sentence do not apply for purposes of determining whether a director has a beneficial ownership interest of at least 5 percent or greater than 50 percent.

(vi) *Employees and former officers*. Whether a director is an employee or a former officer is determined on the basis of the facts at the time that the individual is serving as a director on the compensation committee. Thus, a director is not precluded from being an outside director solely because the director is a former officer of a corporation that previously was an affiliated corporation of the publicly held corporation. For example, a director of a parent corporation of an affiliated group is not precluded from being an outside director solely because that director is a former officer of an affiliated subsidiary that was spun off or liquidated. However, an outside director would no longer be an outside director if a corporation in which the director was previously an officer became an affiliated corporation of the publicly held corporation.

(vii) *Officer*. Solely for purposes of this paragraph (e)(3), *officer* means an administrative executive who is or was in regular and continued service. The term implies continuity of service and excludes those employed for a special and single transaction. An individual who merely has (or had) the title of officer but not the authority of an officer is not considered an officer. The determination of whether an individual is or was an officer is based on all the of facts and circumstances in the particular case, including without limitation the source of the individual's authority, the term for which the individual is elected or appointed, and the nature and extent of the individual's duties.

(viii) *Members of affiliated groups*. For purposes of this paragraph (e)(3), the outside directors of the publicly held member of an affiliated group are treated as the outside directors of all members of the affiliated group.

(ix) *Examples*. This paragraph (e)(3) may be illustrated by the following examples:

Example 1. Corporations X and Y are members of an affiliated group of corporations as defined in section 1504, until July 1, 1994, when Y is sold to another group. Prior to the sale, A served as an officer of Corporation Y. After July 1, 1994, A is not treated as a former officer of Corporation X by reason of having been an officer of Y.

Example 2. Corporation Z, a calendar-year taxpayer, uses the services of a law firm by which B is employed, but in which B has a less-than-5-percent ownership interest. The law firm reports income on a July 1 to June 30 basis. Corporation Z appoints B to serve on its compensation committee for calendar year 1998 after determining that, in calendar year 1997, it did not become liable to the law firm for remuneration exceeding the lesser of $60,000 or five percent of the law firm's gross revenue (calculated for the year ending June 30, 1997). On October 1, 1998, Corporation Z becomes liable to pay remuneration of $50,000 to the law firm on June 30, 1999. For the year ending June 30, 1998, the law firm's gross revenue was less than $1 million. Thus, in calendar year 1999, B is not an outside director. However, B may satisfy the requirements for an outside director in calendar year 2000, if, in calendar year 1999, Corporation Z does not become liable to the law firm for additional remuneration. This is because the remuneration actually paid on June 30, 1999 was considered paid on October 1, 1998 under paragraph (e)(3)(ii)(C) of this section.

Example 3. Corporation Z, a publicly held corporation, purchases goods from Corporation A. D, an executive and less-than-5-percent owner of Corporation A, sits on the board of directors of Corporation Z and on its compensation committee. For 1997, Corporation Z obtains representations to the effect that D is not eligible for any commission for D's sales to Corporation Z and that, for purposes of determining D's compensation for 1997, Corporation A's sales to Corporation Z are not otherwise treated differently than sales to other customers of Corporation A (including its affiliates, if any) or are irrelevant. In addition, Corporation Z has no reason to believe that these representations are inaccurate or that it is otherwise paying remuneration indirectly to D personally. Thus, in 1997, no remuneration is considered paid by Corporation Z indirectly to D personally under paragraph (e)(3)(ii)(A) of this section.

Example 4. (i) Corporation W, a publicly held corporation, purchases goods from Corporation T. C, an executive and less-than-5-percent owner of Corporation T, sits on the board of directors of Corporation W and on its compensation committee. Corporation T develops a new product and agrees on January 1, 1998 to pay C a bonus of $500,000 if Corporation W contracts to purchase the product. Even if Corporation W purchases the new product, sales to Corporation W will represent less than 5 percent of Corporation T's gross revenues. In 1999, Corporation W contracts to purchase the new product and, in 2000, C receives the $500,000 bonus from Corporation T. In 1998, 1999, and 2000, Corporation W does not obtain any representations relating to indirect remuneration to C personally (such as the representations described in *Example 3*).

(ii) Thus, in 1998, 1999, and 2000, remuneration is considered paid by Corporation W indirectly to C personally under paragraph (e)(3)(ii)(A) of this section. Accordingly, in 1998, 1999, and 2000, C is not an outside director of Corporation W. The result would have been the same if Corporation W had obtained appropriate representations but nevertheless had reason to believe that it was paying remuneration indirectly to C personally.

Example 5. Corporation R, a publicly held corporation, purchases utility service from Corporation Q, a public utility. The chief executive officer, and less-than-5-percent owner, of Corporation Q is a director of Corporation R. Corporation R pays Corporation Q more than $60,000 per year for the utility service, but less than 5 percent of Corporation Q's gross revenues. Because utility services are not personal services, the fees paid are not subject to the $60,000 *de minimis* rule for remuneration for personal services within the meaning of paragraph (e)(3)(iii)(B) of this section. Thus, the chief executive officer qualifies as an outside director of Corporation R, unless disqualified on some other basis.

Example 6. Corporation A, a publicly held corporation, purchases management consulting services from Division S of Conglomerate P. The chief financial officer of Division S is a director of Corporation A. Corporation A pays more than $60,000 per year for the management consulting services, but less than 5 percent of Conglomerate P's gross revenues. Because management consulting services are personal services within the meaning of paragraph (e)(3)(iv)(A) of this section, and the chief financial officer performs significant services for Division S, the fees paid are subject to the $60,000 *de minimis* rule as remuneration for personal services. Thus, the chief financial officer does not qualify as an outside director of Corporation A.

Example 7. The facts are the same as in *Example 6*, except that the chief executive officer, and less-than-5-percent owner, of the parent company of Conglomerate P is a director of Corporation A and does not perform significant services for Division S. If the gross revenues of Division S do not constitute more than 50 percent of the gross revenues of Conglomerate P for P's preceding taxable year, the chief executive officer will qualify as an outside director of Corporation A, unless disqualified on some other basis.

(4) *Shareholder approval requirement*—(i) *General rule*. The material terms of the performance goal under which the compensation is to be paid must be disclosed to and subsequently approved by the shareholders of the publicly held corporation before the compensation is paid. The requirements of this paragraph (e)(4) are not satisfied if the compensation would be paid regardless of whether the material terms are approved by shareholders. The material terms include the employees eligible to receive compensation; a description of the business criteria on which the performance goal is based; and either the maximum amount of compensation that could be paid to any employee or the formula used to calculate the amount of compensation to be paid to the employee if the performance goal is attained (except that, in the case of a formula that fails to preclude discretion to increase the amount of compensation (as described in paragraph (e)(2)(iii)(A) of this section) merely because the amount of compensation to be paid is based, in whole or in part, on a percentage of salary or base pay and the dollar amount of the salary or base pay is not fixed at the time the performance goal is established, the maximum dollar amount of compensation that could be paid to the employee must be disclosed).

(ii) *Eligible employees*. Disclosure of the employees eligible to receive compensation need not be so specific as to identify the particular individuals by name. A general description of the class of eligible employees by title or class is sufficient, such as the chief executive officer and vice presidents, or all salaried employees, all executive officers, or all key employees.

(iii) *Description of business criteria*—(A) *In general*. Disclosure of the business criteria on which the performance goal is based need not include the specific targets that must be satisfied under the performance goal. For example, if a bonus plan provides that a bonus will be paid if earnings per share increase by 10 percent, the 10-percent figure is a target that need not be disclosed to shareholders. However, in that case, disclosure must be made that the bonus plan is based on an earnings-per-share business criterion. In the case of a plan under which employees may be granted stock options or stock appreciation rights, no specific description of the business criteria is required if the grants or awards are based on a stock price that is no less than current fair market value.

(B) *Disclosure of confidential information*. The requirements of this paragraph (e)(4) may be satisfied even though information that otherwise would be a material term of a performance goal is not disclosed to shareholders, provided that the compensation committee determines that the information is confidential commercial or business information, the disclosure of which would have an adverse effect on the publicly held corporation. Whether disclosure would adversely affect the corporation is determined on the basis of the facts and circumstances. If the compensation committee makes such a determination, the disclosure to shareholders must state the compensation committee's belief that the information is confidential commercial or business information, the disclosure of which would adversely affect the company. In addition, the ability not to disclose confidential information does not eliminate the requirement that disclosure be made of the maximum amount of compensation that is payable to an individual under a performance goal. Confidential information does not include the identity of an executive or the class of executives to which a performance goal applies or the amount of compensation that is payable if the goal is satisfied.

(iv) *Description of compensation*. Disclosure as to the compensation payable under a performance goal must be specific enough so that shareholders can determine the maximum amount of compensation that could be paid to any employee during a specified period. If the terms of the performance goal do not provide for a maximum dollar amount, the disclosure must include the formula under which the compensation would be calculated. Thus, for example, if compensation attributable to the exercise of stock options is equal to the difference in the exercise price and the current value of the stock, disclosure would be required of the maximum number of shares for which grants may be made to any employee and the exercise price of those options (*e.g.*, fair market value on date of grant). In that case, shareholders could calculate the maximum amount of compensation that would be attributable to the exercise of options on the basis of their assumptions as to the future stock price.

(v) *Disclosure requirements of the Securities and Exchange Commission*. To the extent not otherwise specifically provided in this paragraph (e)(4), whether the material terms of a performance goal are adequately disclosed to shareholders is determined under the same standards as apply under the Exchange Act.

(vi) *Frequency of disclosure*. Once the material terms of a performance goal are disclosed to and approved by shareholders, no additional disclosure or approval is required unless the compensation committee changes the material terms of the performance goal. If, however, the compensation committee has authority to change the targets under a performance goal after shareholder approval of the goal, material terms of the performance goal must be disclosed to and reapproved by shareholders no later than the first shareholder meeting that occurs in the fifth year following the year in which shareholders previously approved the performance goal.

(vii) *Shareholder vote*. For purposes of this paragraph (e)(4), the material terms of a performance goal are approved by shareholders if, in a separate vote, a majority of the votes cast on the issue (including abstentions to the extent abstentions are counted as voting under applicable state law) are cast in favor of approval.

(viii) *Members of affiliated group*. For purposes of this paragraph (e)(4), the shareholders of the publicly held member of the affiliated group are treated as the shareholders of all members of the affiliated group.

(ix) *Examples*. This paragraph (e)(4) may be illustrated by the following examples:

Example 1. Corporation X adopts a plan that will pay a specified class of its executives an annual cash bonus based on the overall increase in corporate sales during the year. Under the terms of the plan, the cash bonus of each executive equals $100,000 multiplied by the number of percentage points by which sales increase in the current year when compared to the prior year. Corporation X discloses to its shareholders prior to the vote both the class of executives eligible to receive awards and the annual formula of $100,000 multiplied by the percentage increase in sales. This disclosure meets the requirements of this paragraph (e)(4). Because the compensation committee does not have the authority to establish a different target under the plan, Corporation X need not re-disclose to its shareholders and obtain their reapproval of the material terms of the plan until those material terms are changed.

Example 2. The facts are the same as in *Example 1* except that Corporation X discloses only that bonuses will be paid on the basis of the annual increase in sales. This disclosure does not meet the requirements of this paragraph (e)(4) because it does not include the formula for calculating the compensation or a maximum amount of compensation to be paid if the performance goal is satisfied.

Example 3. Corporation Y adopts an incentive compensation plan in 1995 that will pay a specified class of its executives a bonus every 3 years based on the following 3 factors: increases in earnings per share, reduction in costs for specified divisions, and increases in sales by specified divisions. The bonus is payable in cash or in Corporation Y stock, at the option of the executive. Under the terms of the plan, prior to the beginning of each 3-year period, the compensation committee determines the specific targets under each of the three factors (*i.e.*, the amount of the increase in earnings per share, the reduction in costs, and the amount of sales) that must be met in order for the executives to receive a bonus. Under the terms of the plan, the compensation committee retains the discretion to determine whether a bonus will be paid under any one of the goals. The terms of the plan also specify that no executive may receive a bonus in excess of $1,500,000 for any 3-year period. To satisfy the requirements of this paragraph (e)(4), Corporation Y obtains shareholder approval of the plan at its 1995 annual shareholder meeting. In the proxy statement issued to shareholders, Corporation Y need not disclose to shareholders the specific targets that are set by the compensation committee. However, Corporation Y must disclose that bonuses are paid on the basis of earnings per share, reductions in costs, and increases in sales of specified divisions. Corporation Y also must disclose the maximum amount of compensation that any executive may receive under the plan is $1,500,000 per 3-year period. Unless changes in the material terms of the plan are made earlier, Corporation Y need not disclose the material terms of the plan to the shareholders and obtain their reapproval until the first shareholders' meeting held in 2000.

Example 4. The same facts as in *Example 3*, except that prior to the beginning of the second 3-year period, the compensation committee determines that different targets will be set under the plan for that period with regard to all three of the performance criteria (*i.e.*, earnings per share, reductions in costs, and increases in sales). In addition, the compensation committee raises the maximum dollar amount that can be paid under the plan for a 3-year period to $2,000,000. The increase in the maximum dollar amount of compensation under the plan is a changed material term. Thus, to satisfy the requirements of this paragraph (e)(4), Corporation Y must disclose to and obtain approval by the shareholders of the plan as amended.

Example 5. In 1998, Corporation Z establishes a plan under which a specified group of executives will receive a cash bonus not to exceed $750,000 each if a new product that has been in development is completed and ready for sale to customers by January 1, 2000. Although the completion of the new product is a material term of the performance goal under this paragraph (e)(4), the compensation committee determines that the disclosure to shareholders of the performance goal would adversely affect Corporation Z because its competitors would be made aware of the existence and timing of its new product. In this case, the requirements of this paragraph (e)(4) are satisfied if all other material terms, including the maximum amount of compensation, are disclosed and the disclosure affirmatively states that the terms of the performance goal are not being disclosed because the compensation committee has determined that those terms include confidential information, the disclosure of which would adversely affect Corporation Z.

(5) *Compensation committee certification*. The compensation committee must certify in writing prior to payment of the compensation that the performance goals and any other material terms were in fact satisfied. For this purpose, approved minutes of the compensation committee meeting in which the certification is made are treated as a written certification. Certification by the compensation committee is not required for compensation that is attributable solely to the increase in the stock of the publicly held corporation.

(f) *Companies that become publicly held, spinoffs, and similar transactions*—(1) *In general*. In the case of a corporation that was not a publicly held corporation and then becomes a publicly held corporation, the deduction limit of paragraph (b) of this section does not apply to any remuneration paid pursuant to a compensation plan or agreement that existed during the period in which the corporation was not publicly held. However, in the case of such a corporation that becomes publicly held in connection with an initial public offering, this relief applies only to the extent that the prospectus accompanying the initial public offering disclosed information concerning those plans or agreements that satisfied all applicable securities laws then in effect. In accordance with paragraph (c)(1)(ii) of this section, a corporation that is a member of an affiliated group that includes a publicly held corporation is considered publicly held and, therefore, cannot rely on this paragraph (f)(1).

(2) *Reliance period*. Paragraph (f)(1) of this section may be relied upon until the earliest of—

(i) The expiration of the plan or agreement;

(ii) The material modification of the plan or agreement, within the meaning of paragraph (h)(1)(iii) of this section;

(iii) The issuance of all employer stock and other compensation that has been allocated under the plan; or

(iv) The first meeting of shareholders at which directors are to be elected that occurs after the close of the third calendar year following the calendar year in which the initial public offering occurs or, in the case of a privately held corporation that becomes publicly held without an initial public offering, the first calendar year following the calendar year in which the corporation becomes publicly held.

(3) *Stock-based compensation*. Paragraph (f)(1) of this section will apply to any compensation received pursuant to the exercise of a stock option or stock appreciation right, or the substantial vesting of restricted property, granted under a plan or agreement described in paragraph (f)(1) of this section if the grant occurs on or before the earliest of the events specified in paragraph (f)(2) of this section.

(4) *Subsidiaries that become separate publicly held corporations*—(i) *In general*. If a subsidiary that is a member of the affiliated group described in paragraph (c)(1)(ii) of this section becomes a separate publicly held corporation (whether by spinoff or otherwise), any remuneration paid to covered employees of the new publicly held corporation will satisfy the exception for performance-based compensation described in paragraph (e) of this section if the conditions in either paragraph (f)(4)(ii) or (f)(4)(iii) of this section are satisfied.

(ii) *Prior establishment and approval*. Remuneration satisfies the requirements of this paragraph (f)(4)(ii) if the remuneration satisfies the requirements for performance-based compensation set forth in paragraphs (e)(2), (e)(3), and (e)(4) of this section (by application of paragraphs (e)(3)(viii) and (e)(4)(viii) of this section) before the corporation becomes a separate publicly held corporation, and the certification required by paragraph (e)(5) of this section is made by the compensation committee of the new publicly held corporation (but if the performance goals are attained before the corporation becomes a separate publicly held corporation, the certification may be made by the compensation committee referred to in paragraph (e)(3)(viii) of this section before it becomes a separate publicly held corporation). Thus, this paragraph (f)(4)(ii) requires that the outside directors and shareholders (within the meaning of paragraphs (e)(3)(viii) and (e)(4)(viii) of this section) of the corporation before it becomes a separate publicly held corporation establish and approve, respectively, the performance-based compensation for the covered employees of the new publicly held corporation in accordance with paragraphs (e)(3) and (e)(4) of this section.

(iii) *Transition period*. Remuneration satisfies the requirements of this paragraph (f)(4)(iii) if the remuneration satisfies all of the requirements of paragraphs (e)(2), (e)(3), and (e)(5) of this section. The outside directors (within the meaning of paragraph (e)(3)(viii) of this section) of the corporation before it becomes a separate publicly held corporation, or the outside directors of the new publicly held corporation, may establish and administer the performance goals for the covered employees of the new publicly held corporation for purposes of satisfying the requirements of paragraphs (e)(2) and (e)(3) of this section. The certification required by paragraph (e)(5) of this section must be made by the compensation committee of the new publicly held corporation. However, a taxpayer may rely on this paragraph (f)(4)(iii) to satisfy the requirements of paragraph (e) of this section only for compensation paid, or stock options, stock appreciation rights, or restricted property granted, prior to the first regularly scheduled meeting of the shareholders of the new publicly held corporation that occurs more than 12 months after the date the corporation becomes a separate publicly held corporation. Compensation paid, or stock options, stock appreciation rights, or restricted property granted, on or after the date of that meeting of shareholders must satisfy all requirements of paragraph (e) of this section, including the shareholder approval requirement of paragraph (e)(4) of this section, in order to satisfy the requirements for performance-based compensation.

(5) *Example*. The following example illustrates the application of paragraph (f)(4)(ii) of this section:

Example. Corporation P, which is publicly held, decides to spin off Corporation S, a wholly owned subsidiary of Corporation P. After the spinoff, Corporation S will be a separate publicly held corporation. Before the spinoff, the compensation committee of Corporation P, pursuant to paragraph (e)(3)(viii) of this section, establishes a bonus plan for the executives of Corporation S that provides for bonuses payable after the spinoff and that satisfies the requirements of paragraph (e)(2) of this section. If, pursuant to paragraph (e)(4)(viii) of this section, the shareholders of Corporation P approve the plan prior to the spinoff, that approval will satisfy the requirements of paragraph (e)(4) of this section with respect to compensation paid pursuant to the bonus plan after the spinoff. However, the compensation committee of Corporation S will be required to certify that the goals are satisfied prior to the payment of the bonuses in order for the bonuses to be considered performance-based compensation.

(g) *Coordination with disallowed excess parachute payments*. The $1,000,000 limitation in paragraph (b) of this section is reduced (but not below zero) by the amount (if any) that would have been included in the compensation of the covered employee for the taxable year but for being disallowed by reason of section 280G. For example, assume that during a taxable year a corporation pays $1,500,000 to a covered employee and no portion satisfies the exception in paragraph (d) of this section for commissions or paragraph (e) of this section for qualified performance-based compensation. Of the $1,500,000, $600,000 is an excess parachute payment, as defined in section 280G(b)(1) and is disallowed by reason of that section. Because the excess parachute payment reduces the limitation of paragraph (b) of this section, the corporation can deduct $400,000, and $500,000 of the otherwise deductible amount is nondeductible by reason of section 162(m).

(h) *Transition rules*—(1) *Compensation payable under a written binding contract which was in effect on February 17, 1993*—(i) *General rule*. The deduction limit of paragraph (b) of this section does not apply to any compensation payable under a written binding contract that was in effect on February 17, 1993. The preceding sentence does not apply unless, under applicable state law, the corporation is obligated to pay the compensation if the employee performs services. However, the deduction limit of paragraph (b) of this section does apply to a contract that is renewed after February 17, 1993. A written binding contract that is terminable or cancelable by the corporation after February 17, 1993, without the employee's consent is treated as a new contract as of the date that any such termination or cancellation, if made, would be effective. Thus, for example, if the terms of a contract provide that it will be automatically renewed as of a certain date unless either the corporation or the employee gives notice of termination of the contract at least 30 days before that date, the contract is treated as a new contract as of the date that termination would be effective if that notice were given. Similarly, for example, if the terms of a contract provide that the contract will be terminated or canceled as of a certain date unless either the corporation or the employee elects to renew within 30 days of that date, the contract is treated as renewed by the corporation as of that date. Alternatively, if the corporation will remain legally obligated by the terms of a contract beyond a certain date at the sole discretion of the employee, the contract will not be treated as a new contract as of that date if the employee exercises the discretion to keep the corporation bound to the contract. A contract is not treated as terminable or cancelable if it can be terminated or canceled only by terminating the employment relationship of the employee.

(ii) *Compensation payable under a plan or arrangement*. If a compensation plan or arrangement meets the requirements of paragraph (h)(1)(i) of this section, the compensation paid to an employee pursuant to the plan or arrangement will not be subject to the deduction limit of paragraph (b) of this section even though the employee was not eligible to participate in the plan as of February 17, 1993. However, the preceding sentence does not apply unless the employee was employed on February 17, 1993, by the corporation that maintained the plan or arrangement, or the employee had the right to participate in the plan or arrangement under a written binding contract as of that date.

(iii) *Material modifications*.

(A) Paragraph (h)(1)(i) of this section will not apply to any written binding contract that is materially modified. A material modification occurs when the contract is amended to increase the amount of compensation payable to the employee. If a binding written contract is materially modified, it is treated as a new contract entered into as of the date of the material modification. Thus, amounts received by an employee under the contract prior to a material modification are not affected, but amounts received subsequent to the material modification are not treated as paid under a binding, written contract described in paragraph (h)(1)(i) of this section.

(B) A modification of the contract that accelerates the payment of compensation will be treated as a material modification unless the amount of compensation paid is discounted to reasonably reflect the time value of money. If the contract is modified to defer the payment of compensation, any compensation paid in excess of the amount that was originally payable to the employee under the contract will not be treated as a material modification if the additional amount is based on either a reasonable rate of interest or one or more predetermined actual investments (whether or not assets associated with the amount originally owed are actually invested therein) such that the amount payable by the employer at the later date will be based on the actual rate of return of the specific investment (including any decrease as well as any increase in the value of the investment).

(C) The adoption of a supplemental contract or agreement that provides for increased compensation, or the payment of additional compensation, is a material modification of a binding, written contract where the facts and circumstances show that the additional compensation is paid on the basis of substantially the same elements or conditions as the compensation that is otherwise paid under the written binding contract. However, a material modification of a written binding contract does not include a supplemental payment that is equal to or less than a reasonable cost-of-living increase over the payment made in the preceding year under that written binding contract. In addition, a supplemental payment of compensation that satisfies the requirements of qualified performance-based compensation in paragraph (e) of this section will not be treated as a material modification.

(iv) *Examples*. The following examples illustrate the exception of this paragraph (h)(1):

Example 1. Corporation X executed a 3-year compensation arrangement with C on February 15, 1993, that constitutes a written binding contract under applicable state law. The terms of the arrangement provide for automatic extension after the 3-year term for additional 1-year periods, unless the corporation exercises its option to terminate the arrangement within 30 days of the end of the 3-year term or, thereafter, within 30 days before each anniversary date. Termination of the compensation arrangement does not require the termination of C's employment relationship with Corporation X. Unless terminated, the arrangement is treated as renewed on February 15, 1996, and the deduction limit of paragraph (b) of this section applies to payments under the arrangement after that date.

Example 2. Corporation Y executed a 5-year employment agreement with B on January 1, 1992, providing for a salary of $900,000 per year. Assume that this agreement constitutes a written binding contract under applicable state law. In 1992 and 1993, B receives the salary of $900,000 per year. In 1994, Corporation Y increases B's salary with a payment of $20,000. The $20,000 supplemental payment does not constitute a material modification of the written binding contract because the $20,000 payment is less than or equal to a reasonable cost-of-living increase from 1993. However, the $20,000 supplemental payment is subject to the limitation in paragraph (b) of this section. On January 1, 1995, Corporation Y increases B's salary to $1,200,000. The $280,000 supplemental payment is a material modification of the written binding contract because the additional compensation is paid on the basis of substantially the same elements or conditions as the compensation that is otherwise paid under the written binding contract and it is greater than a reasonable, annual cost-of-living increase. Because the written binding contract is materially modified as of January 1, 1995, all compensation paid to B in 1995 and thereafter is subject to the deduction limitation of section 162(m).

Example 3. Assume the same facts as in *Example 2*, except that instead of an increase in salary, B receives a restricted stock grant subject to B's continued employment for the balance of the contract. The restricted stock grant is not a material modification of the binding written contract because any additional compensation paid to B under the grant is not paid on the basis of substantially the same elements and conditions as B's salary because it is based both on the stock price and B's continued service. However, compensation attributable to the restricted stock grant is subject to the deduction limitation of section 162(m).

(2) *Special transition rule for outside directors*. A director who is a disinterested director is treated as satisfying the requirements of an outside director under paragraph (e)(3) of this section until the first meeting of shareholders at which directors are to be elected that occurs on or after January 1, 1996. For purposes of this paragraph (h)(2) and paragraph (h)(3) of this section, a director is a disinterested director if the director is disinterested within the meaning of Rule 16b–3(c)(2)(i), 17 CFR 240.16b–3(c)(2)(i), under the Exchange Act (including the provisions of Rule 16b–3(d)(3), as in effect on April 30, 1991).

(3) *Special transition rule for previously-approved plans*—(i) *In general*. Any compensation paid under a plan or agreement approved by shareholders before December 20, 1993, is treated as satisfying the requirements of para-

graphs (e)(3) and (e)(4) of this section, provided that the directors administering the plan or agreement are disinterested directors and the plan was approved by shareholders in a manner consistent with Rule 16b–3(b), 17 CFR 240.16b–3(b), under the Exchange Act or Rule 16b–3(a), 17 CFR 240.16b–3(a) (as contained in 17 CFR part 240 revised April 1, 1990). In addition, for purposes of satisfying the requirements of paragraph (e)(2)(vi) of this section, a plan or agreement is treated as stating a maximum number of shares with respect to which an option or right may be granted to any employee if the plan or agreement that was approved by the shareholders provided for an aggregate limit, consistent with Rule 16b–3(b), 17 CFR 250.16b–3(b), on the shares of employer stock with respect to which awards may be made under the plan or agreement.

(ii) *Reliance period*. The transition rule provided in this paragraph (h)(3) shall continue and may be relied upon until the earliest of—

(A) The expiration or material modification of the plan or agreement;

(B) The issuance of all employer stock and other compensation that has been allocated under the plan; or

(C) The first meeting of shareholders at which directors are to be elected that occurs after December 31, 1996.

(iii) *Stock-based compensation*. This paragraph (h)(3) will apply to any compensation received pursuant to the exercise of a stock option or stock appreciation right, or the substantial vesting of restricted property, granted under a plan or agreement described in paragraph (h)(3)(i) of this section if the grant occurs on or before the earliest of the events specified in paragraph (h)(3)(ii) of this section.

(iv) *Example*. The following example illustrates the application of this paragraph (h)(3):

Example. Corporation Z adopted a stock option plan in 1991. Pursuant to Rule 16b-3 under the Exchange Act, the stock option plan has been administered by disinterested directors and was approved by Corporation Z shareholders. Under the terms of the plan, shareholder approval is not required again until 2001. In addition, the terms of the stock option plan include an aggregate limit on the number of shares available under the plan. Option grants under the Corporation Z plan are made with an exercise price equal to or greater than the fair market value of Corporation Z stock. Compensation attributable to the exercise of options that are granted under the plan before the earliest of the dates specified in paragraph (h)(3)(ii) of this section will be treated as satisfying the requirements of paragraph (e) of this section for qualified performance-based compensation, regardless of when the options are exercised.

(i) (*Reserved*)

(j) *Effective date*—(1) *In general*. Section 162(m) and this section apply to compensation that is otherwise deductible by the corporation in a taxable year beginning on or after January 1, 1994.

(2) *Delayed effective date for certain provisions*—(i) *Date on which remuneration is considered paid*. Notwithstanding paragraph (j)(1) of this section, the rules in the second sentence of each of paragraphs (e)(3)(ii)(A), (e)(3)(ii)(B), and (e)(3)(ii)(C) of this section for determining the date or dates on which remuneration is considered paid to a director are effective for taxable years beginning on or after January 1, 1995. Prior to those taxable years, taxpayers must follow the rules in paragraphs (e)(3)(ii)(A), (e)(3)(ii)(B), and (e)(3)(ii)(C) of this section or another reasonable, good faith interpretation of section 162(m) with respect to the date or dates on which remuneration is considered paid to a director.

(ii) *Separate treatment of publicly held subsidiaries*. Notwithstanding paragraph (j)(1) of this section, the rule in paragraph (c)(1)(ii) of this section that treats publicly held subsidiaries as separately subject to section 162(m) is effective as of the first regularly scheduled meeting of the shareholders of the publicly held subsidiary that occurs more than 12 months after December 2, 1994. The rule for stock-based compensation set forth in paragraph (f)(3) of this section will apply for this purpose, except that the grant must occur before the shareholder meeting specified in this paragraph (j)(2)(ii). Taxpayers may choose to rely on the rule referred to in the first sentence of this paragraph (j)(2)(ii) for the period prior to the effective date of the rule.

(iii) *Subsidiaries that become separate publicly held corporations*. Notwithstanding paragraph (j)(1) of this section, if a subsidiary of a publicly held corporation becomes a separate publicly held corporation as described in paragraph (f)(4)(i) of this section, then, for the duration of the reliance period described in paragraph (f)(2) of this section, the rules of paragraph (f)(1) of this section are treated as applying (and the rules of paragraph (f)(4) of this section do not apply) to remuneration paid to covered employees of that new publicly held corporation pursuant to a plan or agreement that existed prior to December 2, 1994, provided that the treatment of that remuneration as performance-based is in accordance with a reasonable, good faith interpretation of section 162(m). However, if remuneration is paid to covered employees of that new publicly held corporation pursuant to a plan or agreement that existed prior to December 2, 1994, but that remuneration is not performance-based under a reasonable, good faith interpretation of section 162(m), the rules of paragraph (f)(1) of this section will be treated as applying only until the first regularly scheduled meeting of shareholders that occurs more than 12 months after December 2, 1994. The rules of paragraph (f)(4) of this section will apply as of that first regularly scheduled meeting. The rule for stock-based compensation set forth in paragraph (f)(3) of this section will apply for purposes of this paragraph (j)(2)(iii), except that the grant must occur before the shareholder meeting specified in the preceding sentence if the remuneration is not performance-based under a reasonable, good faith interpretation of section 162(m). Taxpayers may choose to rely on the rules of paragraph (f)(4) of this section for the period prior to the applicable effective date referred to in the first or second sentence of this paragraph (j)(2)(iii).

(iv) *Bonus Pools*. Notwithstanding paragraph (j)(1) of this section, the rules in paragraph (e)(2)(iii)(A) that limit the sum of individual percentages of a bonus pool to 100 percent will not apply to remuneration paid before January 1, 2001, based on performance in any performance period that began prior to December 20, 1995.

(v) *Compensation based on a percentage of salary or base pay*. Notwithstanding paragraph (j)(1) of this section, the requirement in paragraph (e)(4)(i) of this section that, in the case of certain formulas based on a percentage of salary or base pay, a corporation disclose to shareholders the maximum dollar amount of compensation that could be paid to the employee, will apply only to plans approved by shareholders after April 30, 1995.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 3. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

§602.101 [Amended]

Par.4. In §602.101, paragraph (c) is amended by adding the entry ''1.162–27 .... 1545–1466'' in numerical order to the table.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved December 12, 1995.

Leslie Samuels,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on December 19, 1995, 8:45 a.m., and published in the issue of the Federal Register for December 20, 1995, 60 F.R. 65534)

Section 165.—Losses

26 CFR 1.165–11: Election in respect of losses attributable to a disaster.

Election in respect of losses attributable to a disaster. This ruling lists the areas declared by the President to qualify as major disaster areas under the Disaster Relief and Emergency Assistance Act since the publication of Rev. Rul. 95–17.

Rev. Rul. 96–13

Under § 165(i) of the Internal Revenue Code, if a taxpayer suffers a loss attributable to a disaster occurring in an area subsequently determined by the President of the United States to warrant assistance by the Federal Government under the Disaster Relief and Emergency Assistance Act, 42 U.S.C. §§ 5121–5204c (1988 & Supp. V 1993) (the Act), the taxpayer may elect to claim a deduction for that loss on the taxpayer's federal income tax return for the taxable year immediately preceding the taxable year in which the disaster occurred.

Section 1.165–11(e) of the Income Tax Regulations provides that the election to deduct a disaster loss for the preceding year must be made by filing a return, an amended return, or a claim for refund on or before the later of (1) the due date of the taxpayer's income tax return (determined without regard to any extension of time to file the return) for the taxable year in which the disaster actually occurred, or (2) the due date of the taxpayer's income tax return (determined with regard to any extension of time to file the return) for the taxable year immediately preceding the taxable year in which the disaster actually occurred.

The provisions of § 165(i) apply only to losses that are otherwise deductible under § 165(a). An individual taxpayer may deduct losses if they are incurred in a trade or business, if they are incurred in a transaction entered into for profit, or if they are casualty losses under § 165(c)(3).

The President has determined that during 1995 the areas listed below have been adversely affected by disasters of sufficient severity and magnitude to warrant assistance by the Federal Government under the Act.

DRAFTING INFORMATION

The principal author of this revenue ruling is David B. Auclair of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Mr. Auclair on (202) 622-4910 (not a toll-free call).

Disaster Areas in 1995	Type of Disaster	Date of Disaster
Alabama		
Counties of Cullman, DeKalb, Marion, Marshall, and Winston	Severe storms, tornadoes, and flooding	February 15-20, 1995
Counties of Autauga, Baldwin, Barbour, Bullock, Bulter, Calhoun, Chambers, Cherokee, Chilton, Clarke, Clay, Cleburne, Coffee, Conecuh, Coosa, Covington, Crenshaw, Cullman, Dale, DeKalb, Elmore, Escambia, Etowah, Geneva, Henry, Houston, Jefferson, Lee, Lowndes, Macon, Mobile, Montgomery, Pike, Randolph, Russell, St. Clair, Talladega, and Tallapoosa	Hurricane Opal	October 4-8, 1995
Alaska		
Chugach and Copper River Education Attendance Areas (these areas include the City of Cordova, the City of Valdez, and the Richardson, Cooper River, and Edgerton Highway Areas); Municipality of Anchorage; Kenai Peninsula Borough, Kodiak Island Borough, and Matanuska-Susitna Borough	Severe storms and flooding	September 18-October 10, 1995

Disaster Areas in 1995	Type of Disaster	Date of Disaster
California		
Counties of Alameda, Amador, Butte, Colusa, Contra Costa, Del Norte, El Dorado, Glenn, Humboldt, Kern, Kings, Lake, Lassen, Los Angeles, Madera, Marin, Mendocino, Modoc, Monterey, Napa, Nevada, Orange, Placer, Plumas, Riverside, Sacramento, San Bernardino, San Diego, San Mateo, San Luis Obispo, Santa Barbara, Santa Clara, Santa Cruz, Shasta, Solano, Sonoma, Sutter, Tehama, Trinity, Ventura, Yolo, and Yuba	Severe winter storms	January 3-February 10, 1995
Counties of Alameda, Alpine, Amador, Butte, Calaveras, Colusa, Contra Costa, El Dorado, Fresno, Glenn, Humboldt, Imperial, Inyo, Kern, Kings, Lake, Lassen, Los Angeles, Madera, Marin, Mariposa, Mendocino, Merced, Modoc, Mono, Monterey, Napa, Nevada, Orange, Placer, Plumas, Riverside, Sacramento, San Benito, San Bernardino, San Diego, San Francisco, San Joaquin, San Luis Obispo, San Mateo, Santa Barbara, Santa Clara, Santa Cruz, Shasta, Sierra, Siskiyou, Sonoma, Solano, Stanislaus, Sutter, Tehama, Trinity, Tulare, Tuolumne, Ventura, Yolo, and Yuba	Severe winter storms	February 13-April 19, 1995
Florida		
Counties of Bay, Brevard, Escambia, Okaloosa, Santa Rosa, and Walton	Hurricane Erin	August 2-3, 1995
Counties of Bay, Calhoun, Escambia, Franklin, Gadsden, Gulf, Holmes, Jackson, Leon, Liberty, Okaloosa, Santa Rosa, Taylor, Wakulla, Walton, and Washington	Hurricane Opal	October 4-11, 1995
Counties of Collier and Lee	Hurricane Opal	October 4-31, 1995
Counties of Martin, Palm Beach, and St. Lucie	Severe storms and flooding	October 13-November 20, 1995
Georgia		
Counties of Banks, Barrow, Bartow, Carroll, Catoosa, Chattooga, Cherokee, Clay, Clayton, Cobb, Coweta, Dade, Dawson, Dekalb, Douglas, Fannin, Fayette, Floyd, Forsyth, Fulton, Gilmer, Gordon, Gwinnett, Habersham, Hall, Haralson, Harris, Heard, Lumpkin, Meriwether, Murray, Muscogee, Paulding, Pickens, Pike, Polk, Quitman, Rabun, Randolph, Rockdale, Spalding, Stewart, Talbot, Towns, Troup, Union, Upson, Walker, White, and Whitfield		
City of Albany located in Dougherty County	Severe storms and tornadoes	November 7-8, 1995
Illinois		
Counties of Alexander, Brown, Calhoun, Cass, Fulton, Greene, Jackson, Jersey, Madison, Mason, Monroe, Morgan, Pike, Pulaski, Randolph, Schuyler, Scott, St. Clair, and Union	Severe storms and flooding	May 15-June 15, 1995
Kentucky		
Counties of Adair, Bath, Boyd, Breathitt, Breckinridge, Carter, Casey, Christian, Clark, Cumberland, Elliot, Floyd, Fulton, Green, Hardin, Jackson, Jessamine, Johnson, Lawrence, Laurel, Magoffin, Meade, Mercer, Montgomery, Owsley, Perry, Pike, Pulaski, Rockcastle, Rowan, Russell, and Taylor	Tornadoes, severe wind and hail storms, torrential rain, and flooding	May 13-19, 1995

Disaster Areas in 1995	Type of Disaster	Date of Disaster
Louisiana		
Parishes of Ascension, Assumption, Jefferson, LaFourche, Orleans, St. Bernard, St. Charles, St. James, St. John, St. Tammany, Tangipahoa, and Terrebonne	Severe storms, tornadoes, and flooding	May 8-16, 1995
Minnesota		
Counties of Aitkin, Becker, Beltrami, Cass, Clay, Clearwater, Crow Wing, Hubbard, Itasca, Kittson, Mahnomen, Otter Tail, St. Louis, Wadena, and Wilkin, and White Earth Indian Reservation	Severe storms, straight line winds, and tornadoes	July 9-14, 1995
Counties of Big Stone, Stevens, Swift, and Traverse	Severe ice storm	October 23-24, 1995
Mississippi		
Counties of Hancock, Harrison, Jackson, and Pearl River	Severe storms, tornadoes, and flooding	May 8-17, 1995
Missouri		
City of St. Louis; Counties of Adair, Andrew, Atchinson, Barry, Barton, Bates, Benton, Boone, Callaway, Camden, Cape Girardeau, Carroll, Cass, Chariton, Clark, Cole, Cooper, Dallas, Daviess, Dekalb, Franklin, Gasconade, Gentry, Henry, Howard, Jackson, Jasper, Jefferson, Johnson, Lafayette, Lewis, Lincoln, Linn, Macon, Maries, McDonald, Mercer, Miller, Mississippi, Moniteau, Montgomery, Morgan, New Madrid, Newton, Nodaway, Osage, Pemiscot, Perry, Ray, Saint Francois, Saline, Scotland, Scott, St. Charles, St. Clair, Ste. Genevieve, St. Louis, Stone, Sullivan, Vernon, and Warren	Severe storms, hail, tornadoes, and flooding	May 13-June 23, 1995
New Hampshire		
Counties of Carroll, Cheshire, Coos, Grafton, Merrimack, and Sullivan	Excessive rain, high winds, and flooding	October 20-November 15, 1995
North Carolina		
Counties of Ashe, Avery, Cherokee, Clay, Graham, Haywood, Jackson, Macon, Madison, Mitchell, Swain, Transylvania, Watauga, Wilkes, and Yancey; the Eastern Band of the Cherokee Indian Reservation	Severe storm, high winds, and flooding	October 4-6, 1995
North Dakota		
Counties of Barnes, Benson, Bottineau, Burleigh, Cavalier, Dickey, Eddy, Emmons, Foster, Griggs, Kidder, La Moure, Logan, McHenry, McIntosh, McLean, Nelson, Pembina, Pierce, Ramsey, Ransom, Renville, Rolette, Sargent, Sheridan, Sioux, Steele, Stutsman, Towner, Traill, Walsh, and Wells	Severe storms, flooding, and ground saturation due to high water tables	March 1-July 5, 1995
Ohio		
Counties of Champaign, Erie, Licking, Logan, Lorain, Marion, Mercer, Miami, Scioto, Shelby, and Washington	Severe storms and flooding	August 7-18, 1995
Oklahoma		
City of Oklahoma City; County of Oklahoma	Explosion at the Alfred P. Murrah Federal Building in Oklahoma City	April 19, 1995
Counties of Alfalfa, Atoka, Beckham, Caddo, Canadian, Carter, Cotton, Creek, Custer, Ellis, Grady, Grant, Harmon, Jackson, Kingfisher, Kiowa, Lincoln, Logan, Major, Murray, Nowata, Osage, Ottawa, Pottawatomie, Roger Mills, Seminole, Tillman, Washita, and Woodward	Severe storms, flooding, and tornadoes	May 26-June 11, 1995

Disaster Areas in 1995	Type of Disaster	Date of Disaster
Counties of Alfalfa, Blaine, Caddo, Canadian, Cotton, Custer, Grant, Greer, Harmon, Jackson, Kay, Kiowa, Major, Oklahoma, Tillman, Washita, and Woods	Tornadoes, severe storms, and flooding	July 21-August 6, 1995
Oregon		
County of Wasco	Flash flooding	July 8-9, 1995
Puerto Rico		
Municipalities of Aquas Buenas, Barranquitas, Canovanas, Carolina, Ceiba, Ciales, Comerio, Culebra, Fajardo, Juncos, Loiza, Naguabo, San Lorenzo, and Vieques	Hurricane Marilyn	September 15-17, 1995
South Dakota		
Counties of Aurora, Brule, Buffalo, Campbell, Corson, Dewey, Edmunds, Faulk, Haakon, Hand, Hughes, Hyde, Jerauld, Jones, Lyman, McPherson, Potter, Stanley, Sully, Walworth, and Ziebach	Severe winter storms	January 13-February 10, 1995
Counties of Aurora, Beadle, Bon Homme, Brookings, Brown, Brule, Buffalo, Butte, Campbell, Charles Mix, Clark, Clay, Codington, Custer, Davison, Day, Deuel, Douglas, Edmunds, Faulk, Grant, Gregory, Haakon, Hamlin, Hand, Hanson, Hughes, Hutchinson, Hyde, Jerauld, Jones, Kingsbury, Lake, Lawrence, Lincoln, Lyman, Marshall, McCook, McPherson, Meade, Miner, Moody, Pennington, Potter, Roberts, Sanborn, Spink, Stanley, Sully, Tripp, Turner, Walworth, and Yankton	Severe storms, flooding, and ground saturation due to high water tables	March 1-June 20, 1995
Counties of Aurora, Beadle, Bon Homme, Brookings, Brule, Buffalo, Charles Mix, Clark, Codington, Davison, Deuel, Douglas, Grant, Gregory, Hamlin, Hanson, Hutchinson, Jerauld, Kingsbury, Lake, McCook, Miner, Roberts, Sanborn, Spink, and Tripp	Severe winter storm	October 22-24, 1995
Tennesee		
Counties of Cumberland, Houston, Lake, Lauderdale, and Lawrence	Severe stroms and tornadoes	May 14-19, 1995
Texas		
County of Tom Green	Severe thunderstorms, flooding, hail, and tornadoes	May 28-31, 1995
U.S. Virgin Islands		
Islands of St. Croix, St. John, and St. Thomas	Hurricane Marilyn	September 15-17, 1995
Vermont		
Counties of Caledonia, Chittenden, Essex, Lamoille, Orleans, and Washington	Excessive rain and flooding	August 4-6, 1995
Virginia		
Cities of Bedford, Buena Vista, Lexington, Lynchburg, Roanoke, and Staunton; Counties of Albemarle, Amherst, Augusta, Bath, Bedford, Campbell, Culpeper, Franklin, Giles, Greene, Halifax, Madison, Orange, Pittsylvania, Rappahannock, Roanoke, Rockbridge, and Warren	Severe storms and flooding	June 22-July 7, 1995
Washington		
Counties of Chelan, Clallam, Clark, Cowlitz, Grays Harbor, Island, Jefferson, King, Kittitas, Lewis, Mason, Pacific, Pierce, Skagit, Snohomish, Thurston, Wahkiakum, Whatcom, and Yakima	Severe storms, high wind, and flooding	November 7-December 18, 1995

Disaster Areas in 1995	Type of Disaster	Date of Disaster
West Virginia		
Counties of Mercer, Mineral, and Nicholas	Severe storms, heavy rain, and flash flooding	June 23-28, 1995

Section 358.—Basis to Distributees

26 CFR 1.358–6: Stock basis in certain triangular reorganizations.

T.D. 8648

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Controlling Corporation's Basis Adjustment in its Controlled Corporation's Stock Following a Triangular Reorganization

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations under sections 358, 1032, and 1502 of the Internal Revenue Code of 1986. The final regulations provide rules for adjusting the basis of a controlling corporation in the stock of a controlled corporation as the result of certain triangular reorganizations involving the stock of the controlling corporation. They also generally provide that the use of the controlling corporation's stock provided by the controlling corporation pursuant to the plan of reorganization is treated as a disposition of those shares by the controlling corporation.

DATES: These regulations are effective December 21, 1995.

For dates of applicability, see the ''Effective Dates'' section under the ''SUPPLEMENTARY INFORMATION'' portion of the preamble and the effective date provisions of the new or revised regulations.

FOR FURTHER INFORMATION CONTACT: Curt Cutting, (202) 622-7550 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains final regulations under sections 358, 1032, and 1502. The proposed regulations were published in the Federal Register on December 23, 1994 (59 F.R. 66280 [CO–993–71], 1995–1 C.B. 832. The IRS received many comments on the proposed regulations and held a public hearing on March 31, 1995.

After consideration of the comments and the statements made at the hearing, the proposed regulations are adopted as revised by this Treasury decision.

Overview

The final regulations adopt the over-the-top model contained in the proposed regulations. Subject to certain modifications, the model generally adjusts a controlling corporation's (P's) basis in the stock of its controlled corporation (S or T) as a result of certain triangular reorganizations as if P had acquired the T assets (and any liabilities assumed or to which the T assets were subject) directly from T in a transaction in which P's basis in the T assets was determined under section 362(b), and P then had transferred the T assets (and liabilities) to S in a transaction in which P's basis in the S or T stock was adjusted under section 358. The preamble to the proposed regulations contains a discussion of the justification for the model. See 59 FR 66280–81.

The final regulations also provide a special rule that treats S's use of P's stock provided by P pursuant to the plan of reorganization as a disposition of those shares by P.

The final regulations apply only for the purpose of determining P's basis in its S or T stock following a transaction that otherwise qualifies as a reorganization within the meaning of section 368. They do not address issues concerning the qualification of a transaction as a reorganization.

With the publication of these final regulations, the IRS announces the closing of its study project referred to in §5.14 of Rev. Proc. 95–3, 1995–1 C.B. 385, 395.

The significant comments on the proposed regulations and revisions made are discussed below.

Summary of comments and explanation of revisions

P's basis in T stock owned before a reverse triangular merger

The proposed regulations adjusted basis as a result of a reverse triangular merger to reflect the amount of T stock received in the transaction. Comments on the proposed regulations questioned how an adjustment based on the amount of T stock received in the transaction would apply in the case in which P owns T stock before the transaction.

In response to these comments, the final regulations allow P to treat its T stock as acquired in the transaction or not, without regard to the form of the transaction. Thus, P may retain its basis in the T stock owned before the transaction, or may determine its basis in that stock as an allocable portion of T's net asset basis. The regulations require no explicit election. Instead, it is assumed P will pick the higher basis. This rule applies only for determining basis, and not for qualifying the transaction as a reverse triangular merger. See Rev. Rul. 74–564, 1974–2 C.B. 124.

The Treasury and the IRS continue to study issues relating to restructurings involving related parties and cross-ownership, and welcome comments and suggestions on these issues.

Net negative adjustment

Under the proposed regulations, P's basis adjustment was reduced by the fair market value of consideration not provided by P, and by the amount of liabilities assumed by S or to which T assets are subject. These reductions did not result in a net negative basis adjustment to P's basis in its S stock before the transaction. This limitation did not apply, however, where P and S, or P and T, as applicable, were members of a consolidated group following the triangular reorganization. In the consolidated context, the negative adjustments could result in a net negative adjustment to P's basis in its S stock before the transaction, even if the adjustment resulted in an excess loss account under §1.1502–19.

Some comments on the proposed regulations argued against reducing P's basis in its S stock before the transaction by a net negative adjustment in the consolidated context. Other comments, however, agreed that it is appropriate not to limit the net negative adjustment in this context.

The Treasury and the IRS continue to believe that the proposed regulations reach the correct result. Therefore, the final regulations adopt the rules as proposed.

Overlap of reverse triangular merger and other transactions

The proposed regulations provided that if a transaction qualified as both a reverse triangular merger and a stock acquisition under section 368(a)(1)(B), P adjusted its basis in its T stock based either on T's net asset basis or on the aggregate basis of the T stock surrendered in the transaction (as if the transaction were a reorganization under section 368(a)(1)(B)).

One comment noted that a reverse triangular merger might overlap with a section 351 transfer and therefore requested that this rule also apply to such a case. The final regulations adopt this suggestion.

Manner of making elections

The proposed and final regulations provide P with elections for its basis adjustments when P owns stock of T and when a reverse triangular merger also qualifies as a section 351 transaction or B reorganization. In these situations, P does not have to declare how it will compute its basis. Rather, P must simply retain appropriate records. See §1.368–3.

Application of section 1032

The proposed regulations under section 1032 generally provided that P stock provided by P to S, or directly to T or T's shareholders on behalf of S, pursuant to the plan of reorganization would be treated as a disposition by P of shares of its own stock for T assets or stock, as applicable. Thus, no gain or loss was recognized on the use of such P stock in the transaction. S, however, recognized gain or loss on its use of P stock if S did not receive the stock from P as part of the plan of reorganization. This rule did not apply in the case of a reverse triangular merger; section 361 provides nonrecognition treatment for S's use of P stock in such a case. To clarify this treatment, a cross-reference has been added to the final regulations.

Comments to the proposed regulations requested that they be expanded to cover P debt, warrants and options provided by P to S, or directly to T or T's shareholders on behalf of S, pursuant to the plan of reorganization. Comments also requested that the rule be extended to taxable transactions.

The issues raised in these comments are beyond the scope of this project. However, the Treasury and the IRS are studying issues relating to the scope of section 1032 and welcome comments and suggestions.

Special analyses

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

Effective dates

Generally, §1.358–6 applies with respect to all triangular reorganizations occurring on or after December 23, 1994, the day that the proposed regulations were published in the Federal Register.

As stated in the preamble to the proposed regulations, any adjustment to P's basis in its S or T stock (as applicable) following a triangular reorganization occurring before December 23, 1994, must be consistent with the adjustment that would be made if P had made the acquisition directly and P then transferred the assets to a controlled subsidiary. However, with respect to reverse triangular mergers occurring before December 23, 1994, P may adjust its basis in its T stock as if P acquired the stock of the former T shareholders in a transaction in which its basis was determined under section 362(b).

Section 1.1032–2 applies with respect to certain triangular reorganizations occurring on or after December 23, 1994. With respect to triangular reorganizations occurring before December 23, 1994, see, *e.g.*, §1.1032–1 and Rev. Rul. 57–278, 1957–1 C.B. 124.

Section 1.1502–30 applies with respect to triangular reorganizations occurring on or after December 21, 1995, in which P and S, or P and T, as applicable, are members of a consolidated group following the triangular reorganization. For similar triangular reorganizations occurring before December 21, 1995, any adjustments to P's basis in its S or T stock (as applicable) must be consistent with the rules applicable for nonconsolidated taxpayers, except to the extent that §1.1502–31 applies to a transaction that is a group structure change.

Drafting information

The principal authors of these regulations are Rose Williams and Curt Cutting, Office of Assistant Chief Counsel (Corporate). However, other personnel from the IRS and the Treasury Department participated in their development.

* * * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Section 1.1502–30 also issued under 26 U.S.C. 1502 * * *

Par. 2. Section 1.358–2(d) is removed.

Par. 3. Section 1.358–6 is added to read as follows:

§1.358–6 Stock basis in certain triangular reorganizations.

(a) *Scope*. This section provides rules for computing the basis of a controlling corporation in the stock of a controlled corporation as the result of certain reorganizations involving the stock of the controlling corporation as described in paragraph (b) of this section. The rules of this section are in addition to rules under other provisions of the Internal Revenue Code and principles of law. See, *e.g.*, section 1001 for the recognition of gain or loss by the controlled corporation on the exchange of property for the assets or stock of a target corporation in a reorganization described in section 368.

(b) *Triangular reorganizations*—(1) *Nomenclature*. For purposes of this section—

(i) *P* is a corporation—

(A) That is a party to a reorganization,

(B) That is in control (within the meaning of section 368(c)) of another party to the reorganization, and

(C) Whose stock is transferred pursuant to the reorganization.

(ii) *S* is a corporation—

(A) That is a party to the reorganization, and

(B) That is controlled by *P*.

(iii) *T* is a corporation that is another party to the reorganization.

(2) *Definitions of triangular reorganizations*. This section applies to the following reorganizations (which are referred to collectively as *triangular reorganizations*):

(i) *Forward triangular merger*. A forward triangular merger is a statutory merger of *T* and *S*, with *S* surviving, that qualifies as a reorganization under section 368(a)(1)(A) or (G) by reason of the application of section 368(a)-(2)(D).

(ii) *Triangular C reorganization*. A triangular C reorganization is an acquisition by *S* of substantially all of *T*'s assets in exchange for *P* stock in a transaction that qualifies as a reorganization under section 368(a)(1)(C).

(iii) *Reverse triangular merger*. A reverse triangular merger is a statutory merger of *S* and *T*, with *T* surviving, that qualifies as a reorganization under section 368(a)(1)(A) by reason of the application of section 368(a)(2)(E).

(iv) *Triangular B reorganization*. A triangular B reorganization is an acquisition by *S* of *T* stock in exchange for *P* stock in a transaction that qualifies as a reorganization under section 368(a)(1)(B).

(c) *General rules*. Subject to the special rule provided in paragraph (d) of this section, *P*'s basis in the stock of *S* or *T*, as applicable, as a result of a triangular reorganization, is adjusted under the following rules—

(1) *Forward triangular merger or triangular C reorganization*—(i) *In general*. In a forward triangular merger or a triangular C reorganization, *P*'s basis in its *S* stock is adjusted as if—

(A) *P* acquired the *T* assets acquired by *S* in the reorganization (and *P* assumed any liabilities which *S* assumed or to which the *T* assets acquired by *S* were subject) directly from *T* in a transaction in which *P*'s basis in the *T* assets was determined under section 362(b); and

(B) *P* transferred the *T* assets (and liabilities which *S* assumed or to which the *T* assets acquired by *S* were subject) to *S* in a transaction in which *P*'s basis in *S* stock was determined under section 358.

(ii) *Limitation*. If, in applying section 358, the amount of *T* liabilities assumed by *S* or to which the *T* assets acquired by *S* are subject equals or exceeds *T*'s aggregate adjusted basis in its assets, the amount of the adjustment under paragraph (c)(1)(i) of this section is zero. *P* recognizes no gain under section 357(c) as a result of a triangular reorganization.

(2) *Reverse triangular merger*—(i) *In general*—(A) *Treated as a forward triangular merger*. Except as otherwise provided in this paragraph (c)(2), *P*'s basis in its *T* stock acquired in a reverse triangular merger equals its basis in its *S* stock immediately before the transaction adjusted as if *T* had merged into *S* in a forward triangular merger to which paragraph (c)(1) of this section applies.

(B) *Allocable share*. If *P* acquires less than all of the *T* stock in the transaction, the basis adjustment described in paragraph (c)(2)(i)(A) of this section is reduced in proportion to the percentage of *T* stock not acquired in the transaction. The percentage of *T* stock not acquired in the transaction is determined by taking into account the fair market value of all classes of *T* stock.

(C) *Special rule if P owns T stock before the transaction*. Solely for purposes of paragraphs (c)(2)(i)(A) and (B) of this section, if *P* owns *T* stock before the transaction, *P* may treat that stock as acquired in the transaction or not, without regard to the form of the transaction.

(ii) *Reverse triangular merger that qualifies as a section 351 transfer or section 368(a)(1)(B) reorganization*. Notwithstanding paragraph (c)(2)(i) of this section, if a reorganization qualifies as both a reverse triangular merger and as a section 351 transfer or as both a reverse triangular merger and a reorganization under section 368(a)-(1)(B), *P* can—

(A) Determine the basis in its *T* stock as if paragraph (c)(2)(i) of this section applies; or

(B) Determine the basis in the *T* stock acquired as if *P* acquired such stock from the former *T* shareholders in a transaction in which *P*'s basis in the *T* stock was determined under section 362(b).

(3) *Triangular B reorganization*. In a triangular B reorganization, *P*'s basis in its *S* stock is adjusted as if—

(i) *P* acquired the *T* stock acquired by *S* in the reorganization directly from the *T* shareholders in a transaction in which *P*'s basis in the *T* stock was determined under section 362(b); and

(ii) *P* transferred the *T* stock to *S* in a transaction in which *P*'s basis in its *S* stock was determined under section 358.

(4) *Examples*. The rules of this paragraph (c) are illustrated by the following examples. For purposes of these examples, *P*, *S*, and *T* are domestic corporations, *P* and *S* do not file consolidated returns, *P* owns all of the only class of *S* stock, the *P* stock exchanged in the transaction satisfies the requirements of the applicable triangular reorganization provisions, and the facts set forth the only corporate activity.

Example 1. Forward triangular merger. (a) *Facts*. *T* has assets with an aggregate basis of $60 and fair market value of $100 and no liabilities. Pursuant to a plan, *P* forms *S* with $5 cash (which S retains), and *T* merges into *S*. In the merger, the *T* shareholders receive *P* stock worth $100 in exchange for their *T* stock. The transaction is a reorganization to which sections 368(a)(1)(A) and (a)(2)(D) apply.

(b) *Basis adjustment*. Under §1.358–6(c)(1), *P*'s $5 basis in its *S* stock is adjusted as if *P* acquired the *T* assets acquired by *S* in the reorganization directly from *T* in a transaction in which *P*'s basis in the *T* assets was determined under section 362(b). Under section 362(b), *P* would have an aggregate basis of $60 in the *T* assets. *P* is then treated as if it transferred the *T* assets to *S* in a transaction in which *P*'s basis in the *S* stock was determined under section 358. Under section 358, *P*'s $5 basis in its *S* stock would be increased by the $60 basis in the *T* assets deemed transferred. Consequently, *P* has a $65 basis in its *S* stock as a result of the reorganization.

(c) *Use of pre-existing S*. The facts are the same as paragraph (a) of this *Example 1*, except that *S* is an operating company with substantial assets that has been in existence for several years. *P* has a $110 basis in the *S* stock. Under §1.358–6(c)(1), *P*'s $110 basis in its *S* stock is increased by the $60 basis in the *T* assets deemed transferred. Consequently, *P* has a $170 basis in its *S* stock as a result of the reorganization.

(d) *Mixed consideration*. The facts are the same as paragraph (a) of this *Example 1*, except that the *T* shareholders receive *P* stock worth $80 and $20 cash from *P*. Under section 358, *P*'s $5 basis in its *S* stock is increased by the $60 basis in the *T* assets deemed transferred. Consequently, *P* has a $65 basis in its *S* stock as a result of the reorganization.

(e) *Liabilities*. The facts are the same as paragraph (a) of this *Example 1*, except that *T*'s assets are subject to $50 of liabilities, and the *T* shareholders receive $50 of *P* stock in exchange for their *T* stock. Under section 358, *P*'s basis in its *S* stock is increased by the $60 basis in the *T* assets deemed transferred and decreased by the $50 of liabilities to which the *T* assets acquired by *S* are subject. Consequently, *P* has a net basis adjustment of $10, and a $15 basis in its *S* stock as a result of the reorganization.

(f) *Liabilities in excess of basis*. The facts are the same as in paragraph (a) of this *Example 1*, except that *T*'s assets are subject to liabilities of $90, and the *T* shareholders receive $10 of *P* stock in exchange for their *T* stock in the reorganization. Under §1.358–6(c)(1)(ii), the adjustment under §1.358–6(c) is zero if the amount of the liabilities which *S* assumed or to which the *T* assets acquired by *S* are subject exceeds the aggregate adjusted basis in *T*'s assets. Consequently, *P* has no adjustment in its *S* stock, and *P* has a $5 basis in its *S* stock as a result of the reorganization.

Example 2. *Reverse triangular merger*. (a) *Facts*. *T* has assets with an aggregate basis of $60 and a fair market value of $100 and no liabilities. *P* has a $110 basis in its *S* stock. Pursuant to a plan, *S* merges into *T* with *T* surviving. In the merger, the *T* shareholders receive $10 cash from *P* and *P* stock worth $90 in exchange for their *T* stock. The transaction is a reorganization to which sections 368(a)(1)(A) and (a)(2)(E) apply.

(b) *Basis adjustment*. Under §1.358–6(c)(2)(i)(A), *P*'s basis in the *T* stock acquired is *P*'s $110 basis in its *S* stock before the transaction, adjusted as if *T* had merged into *S* in a forward triangular merger to which §1.358–6(c)(1) applies. In such a case, *P*'s $110 basis in its *S* stock before the transaction would have been increased by the $60 basis of the *T* assets deemed transferred. Consequently, *P* has a $170 basis in its *T* stock immediately after the transaction.

(c) *Reverse triangular merger that also qualifies under section 368(a)(1)(B)*. The facts relating to *T* are the same as in paragraph (a) of this *Example 2*. *P*, however, forms *S* pursuant to the plan of reorganization. The *T* shareholders receive $100 worth of *P* stock (and no cash) in exchange for their *T* stock. The *T* shareholders have an aggregate basis in their *T* stock of $85 immediately before the reorganization. The reorganization qualifies as both a reverse triangular merger and a reorganization under section 368(a)(1)(B). Under §1.358–6(c)(2)(ii), *P* may determine its basis in its *T* stock either as if §1.358–6(c)(2)(i) applied to the *T* stock acquired, or as if *P* acquired the *T* stock from the former *T* shareholders in a transaction in which *P*'s basis in the *T* stock was determined under section 362(b). Accordingly, *P* may determine a basis in its *T* stock of $60 (*T*'s net asset basis) or $85 (the *T* shareholders' aggregate basis in the *T* stock immediately before the reorganization).

(d) *Allocable share in a reverse triangular merger*. The facts are the same as in paragraph (a) of this *Example 2*, except that *X*, a 10% shareholder of *T*, does not participate in the transaction. The remaining *T* shareholders receive $10 cash from *P* and *P* stock worth $80 for their *T* stock. *P* owns 90% of the *T* stock after the transaction. Under 1.358–6(c)(2)(i)(A), *P*'s basis in its *T* stock is *P*'s $110 basis in its *S* stock before the reorganization, adjusted as if *T* had merged into *S* in a forward triangular merger. In such a case, *P*'s basis would have been adjusted by the $60 basis in the *T* assets deemed transferred. Under §1.358–6(c)(2)(i)(B), however, the basis adjustment determined under §1.358–6(c)(2)(i)(A) is reduced in proportion to the percentage of *T* stock not acquired by *P* in the transaction. The percentage of *T* stock not acquired in the transaction is 10%. Therefore, *P* reduces its $60 basis adjustment by 10%, resulting in a net basis adjustment of $54. Consequently, *P* has a $164 basis in its *T* stock as a result of the transaction.

(e) *P's ownership of T stock*. The facts are the same as in paragraph (a) of this *Example 2*, except that *P* owns 10% of the *T* stock before the transaction. *P*'s basis in that *T* stock is $8. All the *T* shareholders other than *P* surrender their *T* stock for $10 cash from *P* and *P* stock worth $80. *P* does not surrender the stock in the transaction. Under §1.358–6(c)(2)(i)(C), *P* may treat its *T* stock owned before the transaction as acquired in the transaction or not. If *P* treats that *T* stock as acquired in the transaction, *P*'s basis in that *T* stock and the *T* stock actually acquired in the transaction equals *P*'s $110 basis in its *S* stock before the transaction, adjusted by the $60 basis of the *T* assets deemed transferred, for a total basis of $170. If *P* treats its *T* stock as not acquired, *P* retains its $8 pre-transaction basis in that stock. *P*'s basis in its other *T* shares equals *P*'s $110 basis in its *S* stock before the transaction, adjusted by $54 (the $60 basis in the *T* assets deemed transferred, reduced by 10%), for a total basis of $164 in those shares. See §1.358–6(c)(2)(i)(A) and (B). Consequently, if *P* treats its *T* shares as not acquired, *P*'s total basis in all of its *T* shares is $172.

Example 3. *Triangular B reorganization*. (a) *Facts*. *T* has assets with a fair market value of $100 and no liabilities. The *T* shareholders have an aggregate basis in their *T* stock of $85 immediately before the reorganization. Pursuant to a plan, *P* forms *S* with $5 cash and *S* acquires all of the *T* stock in exchange for $100 of *P* stock. The transaction is a reorganization to which section 368(a)(1)(B) applies.

(b) *Basis adjustment*. Under §1.358–6(c)(3), *P* adjusts its $5 basis in its *S* stock by treating *P* as if it acquired the *T* stock acquired by *S* in the reorganization directly from the *T* shareholders in exchange for the *P* stock in a transaction in which *P*'s basis in the *T* stock was determined under section 362(b). Under section 362(b), *P* would have an aggregate basis of $85 in the *T* stock received by *S* in the reorganization. *P* is then treated as if it transferred the *T* stock to *S* in a transaction in which *P*'s basis in the *S* stock was determined under section 358. Under section 358, *P*'s basis in its *S* stock would be increased by the $85 basis in the *T* stock deemed transferred. Consequently, *P* has a $90 basis in its *S* stock as a result of the reorganization.

(d) *Special rule for consideration not provided by P*—(1) *In general*. The amount of *P*'s adjustment to basis in its *S* or *T* stock, as applicable, described in paragraph (c) of this section is decreased by the fair market value of any consideration (including *P* stock in which gain or loss is recognized, see §1.1032–2(c)) that is exchanged in the reorganization and that is not provided by *P* pursuant to the plan of reorganization. This paragraph (d) does not apply to the amount of *T* liabilities assumed by *S* or to which the *T* assets acquired by *S* are subject under paragraph (c)(1) of this section (or deemed assumed or taken subject to by *S* under paragraph (c)(2)(i) of this section).

(2) *Limitation*. *P* makes no adjustment to basis under this section if the decrease required under paragraph (d)(1) of this section equals or exceeds the amount of the adjustment described in paragraph (c) of this section.

(3) *Example*. The rules of this paragraph (d) are illustrated by the following example. For purposes of this example, *P*, *S*, and *T* are domestic corporations, *P* and *S* do not file consolidated returns, *P* owns all of the only class of *S* stock, the *P* stock exchanged in the transaction satisfies the requirements of the applicable triangular reorganization provisions, and the facts set forth the only corporate activity.

Example. (a) *Facts*. *T* has assets with an aggregate basis of $60 and fair market value of $100 and no liabilities. *S* is an operating company with substantial assets that has been in existence for several years. *P* has a $100 basis in its *S* stock. Pursuant to a plan, *T* merges into *S* and the *T* shareholders receive $70 of *P* stock provided by *P* pursuant to the plan and $30 of cash provided by *S* in exchange for their *T* stock.

The transaction is a reorganization to which sections 368(a)(1)(A) and (a)(2)(D) apply.

(b) *Basis adjustment*. Under §1.358–6(c)(1), *P*'s $100 basis in its *S* stock is increased by the $60 basis in the *T* assets deemed transferred. Under §1.358–6(d)(1), the $60 adjustment is decreased by the $30 of cash provided by *S* in the reorganization. Consequently, *P* has a net adjustment of $30 in its *S* stock, and *P* has a $130 basis in its *S* stock as a result of the reorganization.

(c) *Appreciated asset*. The facts are the same as in paragraph (a) of this *Example*, except that in the reorganization *S* provides an asset with a $20 adjusted basis and $30 fair market value instead of $30 of cash. The basis results are the same as in paragraph (b) of this *Example*. In addition, *S* recognizes $10 of gain under section 1001 on its disposition of the asset in the reorganization.

(d) *Depreciated asset*. The facts are the same as in paragraph (c) of this *Example*, except that *S* has a $60 adjusted basis in the asset. The basis results are the same as in paragraph (b) of this *Example*. In addition, *S* recognizes $30 of loss under section 1001 on its disposition of the asset in the reorganization.

(e) *P stock*. The facts are the same as in paragraph (a) of this *Example*, except that in the reorganization *S* provides *P* stock with a fair market value of $30 instead of $30 of cash. *S* acquired the *P* stock in an unrelated transaction several years before the reorganization. *S* has a $20 adjusted basis in the *P* stock. The basis results are the same as in paragraph (b) of this *Example*. In addition, *S* recognizes $10 of gain on its disposition of the *P* stock in the reorganization. See §1.1032–2(c).

(e) *Cross-reference*. For rules relating to stock basis adjustments made as a result of a triangular reorganization in which *P* and *S*, or *P* and *T*, as applicable, are, or become, members of a consolidated group, see §1.1502–30. For rules relating to stock basis adjustments after a group structure change, see §1.1502–31.

(f) *Effective dates*—(1) *General rule*. Except as otherwise provided in this paragraph (f), this section applies to triangular reorganizations occurring on or after December 23, 1994.

(2) *Special rule for reverse triangular mergers*. For a reverse triangular merger occurring before December 23, 1994, *P* may—

(i) Determine the basis in its *T* stock as if paragraph (c)(2)(i) of this section applied; or

(ii) Determine the basis in its *T* stock acquired as if *P* acquired such stock from the former *T* shareholders in a transaction in which *P*'s basis in the *T* stock was determined under section 362(b).

Par. 4. Section 1.1032–2 is added to read as follows:

§1.1032–2 Disposition by a corporation of stock of a controlling corporation in certain triangular reorganizations.

(a) *Scope*. This section provides rules for certain triangular reorganizations described in §1.358–6(b) when the acquiring corporation (*S*) acquires property or stock of another corporation (*T*) in exchange for stock of the corporation (*P*) in control of *S*.

(b) *General nonrecognition of gain or loss*. For purposes of §1.1032–1(a), in the case of a forward triangular merger, a triangular C reorganization, or a triangular B reorganization (as described in §1.358–6(b)), *P* stock provided by *P* to *S*, or directly to *T* or *T*'s shareholders on behalf of *S*, pursuant to the plan of reorganization is treated as a disposition by *P* of shares of its own stock for *T*'s assets or stock, as applicable. For rules governing the use of *P* stock in a reverse triangular merger, see section 361.

(c) *Treatment of S*. *S* must recognize gain or loss on its exchange of *P* stock as consideration in a forward triangular merger, a triangular C reorganization, or a triangular B reorganization (as described in §1.358–6(b)), if *S* did not receive the *P* stock from *P* pursuant to the plan of reorganization. See §1.358–6(d) for the effect on *P*'s basis in its *S* or *T* stock, as applicable. For rules governing *S*'s use of *P* stock in a reverse triangular merger, see section 361.

(d) *Examples*. The rules of this section are illustrated by the following examples. For purposes of these examples, *P*, *S*, and *T* are domestic corporations, *P* and *S* do not file consolidated returns, *P* owns all of the only class of *S* stock, the *P* stock exchanged in the transaction satisfies the requirements of the applicable reorganization provisions, and the facts set forth the only corporate activity.

Example 1. Forward triangular merger solely for P stock. (a) *Facts*. *T* has assets with an aggregate basis of $60 and fair market value of $100 and no liabilities. Pursuant to a plan, *P* forms *S* by transferring $100 of *P* stock to *S* and *T* merges into *S*. In the merger, the *T* shareholders receive, in exchange for their *T* stock, the *P* stock that *P* transferred to *S*. The transaction is a reorganization to which sections 368(a)(1)(A) and (a)(2)(D) apply.

(b) *No gain or loss recognized on the use of P stock*. Under paragraph (b) of this section, the *P* stock provided by *P* pursuant to the plan of reorganization is treated for purposes of §1.1032–1(a) as disposed of by *P* for the *T* assets acquired by *S* in the merger. Consequently, neither *P* nor *S* has taxable gain or deductible loss on the exchange.

Example 2. Forward triangular merger solely for P stock provided in part by S. (a) *Facts*. *T* has assets with an aggregate basis of $60 and fair market value of $100 and no liabilities. *S* is an operating company with substantial assets that has been in existence for several years. *S* also owns *P* stock with a $20 adjusted basis and $30 fair market value. *S* acquired the *P* stock in an unrelated transaction several years before the reorganization. Pursuant to a plan, *P* transfers additional *P* stock worth $70 to *S* and *T* merges into *S*. In the merger, the *T* shareholders receive $100 of *P* stock ($70 of *P* stock provided by *P* to *S* as part of the plan and $30 of *P* stock held by *S* previously). The transaction is a reorganization to which sections 368(a)(1)(A) and (a)(2)(D) apply.

(b) *Gain or loss recognized by S on the use of its P stock*. Under paragraph (b) of this section, the $70 of *P* stock provided by *P* pursuant to the plan of reorganization is treated as disposed of by *P* for the *T* assets acquired by *S* in the merger. Consequently, neither *P* nor *S* has taxable gain or deductible loss on the exchange of those shares. Under paragraph (c) of this section, however, *S* recognizes $10 of gain on the exchange of its *P* stock in the reorganization because *S* did not receive the *P* stock from *P* pursuant to the plan of reorganization. See §1.358–6(d) for the effect on *P*'s basis in its *S* stock.

(e) *Effective date*. This section applies to triangular reorganizations occurring on or after December 23, 1994.

Par. 5. Section 1.1502–30 is added to read as follows:

§1.1502–30 Stock basis after certain triangular reorganizations.

(a) *Scope*. This section provides rules for determining the basis of the stock of an acquiring corporation as a result of a triangular reorganization. The definitions and nomenclature contained in §1.358–6 apply to this section.

(b) *General rules*—(1) *Forward triangular merger, triangular C reorganization, or triangular B reorganization*. *P* adjusts its basis in the stock of *S* as a result of a forward triangular merger, triangular C reorganization, or triangular B reorganization under §1.358–6(c) and (d), except that §1.358–6(c)(1)(ii) and (d)(2) do not apply. Instead, *P* adjusts such basis by taking into account the full amount of—

(i) *T* liabilities assumed by *S* or the amount of liabilities to which the *T* assets acquired by S are subject, and

(ii) The fair market value of any consideration not provided by *P* pursuant to the plan of reorganization.

(2) *Reverse triangular merger*. If *P* adjusts its basis in the *T* stock acquired as a result of a reverse triangular merger under §1.358–6(c)(2)(i) and (d), §1.358–6(c)(1)(ii) and (d)(2) do not apply. Instead, *P* adjusts such basis by taking into account the full amount of—

(i) *T* liabilities deemed assumed by *S* or the amount of liabilities to which the *T* assets deemed acquired by S are subject, and

(ii) The fair market value of any consideration not provided by *P* pursuant to the plan of reorganization.

(3) *Excess loss accounts*. Negative adjustments under this section may exceed *P*'s basis in its *S* or *T* stock. The resulting negative amount is *P*'s excess loss account in its *S* or *T* stock. See §1.1502–19 for rules treating excess loss accounts as negative basis, and treating references to stock basis as including references to excess loss accounts.

(4) *Application of other rules of law*. The rules for this section are in addition to other rules of law. See §1.1502–80(d) for the non-application of section 357(c) to *P*.

(5) *Examples*. The rules of this paragraph (b) are illustrated by the following examples. For purposes of these examples, *P*, *S*, and *T* are domestic corporations, *P* and *S* file consolidated returns, *P* owns all of the only class of *S* stock, the *P* stock exchanged in the transaction satisfies the requirements of the applicable triangular reorganization provisions, the facts set forth the only corporate activity, and tax liabilities are disregarded.

Example 1. Liabilities. (a) *Facts*. *T* has assets with an aggregate basis of $60 and fair market value of $100. *T*'s assets are subject to $70 of liabilities. Pursuant to a plan, *P* forms *S* with $5 of cash (which S retains), and *T* merges into *S*. In the merger, the *T* shareholders receive *P* stock worth $30 in exchange for their *T* stock. The transaction is a reorganization to which sections 368(a)(1)(A) and (a)(2)(D) apply.

(b) *Basis adjustment*. Under §1.358–6, *P* adjusts its $5 basis in the *S* stock as if *P* had acquired the *T* assets with a carryover basis under section 362 and transferred these assets to *S* in a transaction in which *P* determines its basis in the *S* stock under section 358. Under the rules of this section, the limitation described in §1.358–6(c)(1)(ii) does not apply. Thus, *P* adjusts its basis in the *S* stock by –$10 (the aggregate adjusted basis of *T*'s assets decreased by the amount of liabilities to which the *T* assets are subject). Consequently, as a result of the reorganization, *P* has an excess loss account of $5 in its *S* stock.

Example 2. Consideration not provided by P. (a) *Facts*. *T* has assets with an aggregate basis of $10 and fair market value of $100 and no liabilities. *S* is an operating company with substantial assets that has been in existence for several years. *P* has a $5 basis in its *S* stock. Pursuant to a plan, *T* merges into *S* and the *T* shareholders receive $70 of *P* stock provided by *P* pursuant to the plan of reorganization and $30 of cash provided by *S* in exchange for their *T* stock. The transaction is a reorganization to which sections 368(a)(1)(A) and (a)(2)(D) apply.

(b) *Basis adjustment*. Under §1.358–6, *P* adjusts its $5 basis in the *S* stock as if *P* had acquired the *T* assets with a carryover basis under section 362 and transferred these assets to *S* in a transaction in which *P* determines its basis in the *S* stock under section 358. Under the rules of this section, the limitation described in §1.358–6(d)(2) does not apply. Thus, *P* adjusts its basis in the *S* stock by –$20 (the aggregate adjusted basis of *T*'s assets decreased by the fair market value of the consideration provided by *S*). As a result of the reorganization, *P* has an excess loss account of $15 in its *S* stock.

(c) *Appreciated asset*. The facts are the same as in paragraph (a) of this *Example 2*, except that in the reorganization *S* provides an asset with a $20 adjusted basis and $30 fair market value instead of $30 cash. The basis is adjusted in the same manner as in paragraph (b) of this *Example 2*. In addition, because *S* recognizes a $10 gain from the asset under section 1001, *P*'s basis in its *S* stock is increased under §1.1502–32(b) by *S*'s $10 gain. Consequently, as a result of the reorganization, *P* has an excess loss account of $5 in its *S* stock. (The results would be the same if the appreciated asset provided by *S* was *P* stock with respect to which *S* recognized gain. See §1.1032–2(c)).

Example 3. Reverse triangular merger. (a) *Facts*. *T* has assets with an aggregate basis of $60 and fair market value of $100. *T*'s assets are subject to $70 of liabilities. *P* owns all of the only class of *S* stock. *P* has a $5 basis in its *S* stock. Pursuant to a plan, *S* merges into *T* with *T* surviving. In the merger, the *T* shareholders exchange their *T* stock for $2 cash from *P* and $28 worth of *P* stock provided by *P* pursuant to the plan. The transaction is a reorganization to which sections 368(a)(1)(A) and (a)(2)(E) apply.

(b) *Basis adjustment*. Under §1.358–6, *P*'s basis in the *T* stock acquired equals its $5 basis in its S stock immediately before the transaction adjusted by the $60 basis in the *T* assets deemed transferred, and the $70 of liabilities to which the *T* assets are subject. Under the rules of this section, the limitation described in §1.358–6(c)(1)(ii) does not apply. Consequently, *P* has an excess loss account of $5 in its *T* stock as a result of the transaction.

(c) *Effective date*. This section applies to reorganizations occurring on or after December 21, 1995.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved December 12, 1995.

Leslie Samuels,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on December 20, 1995, 8:45 a.m., and published in the issue of the Federal Register for December 21, 1995, 60 F.R. 66077)

Mark to Market for Securities Dealers: The Dealer-Customer Relationship

Notice 96–12

This notice provides immediate guidance, pending the issuance of proposed regulations, concerning whether a taxpayer's transactions with related persons, including members of the taxpayer's consolidated group, may be transactions with customers for purposes of § 475 of the Internal Revenue Code. This guidance will assist consolidated groups in deciding whether or not to make a separate-entity election under § 1.1221–2(d)(2) of the Income Tax Regulations. One result of making this election is that a group takes a separate-entity perspective in determining whether a transaction reduces risk for purposes of the definition of *hedging transaction* in § 1.1221–2(b).

Even when a group makes the separate-entity election, however, an intercompany transaction can be a hedging transaction only if it is entered into with a member that accounts for its position in the intercompany transaction by marking the position to market. *See* § 1.1221–2(d)(2)(ii)(B). Section 475 of the Code requires dealers in securities generally to use mark-to-market accounting for the securities that they hold. Thus, whether a member of a consolidated group is a dealer in securities under section 475 can affect whether intercompany risk-shifting transactions may be hedging transactions.

Whether a taxpayer is a dealer in securities depends on whether certain of its transactions are entered into with customers. Section 475(c)(1) defines a dealer in securities as a taxpayer who: (1) regularly purchases securities from, or sells securities to, customers in the ordinary course of a trade or business (§ 475(c)(1)(A)); or (2) regularly offers to enter into, assume, offset, assign, or otherwise terminate positions in securities with customers in the ordinary course of a trade or business (§ 475(c)(1)(B)).

Under existing proposed regulations, whether a taxpayer is transacting business with customers is based on all of the facts and circumstances. *See* § 1.475(c)–1(c) of the proposed Income Tax Regulations, published in the Federal Register on January 4, 1995 (60 Fed. Reg. 397). Under § 1.475(c)–1(c)(2) of the proposed regulations, the term dealer in securities includes a taxpayer that, in the ordinary course of its trade or business, regularly holds itself out as being willing and able to enter into either side of a transaction enumerated in § 475(c)(1)(B).

EXPECTED ADDITIONAL PROPOSED REGULATIONS

The Service expects to publish additional proposed regulations that address the issue of whether a taxpayer is transacting business with customers. The proposed regulations are expected to contain, in substance, the following rules.

Transactions with related parties

A taxpayer's transactions with members of its consolidated group or with other related persons may be transactions with customers for purposes of § 475. Thus, a sale of a security to another member of a consolidated group is a sale to a customer if the relationship between the parties is consistent with that of a dealer in securities transacting business with an unrelated customer. Similarly, transactions enumerated in § 475(c)(1)(B) between members of a consolidated group are transactions with customers if, in the ordinary course of its business, the taxpayer holds itself out as being willing and able to engage in these transactions on a regular basis and the relationship between the parties is consistent with that of a dealer in securities transacting business with an unrelated customer. A taxpayer may be a dealer in securities within the meaning of section 475(c)(1) even if its only customer transactions are transactions with other members of its consolidated group.

The following example illustrates the foregoing.

Facts: *HC*, a hedging center, provides interest rate hedges to all of the members of its consolidated group. Because of the efficiencies created by having a centralized risk manager, group policy prohibits members other than *HC* from entering into derivative interest rate positions with outside parties. *HC* regularly holds itself out as being willing and able to, and in fact does, enter into either side of interest rate swaps with its fellow members. *HC* periodically computes its aggregate position and hedges the net risk with an unrelated party. *HC* does not otherwise enter into interest rate positions with persons that are not members of the consolidated group. The terms of the transactions between *HC* and its fellow members are consistent with the terms the members would obtain if they entered into the transactions with an unrelated swaps dealer.

Holding: Because the relationship between *HC* and its fellow members is consistent with that of a dealer in securities transacting business with unrelated customers (*see* § 1.475(c)–1(c)(2) of the proposed Income Tax Regulations), *HC* is a dealer in securities for purposes of section 475(c)(1)(B), and the other members are its customers.

The preceding rules are expected to be proposed to be effective for taxable years beginning on or after February 20, 1996.

DRAFTING INFORMATION

The principal author of this notice is Jo Lynn Ricks of the Office of Assistant Chief Counsel (Financial Institutions and Products). For further information regarding this notice contact Ms. Ricks on (202) 622-3920 (not a toll-free call).

Certain Payments from the Presidential Election Campaign Fund

Notice 96–13

This notice announces a change that will be made to the Presidential Election Campaign Fund Regulations for certain payments made to Presidential primary candidates from that Fund.

Section 9006(a) of the Internal Revenue Code established the Presidential Election Campaign Fund (Fund) on the books of the U.S. Treasury. Section 9006(a) requires the Secretary of the Treasury (Secretary) to transfer to the Fund from time to time an amount equal to the individual taxpayer designations for the Fund under section 6096.

Section 701.9006–1(a) of the Presidential Election Campaign Fund Regulations requires the Secretary to determine the amounts designated by individuals for the Fund at least once a month.

Section 9037(a) requires the Secretary to maintain within the Fund a separate account known as the Presidential Primary Matching Payment Account (Account). The Secretary is required to deposit into the Account amounts from the Fund after determining that certain other amounts are available and set aside for certain other payments. The amounts in the Account are for Presidential primary candidates who are certified for payments by the Federal Election Commission (Commission).

Section 702.9037–2(a) provides that, except as provided in section 702.9037–2(c), promptly after the end of each calendar month, but not before the beginning of the calendar year of a Presidential election, the Secretary shall pay the amounts certified by the Commission in the preceding calendar month from the Account to the primary candidates.

Section 702.9037–2(c) provides that if the amount certified by the Commission for primary candidates in a calendar month exceeds the balance in the Account on the last day of the calendar month, the amount paid to a candidate for that month from the Account is determined by multiplying the amount certified by the Commission for the candidate during that month by the ratio of the balance in the Account on the last day of the calendar month over the total amount certified by the Commission for all the candidates during that month. Any amount certified by the Commission, but not paid to a candidate because of the operation of this shortfall rule, is treated as an amount certified by the Commission for that candidate during the succeeding calendar month. Section 702.9037–2(d) provides an example illustrating the shortfall rule of section 702.9037–2(c).

To provide additional payments from the Account to certified primary candidates in a more timely manner when the Account is in a shortfall position, Part 702 of the regulations will be amplified. The revised regulations will require the Secretary to make an additional payment between regular payment dates promptly after funds are available. Such payment will be determined by multiplying the amount certified by the Commission for the candidate in month 1 by the ratio of the balance in the Account (but not to exceed the shortfall) on the 15th day of month 2 (or the first business day thereafter if the 15th is not a business day) over the total amount certified by the Commission for all the candidates in month 1.

The effective date of these amendments to the regulations will be February 2, 1996.

DRAFTING INFORMATION

The principal author of this notice is Joel Rutstein of the Office of the Associate Chief Counsel (Domestic). For further information regarding this notice contact Mr. Rutstein on (202) 622-4530 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking

Loans to Plan Participants

EE–106–82

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed Income Tax Regulations under section 72(p) of the Internal Revenue Code relating to loans made from a qualified employer plan to plan participants or beneficiaries. Section 72(p) was added by section 236 of the Tax Equity and Fiscal Responsibility Act of 1982, and amended by the Technical Corrections Act of 1982, the Deficit Reduction Act of 1984, the Tax Reform Act of 1986 and the Technical and Miscellaneous Revenue Act of 1988. These regulations provide guidance to the public with respect to this provision, and affect any plan participant or beneficiary who receives a loan from a qualified employer plan.

DATES: Written comments and requests for a public hearing must be received by March 20, 1996.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (EE–106–82), Attention: Plan Loans Guidance, Room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (EE–106–82), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Vernon S. Carter, of the Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations), IRS, at (202) 622-6070 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR Part 1) under section 72 of the Internal Revenue Code of 1986 (Code). These amendments are proposed to conform the regulations to section 236 of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), which added section 72(p) to the Code, and to the amendments to section 72(p) made by the Technical Corrections Act of 1982, the Deficit Reduction Act of 1984, the Tax Reform Act of 1986 and the Technical and Miscellaneous Revenue Act of 1988.

Explanation of provisions

Section 72(p) of the Code generally provides that an amount received as a loan from a qualified employer plan by a participant or beneficiary is treated as received as a distribution from the plan for purposes of section 72 (a deemed distribution), except to the extent certain conditions are satisfied. For purposes of section 72, a qualified employer plan includes a plan that qualifies under section 401 (relating to qualified trusts), 403(a) (relating to qualified annuities) or 403(b) (relating to tax sheltered annuities), as well as a plan (whether or not qualified) maintained by the United States, a State or a political subdivision thereof, or an agency or instrumentality thereof. A qualified employer plan also includes a plan which was (or was determined to be) a qualified plan or a government plan. A loan from a contract purchased under a qualified employer plan is also treated as a loan from the plan. Section 72(p) also provides that an assignment or pledge of (or an agreement to assign or pledge) any portion of a participant's or beneficiary's interest in a qualified employer plan is to be treated as a loan from the plan.

Under section 72(p), a loan from a qualified employer plan to a participant or beneficiary is not treated as a distribution from the plan if the loan satisfies certain requirements relating to the terms of the loan and the repayment schedule, and to the extent the loan satisfies certain limitations on the amount loaned. The proposed regulations require that the loan be evidenced by an enforceable agreement, set forth in writing or in another form that is approved by the Commissioner of Internal Revenue, that includes terms that satisfy the statutory requirements. Thus, the agreement must specify the amount of the loan, the term of the loan, and the repayment schedule. The agreement may be set forth in more than one document.

If a loan fails to satisfy the repayment requirements or the enforceable agreement requirement, the proposed regulations provide for the balance then due under the loan to be treated as a distribution from the plan. This may occur at the time the loan is made or at a later date if the loan is not repaid in accordance with the repayment schedule. If the loan satisfies the repayment requirements and the enforceable agreement requirement, but at the time the loan is made the amount of the loan exceeds the statutory limitation on the amount that is permitted to be loaned, the proposed regulations provide that only the excess amount is a deemed distribution.

One of the repayment requirements is that the loan be repaid within five years, unless the loan is used to acquire a dwelling unit which within a reasonable time is used as the principal residence of the participant. The proposed regulations provide that a principal residence has the same meaning as under section 1034 (relating to the taxation of a sale of a residence) and that tracing rules established under section 163(h)(3)(B) (relating to interest deductions for indebtedness incurred with respect to the acquisition of a principal residence) will be used to determine whether the section 72(p)(2)(B)(ii) exception to the five-year repayment requirement applies. (Notice 88–74 (1988–2 C.B. 385), sets forth certain standards applicable under section 163(h)(3).)

The Tax Reform Act of 1986 amended section 72(p) to require that, in order for a loan to not be treated as a distribution, the loan must be repaid in substantially level installments (not less frequently than quarterly) over the term of the loan.

Section 72(p) authorizes regulations to allow exceptions from this requirement. Pursuant to this authorization, the proposed regulations permit loan repayments to be suspended during a leave of absence of up to one year, if the participant's pay from the employer is insufficient to service the debt, but only if the loan is repaid by the latest date permitted under section 72(p)(2)(B).

If the repayment terms of a loan are not satisfied after the loan has been made due to a failure to make a scheduled loan repayment, the proposed regulations provide for the balance then due under the loan to be deemed to be distributed. The proposed regulations permit a grace period, to the extent the grace period does not extend beyond the end of the calendar quarter next following the calendar quarter in which the repayment was scheduled to be made.

If a loan is treated as a distribution under section 72(p), the proposed regulations state that the amount so distributed is to be treated as a taxable distribution, subject to the normal rules of section 72 if the participant's interest in the plan includes after-tax contributions (or other tax basis). A deemed distribution would also be a distribution for purposes of the 10 percent tax in section 72(t) and the excise tax on excess distributions under section 4980A. However, a deemed distribution under section 72(p) is not treated as an actual distribution for purposes of the qualification requirements of section 401, the rollover and income averaging provisions of section 402 and the distribution restrictions of section 403(b).

By contrast, if a participant's accrued benefit is reduced (offset) in order to repay a loan, an actual distribution occurs for purposes of the provisions in sections 401, 402 and 403(b) referred to above. Thus, for example, a plan is prohibited from enforcing its security interest in a participant's account balance attributable to amounts contributed pursuant to an election under section 401(k) until a date on which distribution is permitted under section 401(k).

The proposed regulations do not address all issues arising under section 72(p). Comments are requested on whether further guidance should be provided on issues that are not addressed and how the issues should be resolved, including the effect of a deemed distribution on the tax treatment of subsequent distributions from the plan and the application of the $50,000 limitation and the five year repayment requirement to a refinancing and to multiple loan arrangements.

Taxpayers may rely on these proposed regulations for guidance pending the issuance of final regulations. If, and to the extent, future guidance is more restrictive than the guidance in these proposed regulations, the future guidance will be applied without retroactive effect.

Special Analysis

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

Comments and Request for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the following address:

CC:DOM:CORP:R (EE–106-82)
Attention: Plan Loans Guidance, Room 5228
Internal Revenue Service
POB 7604, Ben Franklin Station
Washington, DC 20044

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

Drafting Information

The principal author of these proposed regulations is Vernon S. Carter, Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.72–17A is amended as follows:

1. Paragraphs (d)(1), (d)(2) and (d)(3) are redesignated as paragraphs (d)(2), (d)(3) and (d)(4), respectively.

2. New paragraph (d)(1) is added to read as follows:

§1.72–17A Special rules applicable to employee annuities and distributions under deferred compensation plans to self-employed individuals and owner-employees.

* * * * * *

(d) * * * (1) The references in this paragraph (d) to section 72(m)(4) are to that section as in effect on August 13, 1982. Section 236(b)(1) of the Tax Equity and Fiscal Responsibility Act of 1982 repealed section 72(m)(4), generally effective for assignments, pledges and loans made after August 13, 1982, and added section 72(p). See section 72(p) and §1.72(p)–1 for rules governing the income tax treatment of certain assignments, pledges and loans from qualified employer plans made after August 13, 1982.

* * * * * *

Par. 3. Section 1.72(p)–1 is added to read as follows:

§1.72(p)–1 Loans treated as distributions.

The questions and answers in this section provide guidance under section 72(p) pertaining to loans from qualified employer plans (including government plans and tax-sheltered annuities and employer plans that were formerly qualified).

ASSUMPTIONS FOR EXAMPLES

The examples included in the questions and answers in this section are based on the assumption that a bona fide loan is made to a participant from a qualified defined contribution plan pursuant to an enforceable agreement (in accordance with Q&A–3(b) of this section), with adequate security and with an interest rate and repayment terms that are commercially reasonable. (The particular interest rate used for illustration in this section is 8.75 percent compounded annually.) In addition, unless the contrary is specified, it is assumed in the examples that the amount of the loan does not exceed 50 percent of the participant's nonforfeitable account balance, the participant has no other outstanding loan (and had no prior loan) from the plan or any other plan maintained by the participant's employer or any other person required to be aggregated with the employer under section 414(b), (c) or (m), and the loan is not excluded from section 72(p) as a loan made in the ordinary course of an investment program as described in Q&A–18 of this section. No inference should be drawn from these regulations or the examples therein that a loan would not result in a prohibited transaction under section 4975 or would be consistent with the fiduciary standards of Title I of the Employee Retirement Income Security Act of 1974, as amended. See, for example, 29 CFR §2550.408b–1 (interpreting the statutory prohibited transaction exemption for loans to participants and beneficiaries).

QUESTIONS AND ANSWERS

Q–1: In general, what does section 72(p) provide with respect to loans from a qualified employer plan?

A–1: (a) *Loans*. Under section 72(p), an amount received by a participant or beneficiary as a loan from a qualified employer plan is treated as having been received as a distribution from the plan (a deemed distribution), unless the loan satisfies the requirements of Q&A–3 of this section. For purposes of section 72(p), a loan made from a contract that has been purchased under a qualified employer plan (including a contract that has been distributed to the participant or beneficiary) shall be considered a loan made under a qualified employer plan.

(b) *Pledges and assignments*. Under section 72(p), if a participant or beneficiary assigns or pledges (or agrees to assign or pledge) any portion of his or her interest in a qualified employer plan as security for a loan, the portion of the individual's interest assigned or pledged (or subject to an agreement to assign or pledge) is treated as a loan from the plan to the individual, with the result that such portion is subject to the deemed distribution rule described in paragraph (a) of this Q&A–1. For purposes of section 72(p), any assignment or pledge of (or agreement to assign or to pledge) by a participant or beneficiary of any portion of his or her interest in a contract that has been purchased under a qualified employer plan (including a contract that has been distributed) shall be considered an assignment or pledge of (or agreement to assign or pledge) an interest in a qualified employer plan. However, if all or a portion of a participant's or beneficiary's interest in a qualified employer plan is pledged or assigned as security for a loan from the plan to the participant or the beneficiary, only the amount of the loan received by the participant or the beneficiary, not the amount pledged or assigned, is treated as a loan.

Q–2: What is a qualified employer plan for purposes of section 72(p)?

A–2: For purposes of section 72(p), a qualified employer plan means—

(a) A plan described in section 401(a) which includes a trust exempt from tax under section 501(a);

(b) An annuity plan described in section 403(a);

(c) A plan under which amounts are contributed by an individual's employer for an annuity contract described in section 403(b);

(d) Any plan, whether or not qualified, established and maintained for its employees by the United States, by a State or political subdivision thereof, or by an agency or instrumentality of the United States, a State or a political subdivision of a State; or

(e) Any plan which was (or was determined to be) described in paragraph (a), (b), (c), or (d) of this Q&A–2.

Q–3: What requirements must be satisfied in order for a loan to a participant or beneficiary from a qualified employer plan not to be a deemed distribution?

A–3: (a) *In general*. A loan to a participant or beneficiary from a qualified employer plan will not be a deemed distribution to the participant or beneficiary if the loan satisfies the repayment term requirement of section 72(p)(2)(B), the level amortization requirement of section 72(p)(2)(C), and the enforceable agreement requirement of paragraph (b) of this Q&A–3, but only to the extent the loan satisfies the amount limitations of section 72(p)(2)(A).

(b) *Enforceable agreement requirement*. A loan does not satisfy the requirements of this paragraph unless the loan is evidenced by a legally enforceable agreement (which may include more than one document) set forth in writing or in such other form as may be approved by the Commissioner, and the terms of the agreement demonstrate compliance with the requirements of section 72(p)(2) and this section. Thus, the agreement must specify the amount of the loan, the term of the loan, and the repayment schedule.

Q–4: If a loan from a qualified employer plan to a participant or beneficiary fails to satisfy the requirements of Q&A-3 of this section, when does a deemed distribution occur?

A–4: (a) *Deemed distribution*. For purposes of section 72, a deemed distribution occurs at the first time that the requirements of Q&A–3 of this section are not satisfied, in form or in operation, with respect to that amount. This may occur at the time the loan is made or at a later date. If the terms of the loan do not require repayments that satisfy the repayment term requirement of section 72(p)(2)(B) or the level amortization requirement of section 72(p)(2)(C), or the loan is not evidenced by an enforceable agreement satisfying the requirements of Q&A–3(b) of this section, the entire amount of the loan is a deemed distribution under section 72(p) at the time the loan is made. If the loan satisfies the requirements of Q&A–3 of this section except that the amount loaned exceeds the limitations of 72(p)(2)(A), the amount of the loan in excess of the applicable limitation is a deemed distribution under section 72(p) at the time the loan is made. If the loan initially satisfies the requirements of section 72(p)(2)(A), (B) and (C) and the enforceable agreement requirement of Q&A–3(b) of this section, but payments are not made in accordance with the terms applicable to the loan, a deemed distribution occurs as a result of the failure to make such payments. See Q&A–10 of this section regarding when such a deemed distribution occurs and the amount thereof and Q&A–11 of this section regarding the tax treatment of a deemed distribution.

(b) *Examples*. The following examples illustrate the rules in paragraph (a) of this Q&A–4 and are based upon the assumptions described in ASSUMPTIONS FOR EXAMPLES:

Example 1. (a) A participant has a nonforfeitable account balance of $200,000 and receives $70,000 as a loan repayable in level quarterly installments over five years.

(b) Under section 72(p), the participant has a deemed distribution of $20,000 (the excess of $70,000 over $50,000) at the time of the loan, because the loan exceeds the $50,000 limit in section 72(p)(2)(A)(i). The remaining $50,000 is not a deemed distribution.

Example 2. (a) A participant with a nonforfeitable account balance of $30,000 borrows $20,000 as a loan repayable in level monthly installments over five years.

(b) Because the amount of the loan is $5,000 more than 50% of the participant's nonforfeitable account balance, the participant has a deemed distribution of $5,000 at the time of the loan. The remaining $15,000 is not a deemed distribution. (Note also that, if the loan is secured solely by the participant's account balance, the loan may be a prohibited transaction under section 4975 because the loan may not satisfy 29 CFR § 2550.408b–1(f)(2)).

Example 3. (a) The nonforfeitable account balance of a participant is $100,000 and a $50,000 loan is made to the participant repayable in level quarterly installments over seven years. The loan is not eligible for the section 72(p)(2)(B)(ii) exception for loans used to acquire certain dwelling units.

(b) Because the repayment period exceeds the maximum five-year period in section 72(p)(2)(B)(i), the participant has a deemed distribution of $50,000 at the time the loan is made.

Example 4. (a) On August 1, 1998, a participant has a nonforfeitable account balance of $45,000 and borrows $20,000 from a plan to be repaid over five years in level monthly installments due at the end of each month. After making monthly payments through July 1999, the participant fails to make any of the payments due thereafter.

(b) As a result of the failure to satisfy the requirement that the loan be repaid in level monthly installments, the participant has a deemed distribution. See Q&A–10(c) *Example* of this section regarding when such a deemed distribution occurs and the amount thereof.

Q–5: What is a principal residence for purposes of the exception in section 72(p)(2)(B)(ii) from the requirement that a loan be repaid in five years?

A–5: Section 72(p)(2)(B)(ii) provides that the requirement in section 72(p)(2)(B)(i) that a plan loan be repaid within five years does not apply to a loan used to acquire a dwelling unit which will within a reasonable time be used as the principal residence of the participant (a principal residence plan loan). For this purpose, a principal residence has the same meaning as a principal residence under section 1034.

Q–6: In order to satisfy the requirements for a principal residence plan loan, is a loan required to be secured by the dwelling unit that will within a reasonable time be used as the principal residence of the participant?

A–6: A loan is not required to be secured by the dwelling unit that will within a reasonable time be used as the participant's principal residence in order to satisfy the requirements for a principal residence plan loan.

Q–7: What tracing rules apply in determining whether a loan qualifies as a principal residence plan loan?

A–7: The tracing rules established under section 163(h)(3)(B) apply in determining whether a loan is treated as for the acquisition of a principal residence in order to qualify as a principal residence plan loan.

Q–8: Can a refinancing qualify as a principal residence plan loan?

A–8: (a) *Refinancings*. In general, no. However, a loan from a qualified employer plan used to repay a loan from a third party will qualify as a principal residence plan loan if the plan loan qualifies as a principal residence plan loan without regard to the loan from the third party.

(b) *Example*. The following example illustrates the rules in paragraph (a) of this Q&A–8 and is based upon the assumptions described in ASSUMPTIONS FOR EXAMPLES:

Example. (a) On July 1, 1999, a participant requests a $50,000 plan loan to be repaid in level monthly installments over 15 years. On August 1, 1999, the participant acquires a principal residence and pays a portion of the purchase price with a $50,000 bank loan. On September 1, 1999, the plan loans $50,000 to the participant, which the participant uses to pay the bank loan.

(b) Because the plan loan satisfies the requirements to qualify as a principal residence plan loan (taking into account the tracing rules of section 163(h)(3)(B)), such plan loan qualifies for the exception in section 72(p)(2)(B)(ii).

Q–9: Does the level amortization requirement of section 72(p)(2)(C) apply when a participant is on a leave of absence without pay?

A–9: (a) *Leave of absence*. The level amortization requirement of section 72(p)(2)(C) does not apply for a period, not longer than one year, that a participant is on a leave of absence, either without pay from the employer or at a rate of pay (after income and employment tax withholding) that is less than the amount of the installment payments required under the terms of the loan. However, the loan must be repaid by the latest date permitted under section 72(p)(2)(B) and the installments due after the leave ends (or, if earlier, after the first year of the leave) must not be less than those required under the terms of the original loan.

(b) *Example*. The following example illustrates the rules of paragraph (a) of this Q&A-9 and is based upon the assumptions described in ASSUMPTIONS FOR EXAMPLES:

Example. (a) On July 1, 1997, a participant with a nonforfeitable account balance of $80,000, borrows $40,000 to be repaid in level monthly installments of $825 each over five years. The loan is not a principal residence plan loan. The participant makes nine monthly payments and commences an unpaid leave of absence that lasts for 12 months. Thereafter, the participant resumes active employment and resumes making repayments on the loan until the loan is repaid. The amount of each monthly installment is increased to $1,130 in order to repay the loan by June 30, 2002.

(b) Because the loan satisfies the requirements of section 72(p)(2), the participant does not have a deemed distribution. Alternatively, section 72(p)(2) would be satisfied if the participant continued the monthly installments of $825 after resuming active employment and on June 30, 2002 repaid the full balance remaining due.

Q–10: If a participant fails to make the installment payments required under the terms of a loan that satisfied the requirements of Q&A–3 of this section when made, when does a deemed distribution occur and what is the amount of the deemed distribution?

A–10: (a) *Timing of deemed distribution*. Failure to make any installment payment when due in accordance with the terms of the loan violates section 72(p)(2)(C) and, accordingly, results in a deemed distribution at the time of such failure. However, the plan administrator may allow a grace period, and section 72(p)(2)(C) will not be considered to have been violated until the last day of the grace period. Any such grace period shall be given effect for purposes of section 72(p)(2)(C) only to the extent it does not continue beyond the last day of the calendar quarter following the calendar quarter in which the required installment payment was due.

(b) *Amount of deemed distribution*. If a loan satisfies Q&A–3 of this section when made, but there is a failure to pay the installment payments required under the terms of the loan (taking into account any grace period allowed under the preceding paragraph (a) of this Q&A–10), then the amount of the deemed distribution equals the entire outstanding balance of the loan at the time of such failure.

(c) *Example*. The following example illustrates the rules in Q&A–10(a) and (b) of this section and is based upon the assumptions described in ASSUMPTIONS FOR EXAMPLES:

Example. (1) On August 1, 1998, a participant has a nonforfeitable account balance of $45,000 and borrows $20,000 from a plan to be repaid over five years in level monthly installments due at the end of each month. After making all monthly payments due through July 31, 1999, the participant fails to make the payment due on August 31, 1999 or any other monthly payments due thereafter. The plan administrator allows a three-month grace period.

(2) As a result of the failure to satisfy the requirement that the loan be repaid in level installments pursuant to section 72(p)(2)(C), the participant has a deemed distribution on November 30, 1999, which is the last day of the three-month grace period for the August 31, 1999 installment. The amount of the deemed distribution is $17,157, which is the outstanding balance on the loan at November 30, 1999. Alternatively, if the plan administrator had allowed a grace period through the end of the next calendar quarter, there would be a deemed distribution on December 31, 1999 equal to $17,282, which is the outstanding balance of the loan at December 31, 1999.

Q–11: Do sections 72 and 4980A apply to a deemed distribution as if it were an actual distribution?

A–11: (a) *Tax Basis*. If the employee's account includes after-tax contributions or other investment in the contract under section 72(e), section 72 applies to a deemed distribution as if it were an actual distribution, with the result that all or a portion of the deemed distribution may not be taxable.

(b) *Sections 72(t) and (m)*. Section 72(t) (which imposes a 10 percent tax on certain early distributions) and section 72(m)(5) (which imposes a separate 10 percent tax on certain amounts received by a 5-percent owner) apply to a deemed distribution under section 72(p) in the same manner as if the deemed distribution were an actual distribution.

(c) *Section 4980A*. For purposes of section 4980A, a deemed distribution under section 72(p) is taken into account in determining an individual's excess distributions, as provided in §54.4981A–1T, Q&A a–8.

Q–12: Is a deemed distribution under section 72(p) treated as an actual distribution for purposes of the qualification requirements of section 401, the distribution provisions of section 402, or the distribution restrictions of section 401(k)(2)(B) or 403(b)(11)?

A–12: No. Thus, for example, if a participant in a money purchase plan who is an active employee has a deemed distribution under section 72(p), the plan will not be considered to have made an in-service distribution to the participant in violation of the qualification requirements applicable to money purchase plans. Similarly, the deemed distribution is not eligible to be rolled over to an eligible retirement plan and the participant is not eligible to elect income averaging with respect to the deemed distribution. See also §§1.402(c)–2, Q&A–4(d) and §1.401(k)–1(d)(6)(ii).

Q–13: How does a reduction (offset) of an account balance in order to repay a plan loan differ from a deemed distribution?

A–13: (a) *Difference between deemed distribution and plan loan offset amount*. (1) Loans to a participant from a qualified employer plan can give rise to two types of taxable distributions—

(i) A deemed distribution pursuant to section 72(p); and

(ii) A distribution of an offset amount.

(2) As described in Q&A–4 of this section, a deemed distribution occurs when the requirements of Q&A–3 of this section are not satisfied, either when the loan is made or at a later time. A deemed distribution is treated as a distribution to the participant or beneficiary only for certain tax purposes and is not a distribution of the accrued benefit. A distribution of a plan loan offset amount (as defined in §1.402(c)–2, Q&A–9(b)) occurs when, under the terms governing a plan loan, the accrued benefit of the participant or beneficiary is reduced (offset) in order to repay the loan (including the enforcement of the plan's security interest in the accrued benefit). A distribution of a plan loan offset amount could occur in a variety of circumstances, such as where the terms governing the plan loan require that, in the event of the participant's request for a distribution, a loan be repaid immediately or treated as in default.

(b) *Plan loan offset*. In the event of a plan loan offset, the amount of the account balance that is offset against the loan is an actual distribution for purposes of the Internal Revenue Code, not a deemed distribution under section 72(p). Accordingly, a plan may be prohibited from making such an offset under the provisions of section 401(a), 401(k)(2)(B) or 403(b)(11) prohibiting or limiting distributions to an active employee. See §1.402(c)–2, Q&A–9(c) *Example 6*.

Q–14: How is the amount includible in income as a result of a deemed distribution under section 72(p) required to be reported?

A–14: The amount includible in income as a result of a deemed distribution under section 72(p) is required to be reported on Form 1099–R (or any other form prescribed by the Commissioner).

Q–15: What withholding rules apply to plan loans?

A–15: To the extent that a loan, when made, is a deemed distribution or an account balance is reduced (offset) to repay a loan, the amount includible in income is subject to withholding. If a deemed distribution of a loan or a loan repayment by benefit offset results in income at a date after the date the loan is made, withholding is required only if a transfer of cash or property (excluding employer securities) is made to the participant or beneficiary from the plan at the same time. See §§35.3405–1(f)(4) and 31.3405(c)–1, Q&A–9 and Q&A–11 of this chapter for further guidance on withholding rules.

Q–16: If a loan fails to satisfy the requirements of Q&A–3 of this section and is a prohibited transaction under section 4975, is the deemed distribution of the loan under section 72(p) a correction of the prohibited transaction?

A–16: A deemed distribution is not a correction of a prohibited transaction under section 4975. See §§141.4975–13 and 53.4941(e)–1(c)(1) of this chapter for guidance concerning correction of a prohibited transaction.

Q–17: What are the income tax consequences if an amount is transferred from a qualified employer plan to a participant or beneficiary as a loan, but there is an express or tacit understanding that the loan will not be repaid?

A–17: If there is an express or tacit understanding that the loan will not be repaid, or, for any reason, the transaction does not create a debtor-creditor relationship, then the amount transferred is treated as an actual distribution from the plan for purposes of the Internal Revenue Code, and is not treated as a loan or as a deemed distribution under section 72(p).

Q–18: If a qualified employer plan maintains a program to invest in residential mortgages, are loans made pursuant to the investment program subject to section 72(p)?

A–18: Residential mortgage loans made by a plan in the ordinary course of an investment program are not subject to section 72(p) if the property acquired with the loans is the primary security for such loans and the amount loaned does not exceed the fair market value of the property. An investment program exists only if the plan has established, in advance of a specific investment under the program, that a certain percentage or amount of plan assets will be invested in residential mortgages available to persons purchasing the property who satisfy commercially customary financial criteria. Loans will not be considered as made under an investment program if the loans are only made available to, or any loan is earmarked for, any person or persons who are participants or beneficiaries in the plan, or if such loans mature upon a participant's termination from employment. In addition, no loan that benefits an officer, director, or owner of the employer maintaining the plan, or his or her beneficiaries, will be treated as made under an investment program. No inference should be drawn that a transaction under such an investment program is not a prohibited transaction under section 503 or 4975 or is not a violation of the applicable fiduciary standards for an employee benefit plan, so that such a loan could be a prohibited transaction if it does not satisfy the requirements of 29 CFR §2550.408b–1.

Q–19: When is the effective date of these regulations?

A–19: This section applies to assignments, pledges, and loans made on or after the date that is three months after the date of publication of the final regulations in the Federal Register.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on December 20, 1995, 8:45 a.m., and published in the issue of the Federal Register for December 21, 1995, 60 F.R. 66233)

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

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

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

To enable attorneys, certified public accountants, enrolled agents and enrolled actuaries to identify practitioners under consent suspension from practice before the Internal Revenue Service, the Director of Practice will announce in the Internal Revenue Bulletin the names and addresses of practitioners who have been suspended from such practice, their designation as attorney, certified public accountant, enrolled agent or enrolled actuary and date or period of suspension. This announcement will appear in the weekly Bulletin at the earliest practicable date after such action and will continue to appear in the weekly Bulletins for five successive weeks or for as many weeks as is practicable for each attorney, certified public accountant, enrolled agent or enrolled actuary so suspended and will be consolidated and published in the Cumulative Bulletin.

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

Name	Address	Designation	Date of Suspension
Isdaner, Thomas M.	Crofton, MD	CPA	October 31, 1995 to October 30, 1996
Cacciola, Marlene	Pittsburg, CA	Enrolled Agent	November 9, 1995 to May 8, 1996
Goldman, William D.	Hot Springs, AR	Attorney	November 9, 1995 to November 8, 1996
Armstrong, David L.	Norman, OK	CPA	Indefinite from November 10, 1995
Heckathorn, Ben	Red Oak, TX	CPA Attorney	Indefinite from November 28, 1995
Tisdel, Linda	Seattle, WA	Enrolled Agent	November 28, 1995 to May 27, 1997
Webb, Herbert M.	Gainsville, FL	Attorney	December 21, 1995 to June 20, 1997
Hipp, Robert J.	Evanston, IL	CPA	December 28, 1995 to April 27, 1996
Ruff, James M.	Willmar, MN	CPA	January 1, 1996 to March 31, 1996
Mulkerin, John J.	Wheaton, IL	CPA	January 5, 1996 to April 4, 1996
Redwitz, Robert	Irvine, CA	CPA	February 15, 1996 to May 14, 1996
Lind, Stanley L.	Milwaukee, WI	Attorney	March 1, 1996 to February 28, 1997
Dais, Robert E.	Plano, TX	CPA	March 1, 1996 to February 28, 1997

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

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

To enable attorneys, certified public accountants, enrolled agents and enrolled actuaries to identify such disbarred or suspended practitioners, the Director of Practice will announce in the Internal Revenue Bulletin the names and addresses of practitioners who have been suspended from such practice, their designation as attorney, certified public accountant, enrolled agent or enrolled actuary, and the date of disbarment or period of suspension. This announcement will appear in the weekly Bulletin for five successive weeks or as long as it is practicable for each attorney, certified public accountant, enrolled agent or enrolled actuary so suspended or disbarred and will be consolidated and published in the Cumulative Bulletin.

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

Name	Address	Designation	Effective Date
Muraskin, David	New York, NY	Attorney	November 6, 1995
Kelsey, Patrick	Poolesville, MD	CPA	November 13, 1995

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

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

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

To enable attorneys, certified public accountants, enrolled agents, and enrolled actuaries to identify practitioners under expedited suspension from practice before the Internal Revenue Service, the Director of Practice will announce in the Internal Revenue Bulletin the names and addresses of practitioners who have been suspended from such practice, their designation as attorney, certified public accountant, enrolled agent, or enrolled actuary, and date or period of suspension. This announcement will appear in the weekly Bulletin at the earliest practicable date after such action and will continue to appear in the weekly Bulletins for five successive weeks or for as many weeks as is practicable for each attorney, certified public accountant, enrolled agent, or enrolled actuary so suspended and will be consolidated and published in the Cumulative Bulletin.

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

Name	Address	Designation	Date of Suspension
Trebatch, Henry T.	Great Neck, NY	CPA	Indefinite from November 6, 1995
Roomberg, Alan	Minersville, PA	CPA	Indefinite from November 10, 1995
Elfenbein, Emanuel B.	Miami, FL	Enrolled Agent	Indefinite from November 27, 1995
Cerullo, Louis, J.	Boca Raton, FL	CPA	Indefinite from November 27, 1995
Fogel, Harold	St. Paul, MN	CPA	Indefinite from December 13, 1995
Glover, Paul L.	Downers Grove, IL	Attorney	Indefinite from December 13, 1995
Miller, John R.	Akron, OH	Attorney	Indefinite from December 13, 1995
Pofahl, Charles	Dallas, TX	Attorney	Indefinite from December 18, 1995
Walburg, Douglas	Mahtomedi, MN	CPA	Indefinite from December 18, 1995
Hibler, Thomas M.	Plymouth, MI	CPA Attorney	Indefinite from December 18, 1995
Oringer, Ronald	Flanders, NJ	CPA	Indefinite from December 29, 1995
Butcher, Frederick	Stillwater, NJ	CPA	Indefinite from December 29, 1995
Tokars, Frederic	Atlanta, GA	Attorney	Indefinite from December 29, 1995
Atkins, Sanford I.	Moreland Hills, OH	Attorney	Indefinite from December 29, 1995

Definition of Terms

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

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

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

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

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

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

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

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

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

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

Abbreviations

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

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

Numerical Finding List[1]

Bulletins 1996–1 through 1996–9

Announcements:

96–1, 1996–2 I.R.B. *57*
96–2, 1996–2 I.R.B. *57*
96–3, 1996–2 I.R.B. *57*
96–4, 1996–3 I.R.B. *50*
96–5, 1996–4 I.R.B. *99*
96–6, 1996–5 I.R.B. *43*
96–7, 1996–5 I.R.B. *44*
96–8, 1996–7 I.R.B. *56*
96–9, 1996–8 I.R.B. *30*
96–10, 1996–8 I.R.B. *30*
96–11, 1996–9 I.R.B. *11*

Delegations Orders:

232 (Rev. 2), 1996–7 I.R.B. *49*
239 (Rev. 1), 1996–7 I.R.B. *49*

Notices:

96–2, 1996–2 I.R.B. *15*
96–1, 1996–3 I.R.B. *30*
96–4, 1996–4 I.R.B. *69*
96–5, 1996–6 I.R.B. *22*
96–6, 1996–5 I.R.B. *27*
96–7, 1996–6 I.R.B. *22*
96–8, 1996–6 I.R.B. *23*
96–9, 1996–6 I.R.B. *26*
96–10, 1996–7 I.R.B. *47*
96–11, 1996–8 I.R.B. *19*

Proposed Regulations:

DL–1–95, 1996–6 I.R.B. *28*
EE–20–95, 1996–5 I.R.B. *15*
EE–34–95, 1996–3 I.R.B. *49*
EE–35–95, 1996–5 I.R.B. *19*
EE–53–95, 1996–5 I.R.B. *23*
IA–33–95, 1996–4 I.R.B. *99*
INTL–3–95, 1996–6 I.R.B. *29*
INTL–9–95, 1996–5 I.R.B. *25*
PS–2–95, 1996–7 I.R.B. *50*

Revenue Procedures:

96–1, 1996–1 I.R.B. *8*
96–2, 1996–1 I.R.B. *60*
96–3, 1996–1 I.R.B. *82*
96–4, 1996–1 I.R.B. *94*
96–5, 1996–1 I.R.B. *129*
96–6, 1996–1 I.R.B. *151*
96–7, 1996–1 I.R.B. *185*
96–8, 1996–1 I.R.B. *187*
96–8A, 1996–9 I.R.B. *10*
96–9, 1996–2 I.R.B. *15*
96–10, 1996–2 I.R.B. *17*
96–11, 1996–2 I.R.B. *18*

Revenue Procedures—Continued

96–12, 1996–3 I.R.B. *30*
96–13, 1996–3 I.R.B. *31*
96–14, 1996–3 I.R.B. *41*
96–15, 1996–3 I.R.B. *41*
96–16, 1996–3 I.R.B. *45*
96–17, 1996–4 I.R.B. *69*
96–18, 1996–4 I.R.B. *73*
96–19, 1996–4 I.R.B. *80*
96–20, 1996–4 I.R.B. *88*
96–21, 1996–4 I.R.B. *96*
96–22, 1996–5 I.R.B. *27*
96–23, 1996–5 I.R.B. *27*
96–24, 1996–5 I.R.B. *28*
96–25, 1996–8 I.R.B. *19*
96–26, 1996–8 I.R.B. *22*

Revenue Rulings:

96–1, 1996–1 I.R.B. *7*
96–2, 1996–2 I.R.B. *5*
96–3, 1996–2 I.R.B. *14*
96–6, 1996–2 I.R.B. *8*
96–4, 1996–3 I.R.B. *16*
96–5, 1996–3 I.R.B. *29*
96–7, 1996–3 I.R.B. *12*
96–8, 1996–4 I.R.B. *62*
96–9, 1996–4 I.R.B. *5*
96–10, 1996–4 I.R.B. *27*
96–11, 1996–4 I.R.B. *28*
96–12, 1996–9 I.R.B. *4*
96–14, 1996–6 I.R.B. *20*

Treasury Decisions:

8630, 1996–3 I.R.B. *19*
8631, 1996–3 I.R.B. *7*
8632, 1996–4 I.R.B. *6*
8633, 1996–4 I.R.B. *20*
8634, 1996–3 I.R.B. *17*
8635, 1996–3 I.R.B. *5*
8636, 1996–4 I.R.B. *64*
8637, 1996–4 I.R.B. *29*
8638, 1996–5 I.R.B. *5*
8639, 1996–5 I.R.B. *12*
8640, 1996–2 I.R.B. *10*
8641, 1996–6 I.R.B. *4*
8642, 1996–7 I.R.B. *4*
8644, 1996–7 I.R.B. *16*
8645, 1996–8 I.R.B. *4*
8646, 1996–8 I.R.B. *10*
8647, 1996–9 I.R.B. *7*
8649, 1996–9 I.R.B. *5*

[1]A cumulative list of all Revenue Rulings, Revenue Procedures, Treasury Decisions, etc., published in Internal Revenue Bulletins 1995–27 through 1995–52 will be found in Internal Revenue Bulletin 1996–1, dated January 2, 1996.

Finding List of Current Action on Previously Published Items[1]

Bulletins 1996–1 through 1996–9

*Denotes entry since last publication

Delegation Orders:

232 (Rev. 1)
Superseded by
232 (Rev. 2), 1996–7 I.R.B. *49*

239
Amended by
239 (Rev. 1), 1996–7 I.R.B. *49*

Revenue Procedures:

65–17
Modified by
96–14, 1996–3 I.R.B. *41*

66–49
Modified by
96–15, 1996–3 I.R.B. *41*

88–32
Obsoleted by
96–15, 1996–3 I.R.B. *41*

88–33
Obsoleted by
96–15, 1996–3 I.R.B. *41*

89–19
Superseded by
96–17, 1996–4 I.R.B. *69*

89–48
Superseded in part by
96–17, 1996–4 I.R.B. *69*

91–22
Modified by
96–1, 1996–1 I.R.B. *8*

91–22
Amplified by
96–13, 1996–3 I.R.B. *31*

91–23
Superseded by
96–13, 1996–3 I.R.B. *31*

91–24
Superseded by
96–14, 1996–3 I.R.B. *41*

91–26
Superseded by
96–13, 1996–3 I.R.B. *31*

92–20
Modified by
96–1, 1996–1 I.R.B. *8*

Revenue Procedures—Continued

92–85
Modified by
96–1, 1996–1 I.R.B. *8*

93–16
Superseded by
96–11, 1996–2 I.R.B. *18*

93–46
Superseded in part by
96–17, 1996–4 I.R.B. *69*

Superseded by
96–18, 1996–4 I.R.B. *73*

94–18
Superseded in part by
96–17, 1996–4 I.R.B. *69*

Superseded by
96–18, 1996–4 I.R.B. *73*

94–59
Superseded in part by
96–17, 1996–4 I.R.B. *69*

Superseded by
96–18, 1996–4 I.R.B. *73*

95–1
Superseded by
96–1, 1996–1 I.R.B. *8*

95–2
Superseded by
96–2, 1996–1 I.R.B. *60*

95–3
Superseded by
96–3, 1996–1 I.R.B. *82*

95–4
Superseded by
96–4, 1996–1 I.R.B. *94*

95–5
Superseded by
96–5, 1996–1 I.R.B. *129*

95–6
Superseded by
96–6, 1996–1 I.R.B. *151*

95–7
Superseded by
96–7, 1996–1 I.R.B. *185*

95–8
Superseded by
96–8, 1996–1 I.R.B. *187*

95–13
Superseded by
96–20, 1996–4 I.R.B. *88*

Revenue Procedures—Continued

95–20
Superseded by
96–24, 1996–5 I.R.B. *28*

95–50
Superseded by
96–3, 1996–1 I.R.B. *82*

96–3
Amplified by
96–12, 1996–3 I.R.B. *30*

Revenue Rulings:

66–307
Obsoleted by
96–3, 1996–2 I.R.B. *14*

72–437
Modified by
96–13, 1996–3 I.R.B. *31*

80–80
Obsoleted by
96–3, 1996–2 I.R.B. *14*

82–80
Modified by
96–14, 1996–3 I.R.B. *41*

92–19
Supplemented in part
96–2, 1996–2 I.R.B. *5*

92–75
Clarified by
96–13, 1996–3 I.R.B. *31*

95–10
Supplemented and superseded by
96–4, 1996–3 I.R.B. *16*

95–11
Supplemented and superseded by
96–5, 1996–3 I.R.B. *29*

[1]A cumulative finding list for previously published items mentioned in Internal Revenue Bulletins 1995–27 through 1995–52 will be found in Internal Revenue Bulletin 1996–1, dated January 2, 1996.

INDEX

Internal Revenue Bulletins 1996–1 Through 1996–9

For index of items published during the last six months of 1995, see I.R.B. 1996–1, dated January 2, 1996.

The abbreviation and number in parentheses following the index entry refer to the specific item; numbers in roman and italic type following the parentheses refer to the Internal Revenue Bulletin in which the item may be found and the page number on which it appears.

Key to Abbreviations:

RR	Revenue Ruling
RP	Revenue Procedure
TD	Treasury Decision
CD	Court Decision
PL	Public Law
EO	Executive Order
DO	Delegation Order
TDO	Treasury Department Order
TC	Tax Convention
SPR	Statement of Procedural Rules
PTE	Prohibited Transaction Exemption

EXCISE TAXES—Continued

INCOME TAX

INCOME TAX—Continued

INCOME TAX—Continued

NOTES

NOTES

NOTES