

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. 2003-105, page 696.

Split-dollar life insurance arrangements. Certain previously published revenue rulings are obsoleted to the extent described in this ruling. The previously published rulings are obsoleted in light of T.D. 9092, which provides comprehensive final regulations regarding the federal income, gift, and employment taxation of split-dollar life insurance arrangements. Rev. Ruls. 78-420 and 79-50 obsoleted. Rev. Rul. 66-610 partially obsoleted.

T.D. 9080, page 696.

REG-113112-03, page 760.

Final, temporary, and proposed regulations under section 108 of the Code clarify that, in the case of a transaction described in section 381(a) that ends a year in which the distributor or transferor corporation excludes COD income from gross income under section 108(a), any tax attributes to which the acquiring corporation succeeds under section 381, and the basis of property acquired by the acquiring corporation in the transaction, shall reflect the reductions required by sections 108 and 1017.

T.D. 9083, page 700.

Final regulations under section 280G of the Code provide rules for the treatment of golden parachute payments. A golden parachute payment includes certain compensation payments made to certain individuals in connection with a change in ownership or control of a corporation. These rules are effective for payments made on a change in control if the change in control occurs on or after January 1, 2004.

T.D. 9084, page 742.

Final regulations under section 1503(d) of the Code provide guidance regarding the events that require the recapture of dual consolidated losses. The regulations will facilitate compliance by taxpayers with the dual consolidated loss provisions. The regulations generally provide that certain events will not trigger recapture of a dual consolidated loss or payment of the associated interest charge. The regulations provide for the filing of certain agreements in such cases. This document also makes clarifying and conforming changes to the current regulations.

Notice 2003-67, page 752.

This notice provides guidance to brokers and individuals for information reporting of payments in lieu of dividends.

EMPLOYEE PLANS

T.D. 9079, page 729.

Final regulations under section 419A of the Code provide guidance regarding whether a welfare benefit fund is part of a ten-or-more employer plan described in section 419A(f)(6).

Announcement 2003-54, page 761.

Nonbank trustees; section 1.408-2(e) of the regulations.

This announcement contains a list of entities previously approved to act as nonbank trustees and nonbank custodians within the meaning of section 1.408-2(e) of the regulations. In addition, the announcement contains instructions on how errors in the list may be corrected.

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Finding Lists begin on page ii.

Index for July through September begins on page ix.



GIFT TAX

Rev. Rul. 2003–105, page 696.

Split-dollar life insurance arrangements. Certain previously published revenue rulings are obsoleted to the extent described in this ruling. The previously published rulings are obsoleted in light of T.D. 9092, which provides comprehensive final regulations regarding the federal income, gift, and employment taxation of split-dollar life insurance arrangements. Rev. Ruls. 78–420 and 79–50 obsoleted. Rev. Rul. 66–610 partially obsoleted.

EMPLOYMENT TAX

Rev. Rul. 2003–105, page 696.

Split-dollar life insurance arrangements. Certain previously published revenue rulings are obsoleted to the extent described in this ruling. The previously published rulings are obsoleted in light of T.D. 9092, which provides comprehensive final regulations regarding the federal income, gift, and employment taxation of split-dollar life insurance arrangements. Rev. Ruls. 78–420 and 79–50 obsoleted. Rev. Rul. 66–610 partially obsoleted.

EXCISE TAX

T.D. 9083, page 700.

Final regulations under section 280G of the Code provide rules for the treatment of golden parachute payments. A golden parachute payment includes certain compensation payments made to certain individuals in connection with a change in ownership or control of a corporation. These rules are effective for payments made on a change in control if the change in control occurs on or after January 1, 2004.

TAX CONVENTIONS

Announcement 2003–58, page 746.

Austria agreement on deferred payments. A copy of the news release issued by the Director, International (U.S. Competent Authority) on August 27, 2003, is set forth.

Announcement 2003–59, page 746.

This announcement contains the text of a competent authority agreement with the Swiss government that provides guidance on the application of the Limitation on Benefits (LOB) article of the income tax treaty and accompanying revised Memorandum of Understanding (MOU) between the United States and the Swiss Confederation. The agreement sets forth the categories of U.S. residents that will be taken into account for purposes of the derivative benefits ownership tests of the revised MOU.

ADMINISTRATIVE

REG–208199–91, page 756.

Proposed regulations under section 6503(j) of the Code concern the use of designated summonses and related summonses and the effect on the period of limitations on assessment when a case is brought with respect to a designated or related summons.

Notice 2003–65, page 747.

This notice provides two alternative safe harbors regarding the identification of built-in items under section 382(h) of the Code and requests comments on this subject. Notice 87–79 modified.

The IRS Mission

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

Introduction

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

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

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

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

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

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.

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

Part II.—Treaties and Tax Legislation.

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

Part III.—Administrative, Procedural, and Miscellaneous.

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

Part IV.—Items of General Interest.

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

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

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

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

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

Section 61.—Gross Income Defined

26 CFR 1.61–22: *Taxation of split-dollar life insurance arrangements.*

(Also: §§ 83; 301; 316; 2503; 2511; 2512; 7805; 7872; 1.83–3; 1.83–6; 1.301–1; 1.316–1; 25.2503–1; 25.2511–1; 25.2512–6; 301.7805–1; 1.7872–15.)

Split-dollar life insurance arrangements. Certain previously published revenue rulings are obsoleted to the extent described in this ruling. The previously published rulings are obsoleted in light of T.D. 9092, which provides comprehensive final regulations regarding the federal income, gift, and employment taxation of split-dollar life insurance arrangements. Rev. Ruls. 78–420 and 79–50 obsoleted. Rev. Rul. 66–610 partially obsoleted.

Rev. Rul. 2003–105

Treasury Decision 9092 provides comprehensive final regulations (under §§ 1.61–22, 1.83–3(e), 1.83–6(a)(5), 1.301–1(q), and 1.7872–15 of the Income Tax Regulations) regarding the federal income, gift, and employment taxation of split-dollar life insurance arrangements (as defined in § 1.61–22(b)(1) or (2)). These regulations apply to any split-dollar life insurance arrangement that is entered into after September 17, 2003, and to any split-dollar life insurance arrangement entered into on or before September 17, 2003, that is materially modified after September 17, 2003. See § 1.61–22(j).

The revenue rulings listed below are obsolete to the extent described below.

Rev. Rul. 79–50, 1979–1 C.B. 139

Rev. Rul. 78–420, 1978–2 C.B. 67

Rev. Rul. 66–110, 1966–1 C.B. 12 (except as provided in Section III, Paragraph 3 of Notice 2002–8, 2002–1 C.B. 398, and Notice 2002–59, 2002–36 I.R.B. 481)

Rev. Rul. 64–328, 1964–2 C.B. 11.

In the case of any split-dollar life insurance arrangement entered into on or before September 17, 2003, taxpayers may continue to rely on these revenue rulings

to the extent described in Notice 2002–8, but only if the arrangement is not materially modified after September 17, 2003.

DRAFTING INFORMATION

The principal author of this revenue ruling is Elizabeth K. Kaye of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Elizabeth K. Kaye at (202) 622–4920 (not a toll-free call).

Section 83.—Property Transferred in Connection With Performance of Services

26 CFR 1.83-3: *Meaning and use of certain terms.*
26 CFR 1.83-6: *Deduction by employer.*

Certain previously published revenue rulings are obsolete with respect to the taxation of split-dollar life insurance arrangements entered into or materially modified after September 17, 2003. See Rev. Rul. 2003-105, page 696.

Section 108.—Income From Discharge of Indebtedness

26 CFR 1.108–7T: *Reduction of attributes (temporary).*

T.D. 9080

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Reduction of Tax Attributes Due to Discharge of Indebtedness

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains regulations relating to the reduction of tax attributes under sections 108 and 1017 of the Internal Revenue Code. These temporary regulations affect taxpayers that exclude discharge of indebtedness income from gross income under section 108. The text of the temporary regulations

also serves as the text of the proposed regulations (REG–113112–03) set forth in the notice of proposed rulemaking on this subject in this issue of the Bulletin.

DATES: Effective Date: These temporary regulations are effective July 17, 2003.

Applicability Date: These temporary regulations apply to discharges of indebtedness occurring after July 17, 2003.

FOR FURTHER INFORMATION CONTACT: Theresa M. Kolish (202 622–7930) of the Office of the Associate Chief Counsel (Corporate) (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

The Debt Discharge Rules

Pursuant to section 61(a)(12), gross income includes income from the discharge of indebtedness (COD income). Section 108(a)(1), which reflects the amendments enacted in the Bankruptcy Tax Act of 1980, Public Law 96–589, section 2, 94 Stat. 3389 (1980) (1980–2 C.B. 607), however, provides that, where the discharge occurs in a title 11 case, where the taxpayer is insolvent, or where the indebtedness is “qualified farm indebtedness” or “qualified real property business indebtedness,” gross income does not include any amount that otherwise would be includible in gross income by reason of that discharge (in whole or in part) of the indebtedness of the taxpayer.

Although section 108(a) excludes COD income from gross income under those circumstances, section 108(b) requires the reduction of certain tax attributes in an amount that reflects the amount excluded from gross income, thereby generally deferring, rather than permanently eliminating, the inclusion of COD income. Section 108(b)(2) requires the reduction of the following tax attributes of the taxpayer in the following order: (A) net operating losses; (B) general business credits; (C) minimum tax credits; (D) capital loss carryovers; (E) adjusted basis of property; (F) passive activity losses and credit carryovers; and (G) foreign tax credit carryovers. Section 108(b)(4)(A) provides that the reductions

are made after the determination of the tax imposed for the taxable year of the discharge. Section 108(b)(4)(B) provides that the reductions of net operating losses and capital loss carryovers are made first in the loss for the taxable year of the discharge and then in the carryovers to such taxable year in the order of the taxable years from which each such carryover arose. If the excluded COD income exceeds the sum of the taxpayer's tax attributes, the excess is disregarded such that it does not result in income or have other tax consequences. See H.R. Rep. No. 96-833, at 11 (1980).

Instead of reducing tax attributes in the order set forth in section 108(b)(2), a taxpayer may elect under section 108(b)(5) to reduce first the adjusted bases of depreciable property to the extent of the excluded COD income. The amount to which the election applies is limited to the aggregate adjusted basis of the depreciable property held by the taxpayer as of the beginning of the taxable year following the taxable year in which the discharge occurs. If the adjusted bases of depreciable property are insufficient to offset the entire amount of excluded COD income, the taxpayer must then reduce any remaining tax attributes in the order set forth in section 108(b)(2). Congress intended the election under section 108(b)(5) to allow debtors, including debtors in bankruptcy, to account for a debt discharge amount in a manner most favorable to their tax situations. See S. Rep. No. 96-1035, at 10 (1980); H.R. Rep. No. 96-833, at 9 (1980).

Section 1017(a) provides that when any portion of COD income excluded from gross income under section 108(a) is to be applied to reduce basis, then such portion shall be applied to reduce the basis of any property held by the taxpayer at the beginning of the taxable year following the taxable year in which the discharge occurs. Section 1017(b)(1) provides that the amount of reduction under section 1017(a), and the particular properties the bases of which are to be reduced, shall be determined under regulations.

The Reorganization Rules

Section 368(a)(1) defines a reorganization to include certain types of asset acquisitions. Under section 361, a corporation that is a party to a reorganization recognizes neither gain nor loss when it exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation that is a party to the reorganization. If the corporation receives in the exchange not only stock or securities permitted to be received without the recognition of gain, but also other property or money, then the corporation may be required to recognize gain. Under section 362(b), if property is acquired by a corporation in connection with a reorganization, then the basis is the same as it would be in the hands of the transferor, increased by the amount of gain recognized to the transferor on such transfer.

Section 332(a) provides that a corporation recognizes no gain or loss on the receipt of property distributed in complete liquidation of another corporation. Section 337(a) provides that a liquidating corporation recognizes no gain or loss on the distribution to the 80-percent distributee of any property in a complete liquidation to which section 332 applies. Under section 334(b)(1), if property is received by a corporate distributee in a distribution in a complete liquidation to which section 332 applies, the basis of such property in the hands of such distributee is the same as it would be in the hands of the transferor. However, in any case in which gain or loss is recognized by the liquidating corporation with respect to such property, the basis of such property in the hands of such distributee is the fair market value of the property at the time of the distribution.

Section 381 provides that a corporation that acquires the assets of another corporation in a distribution to which section 332 applies or in a transfer to which section 361 applies (but only if the transfer is in connection with certain reorganizations described in sections 368(a)(1)(A), (C), (D), (F), or (G)) shall succeed to, and take into account, as of the close of the day of distribution or transfer, the items described in section 381(c) of the distributor or transferor corporation, subject to certain conditions and limitations. Among those items described in section 381(c) are net operating loss carryovers,

capital loss carryovers, general business credits, and minimum tax credits. With respect to net operating loss carryovers and capital loss carryovers, the regulations under section 381 reflect that the acquiring corporation succeeds to only those carryovers that remain after the application of sections 172 and 1212 and their carryforward and carryback provisions. See §§1.381(c)(1)-1; 1.381(c)(3)-1. Furthermore, those regulations provide that the acquiring corporation succeeds to only those general business credits that remain unused by the transferor corporation after computing its taxable income for the year of the transfer. See §1.381(c)(23)-1. Section 381(b)(1) provides that, except in the case of an acquisition in connection with a reorganization described in section 368(a)(1)(F), the taxable year of the distributor or transferor corporation ends on the date of distribution or transfer.

Interaction Between Debt Discharge and Reorganization Rules

Questions have arisen regarding the application of the attribute reduction rules of sections 108 and 1017 when a transaction described in section 381(a) ends a taxable year in which the transferor excludes COD income from gross income. If section 108(b)(4)(A) and section 1017 were interpreted to require attribute reduction to occur after the close of the taxable year of discharge and after the transfer of assets and carryover of items described in section 381(c), then arguably no attributes described in section 108(b)(2) would be available for reduction.

Explanation of Provisions

The IRS and Treasury Department believe that the rule of section 108(b)(4)(A) prescribes an ordering of calculations. First, section 108(b)(4)(A) requires a determination of the taxpayer's tax for the taxable year of discharge in order to identify the amounts, if any, of the tax attributes described in section 108(b)(2) that remain available for reduction. Second, section 108(b)(4)(A) requires the reduction of those attributes. This ordering rule affords the taxpayer the use of certain of its tax attributes described in section 108(b)(2), including any losses carried forward to the taxable year of discharge,

for purposes of determining its tax for the taxable year of discharge, before subjecting those attributes to reduction.

Similarly, the IRS and Treasury believe that the rule of section 1017 prescribes an ordering of calculations. The Bankruptcy Tax Act of 1980 reflects that Congress enacted the rule of section 1017 “to avoid interaction between basis reduction and reduction of other attributes.” S. Rep. No. 96-1035, at 14 (1980); H. Rep. No. 96-833, at 11 (1980). Without this rule, a circular calculation could be required. The taxpayer’s net operating loss for the year of the discharge of indebtedness might be based in part on the amount of cost recovery deductions allowed to the taxpayer. The amount of cost recovery deductions, however, would depend on the taxpayer’s basis in its depreciable or amortizable property at the end of the year. Because net operating losses are reduced by excluded COD income prior to the reduction of asset basis absent an election under section 108(b)(5), the amount of basis required to be reduced would depend on the amount of net operating losses. Reducing the basis of property held by the taxpayer at the beginning of the taxable year following the taxable year in which the discharge occurs avoids this circularity.

The position that sections 108 and 1017 require the reduction of attributes, including the basis of transferred assets, in cases where the debtor’s taxable year ends with a transfer of assets in a transaction described in section 381 is consistent with the policies underlying sections 108 and 1017 and the corporate reorganization provisions, including “deferring, but eventually collecting within a reasonable period, tax on ordinary income realized from debt discharge.” S. Rep. No. 96-1035, at 10 (1980). For example, assume that a debt of corporation X is discharged in a title 11 case. X’s attributes described in section 108(b)(2) consist solely of basis in property. As part of a plan of reorganization, X transfers all of its assets to a newly formed corporation, Y. Under section 368(a)(3)(C), even though the transaction also qualifies as a reorganization under section 368(a)(1)(F), the transaction is treated as qualifying as a reorganization

only under section 368(a)(1)(G). If sections 108 and 1017 were interpreted to not require a reduction of the bases of the property transferred, X would permanently exclude from gross income the COD income, notwithstanding that X underwent nothing more than a mere change in identity, form, or place of organization. Accordingly, consistent with the legislative history of the Bankruptcy Tax Act of 1980, the IRS and Treasury Department believe that the basis reduction rules of sections 108 and 1017 apply to property of a debtor transferred in a transaction described in section 381(a).

The legislative history of the Bankruptcy Tax Act of 1980 reflects that Congress specifically anticipated that amounts that carry over in a transaction described in section 381, including the basis of transferred property, are to be adjusted under the rules of sections 108 and 1017 to account for excluded COD income. See H.R. Rep. No. 96-833, at 32-34 (1980). The legislative history states:

Assume that Corporation A is in a bankruptcy case commenced after October 1, 1979. Immediately prior to a transfer under a plan of reorganization, A’s assets have an adjusted basis of \$75,000 and a fair market value of \$100,000. A has a net operating loss carryover of \$200,000. A has outstanding bonds of \$100,000 (on which there is no accrued but unpaid interest) and trade debts of \$100,000.

Under the plan of reorganization, A is to transfer all its assets to Corporation B in exchange for \$100,000 of B stock. Corporation A will distribute the stock, in exchange for their claims against A, one-half to the security holders and one-half to the trade creditors. A’s shareholders will receive nothing.

The transaction would qualify as a reorganization under new section 368(a)(1)(G) of the Code, since all the creditors are here treated as proprietors for continuity of interest purposes. Thus, A would recognize no gain or loss on the transfer of its assets to B (sec. 361). B’s basis in the assets would be \$75,000 (sec. 362), and B would succeed to A’s net operating loss carryover (sec. 381).

Under the bill, . . . [o]n the distribution of B stock to A’s trade creditors, A excludes from gross income the debt discharge amount of \$50,000 — *i.e.*, the difference between the \$100,000 debt held by non-security creditors and the \$50,000 worth of stock given for such debt. A may elect to reduce the basis of its depreciable assets transferred to B by all or part of the \$50,000 debt discharge amount; to the extent the election is not made, the debt discharge amount reduces A’s net operating loss carryover by the remainder of the debt discharge amount.

H.R. Rep. No. 96-833, at 34 (1980). The treatment of the net operating loss and basis in the legislative history demonstrates that, in a transaction described in section 381, the transferor’s attributes, including the basis of transferred property, that carry over to the transferee are reduced.

Accordingly, these temporary regulations clarify that, in the case of a transaction described in section 381(a) that ends a year in which the distributor or transferor corporation excludes COD income from gross income under section 108(a), any tax attributes to which the acquiring corporation succeeds and the basis of property acquired by the acquiring corporation in the transaction shall reflect the reductions required by sections 108 and 1017. For this purpose, all attributes listed in section 108(b)(2) of the distributor or transferor corporation immediately prior to the transaction described in section 381(a), including the basis of property, but after the determination of tax for the year of the discharge, are available for reduction under section 108(b)(2).

These temporary regulations also clarify that the tax attributes subject to reduction under section 108(b)(2) that are carryovers to the taxable year of the discharge, or that may be carried back to taxable years preceding the year of the discharge, are first taken into account by the taxpayer for the taxable year of the discharge or the preceding years, as the case may be, before such attributes are reduced pursuant to section 108(b)(2).

These temporary regulations apply to discharges of indebtedness occurring after July 17, 2003.

Special Analyses

It has been determined that these temporary regulations are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedures Act (5 U.S.C. chapter 5) does not apply to these temporary regulations, and, because no preceding notice of proposed rulemaking is required for these temporary regulations, the provisions of the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply. Pursuant to section 7805(f) of the Internal Revenue Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these temporary regulations is Theresa M. Kolish, Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Section 1.108-7T also issued under 26 U.S.C. 108. * * *

Par. 2. Section 1.108-7T is added to read as follows:

§1.108-7T Reduction of attributes (temporary).

(a) *In general.* (1) If a taxpayer excludes discharge of indebtedness income (COD income) from gross income under section 108(a)(1)(A), (B), or (C), then the amount excluded shall be applied to reduce the following tax attributes of the taxpayer in the following order:

- (i) Net operating losses.
- (ii) General business credits.

- (iii) Minimum tax credits.
- (iv) Capital loss carryovers.
- (v) Basis of property.
- (vi) Passive activity loss and credit carryovers.
- (vii) Foreign tax credit carryovers.

(2) The taxpayer may elect under section 108(b)(5), however, to apply any portion of the excluded COD income to reduce first the basis of depreciable property. To the extent the excluded COD income is not applied, the taxpayer must then reduce any remaining tax attributes in the order specified in section 108(b)(2). If the excluded COD income exceeds the sum of the taxpayer's tax attributes, the excess is permanently excluded from the taxpayer's gross income. For rules relating to basis reductions required by sections 108(b)(2)(E) and 108(b)(5), see section 1017 and §1.1017-1. For rules relating to the time and manner for making an election under section 108(b)(5), see §1.108-4.

(b) *Carryovers and carrybacks.* The tax attributes subject to reduction under section 108(b)(2) and paragraph (a)(1) of this section that are carryovers to the taxable year of the discharge, or that may be carried back to taxable years preceding the year of the discharge, are taken into account by the taxpayer for the taxable year of the discharge or the preceding years, as the case may be, before such attributes are reduced pursuant to section 108(b)(2) and paragraph (a)(1) of this section.

(c) *Transactions to which section 381 applies.* In the case of a transaction described in section 381(a) that ends a taxable year in which the distributor or transferor corporation excludes COD income under section 108(a), any tax attributes to which the acquiring corporation succeeds and the basis of property acquired by the acquiring corporation in the transaction shall reflect the reductions required by section 108(b). For this purpose, all attributes listed in section 108(b)(2) of the distributor or transferor corporation immediately prior to the transaction described in section 381(a), but after the determination of tax for the year of the discharge, including basis of property, shall be available for reduction under section 108(b)(2).

(d) *Examples.* The following examples illustrate the application of this section:

Example 1. (i) *Facts.* In Year 4, X, a corporation in a title 11 case, is entitled under section

108(a)(1)(A) to exclude from gross income \$100,000 of COD income. For Year 4, X has gross income in the amount of \$50,000. In each of Years 1 and 2, X had no taxable income or loss. In Year 3, X had a net operating loss of \$100,000, the use of which when carried over to Year 4 is not subject to any restrictions other than those of section 172.

(ii) *Analysis.* Pursuant to paragraph (b) of this section, X takes into account the net operating loss carryover from Year 3 in computing its taxable income for Year 4 before any portion of the COD income excluded under section 108(a)(1)(A) is applied to reduce tax attributes. Thus, the amount of the net operating loss carryover that is reduced under section 108(b)(2) and paragraph (a) of this section is \$50,000.

Example 2. (i) *Facts.* The facts are the same as in *Example 1*, except that in Year 4 X sustains a net operating loss in the amount of \$100,000. In addition, in each of Years 2 and 3, X reported taxable income in the amount of \$25,000.

(ii) *Analysis.* Pursuant to paragraph (b) of this section and section 172, the net operating loss sustained in Year 4 is carried back to Years 2 and 3 before any portion of the COD income excluded under section 108(a)(1)(A) is applied to reduce tax attributes. Thus, the amount of the net operating loss that is reduced under section 108(b)(2) and paragraph (a) of this section is \$50,000.

Example 3. (i) *Facts.* In Year 2, X, a corporation in a title 11 case, has outstanding debts of \$200,000 and a depreciable asset that has an adjusted basis of \$75,000 and a fair market value of \$100,000. X has no other assets or liabilities. X has a net operating loss of \$80,000 that is carried over to Year 2 but has no general business credit, minimum tax credit, or capital loss carryovers. Under a plan of reorganization, X transfers its asset to Corporation Y in exchange for Y stock with a value of \$100,000. X distributes the Y stock to its creditors in exchange for release of their claims against X. X's shareholders receive nothing in the transaction. The transaction qualifies as a reorganization under section 368(a)(1)(G) that satisfies the requirements of section 354(b)(1)(A) and (B). For Year 2, X has gross income of \$10,000 (without regard to any income from the discharge of indebtedness) and is allowed a depreciation deduction of \$10,000 in respect of the asset. In addition, it generates no general business credits.

(ii) *Analysis.* On the distribution of Y stock to X's creditors, under section 108(a)(1)(A), X is entitled to exclude from gross income the debt discharge amount of \$100,000. (Under section 108(e)(8), X is treated as satisfying \$100,000 of the debt owed the creditors for \$100,000, the fair market value of the Y stock transferred to those creditors.) In Year 2, X has no taxable income or loss because its gross income is exactly offset by the depreciation deduction. As a result of the depreciation deduction, X's basis in the asset is reduced by \$10,000 to \$65,000. Pursuant to paragraph (c) of this section, the amount of X's net operating loss to which Y succeeds pursuant to section 381 and the basis of X's property transferred to Y must take into account the reductions required by section 108(b). Pursuant to paragraph (a) of this section, X's net operating loss carryover in the amount of \$80,000 is reduced by \$80,000 of the COD income excluded under section 108(a)(1). In addition, X's basis in the asset is reduced by \$20,000, the extent to which the COD income excluded under section

108(a)(1) did not reduce the net operating loss. Accordingly, as a result of the reorganization, there is no net operating loss to which Y succeeds under section 381. Pursuant to section 361, X recognizes no gain or loss on the transfer of its property to Y. Pursuant to section 362(b), Y's basis in the asset acquired from X is \$45,000.

Example 4. (i) Facts. The facts are the same as in *Example 3*, except that X elects under section 108(b)(5) to reduce first the basis of its depreciable asset.

(ii) *Analysis.* As in *Example 3*, on the distribution of Y stock to X's creditors, under section 108(a)(1)(A), X is entitled to exclude from gross income the debt discharge amount of \$100,000. In addition, in Year 2, X has no taxable income or loss because its gross income is exactly offset by the depreciation deduction. As a result of the depreciation deduction, X's basis in the asset is reduced by \$10,000 to \$65,000. Pursuant to paragraph (c) of this section, the amount of X's net operating loss to which Y succeeds pursuant to section 381 and the basis of X's property transferred to Y must take into account the reductions required by section 108(b). As a result of the election under section 108(b)(5), X's basis in the asset is reduced by \$65,000 to \$0. In addition, X's net operating loss is reduced by \$35,000, the extent to which the amount excluded from income under section 108(a)(1)(A) does not reduce X's asset basis. Accordingly, as a result of the reorganization, Y succeeds to X's net operating loss in the amount of \$45,000 under section 381. Pursuant to section 361, X recognizes no gain or loss on the transfer of its property to Y. Pursuant to section 362(b), Y's basis in the asset acquired from X is \$0.

(e) *Effective date.* This section applies to discharges of indebtedness occurring after July 17, 2003.

Par. 3. Section 1.1017-1 is amended by adding paragraph (b)(4) to read as follows:

§1.1017-1 Basis reductions following a discharge of indebtedness.

* * * * *

(b) * * *

(4) For further guidance, see §1.1017-1T(b)(4).

* * * * *

Par. 4. Section 1.1017-1T is added to read as follows:

§1.1017-1T Basis reductions following a discharge of indebtedness (temporary).

(a) through (b)(3) [Reserved]. For further guidance, see §1.1017-1(a) through (b)(3).

(4) *Transactions to which section 381 applies.* In the case of a transaction described in section 381(a) that ends a taxable year in which the distributor or

transferor corporation excludes COD income from gross income under section 108(a), the basis of property acquired by the acquiring corporation in the transaction shall reflect the reductions required by section 1017 and this section. For this purpose, the basis of property of the distributor or transferor corporation immediately prior to the transaction described in section 381(a), but after the determination of tax for the year of the discharge, shall be available for reduction under section 108(b)(2). See §1.108-7T. This paragraph (b)(4) applies to discharges of indebtedness occurring after July 17, 2003.

(c) through (i) [Reserved]. For further guidance, see §1.1017-1(c) through (i).

Robert E. Wenzel,
*Deputy Commissioner for
Services and Enforcement.*

Approved July 9, 2003.

Pamela F. Olson,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on July 17, 2003, 8:45 a.m., and published in the issue of the Federal Register for July 18, 2003, 68 F.R. 42590)

Section 280G.—Golden Parachute Payments

26 CFR 280G-1: Golden parachute payments.

T.D. 9083

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Parts 1

Golden Parachute Payments

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to golden parachute payments under section 280G of the Internal Revenue Code. These regulations incorporate changes and clarifications to reflect comments received concerning the proposed regulations primarily concerning the small corporation exemption, prepayment of the excise tax, and the definition of change in ownership or control.

DATES: Effective Date: August 4, 2003. These regulations apply to any payment that is contingent on a change in ownership or control if the change in ownership or control occurs on or after January 1, 2004.

Comments on the collection of information in §1.280G-1, Q/A-7(a) should be received by October 3, 2003.

ADDRESSES: Comments on the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, W:CAR:MP:T:T:SP, Washington, DC 20224.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Erinn Madden at (202) 622-6030 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

PAPERWORK REDUCTION ACT

The collection of information in this final rule has been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget (OMB) under 44 U.S.C. 3507 and assigned control number 1545-1851.

The collection of information in this regulation is in §1.280G-1, Q/A-7(a). This information is a brief description of all material facts concerning all payments which would be parachute payments (but for §1.280G-1, Q/A-6). This information may be used by certain corporations with no readily tradeable stock (assuming certain shareholder approval requirements are also met) to determine if the payments to a disqualified individual are exempt from the definition of parachute payments. The collection of information is voluntary. The likely respondents are business or other for-profit institutions.

Comments on the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, W:CAR:MP:T:T:SP, Washington, DC

20224. Comments on the collection of information in §1.280G-1, Q/A-7(a) should be received by October 3, 2003. Comments are specifically requested concerning:

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

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

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

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

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

Estimated total annual reporting and/or recordkeeping burden: 12,000 hours.

Estimated average annual burden hours per respondent: 15 hours.

Estimated number of respondents and/or recordkeepers: 800

Estimated annual frequency of responses: On occasion.

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

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

Background

This document contains amendments to 26 CFR part 1 under section 280G of the Internal Revenue Code (Code). Sections 280G and 4999 of the Code were added to the Code by section 67 of the Deficit Reduction Act of 1984, Public Law 98-369 (98 Stat. 585). Section 280G was amended by section 1804(j) of the Tax Reform Act of 1986, Public Law 99-514 (100 Stat. 2807), section 1018(d) of the Technical

and Miscellaneous Revenue Act of 1988, Public Law 100-647 (102 Stat. 3581) and section 1421 of the Small Business Job Protection Act of 1996, Public Law 104-188 (110 Stat. 1755).

Section 280G denies a deduction to a corporation for any excess parachute payment. Section 4999 imposes a 20-percent excise tax on the recipient of any excess parachute payment. Related provisions include section 275(a)(6), which denies the recipient a deduction for the section 4999 excise tax, and section 3121(v)(2)(A), which relates to the Federal Insurance Contributions Act.

On February 20, 2002, a notice of proposed rulemaking (REG-209114-90, 2002-1 C.B. 576), was published in the **Federal Register** at 67 FR 7630 (the 2002 proposed regulations) and corrected in the **Federal Register** at 67 FR 42210 on June 21, 2002 (Ann. 2002-65, 2002-2 C.B. 182). No hearing was requested or held. The IRS received written and electronic comments responding to the notice of proposed rulemaking. After consideration of the comments, the 2002 proposed regulations are adopted as amended by this Treasury decision. The significant revisions are discussed below.

Explanation of Provisions and Summary of Comments

Overview

Section 280G(b)(2)(A) defines a *parachute payment* as any payment that meets all of the following four conditions: (a) the payment is in the nature of compensation; (b) the payment is to, or for the benefit of, a disqualified individual; (c) the payment is contingent on a change in the ownership of a corporation, the effective control of a corporation, or the ownership of a substantial portion of the assets of a corporation (a change in ownership or control); and (d) the payment has (together with other payments described in (a), (b), and (c) of this paragraph with respect to the same individual) an aggregate present value of at least 3 times the individual's base amount. Section 280G(b)(2)(B) provides that the term *parachute payment* also includes any payment in the nature of compensation to, or for the benefit of, a disqualified individual if the payment is pursuant to an agreement that violates

any generally enforced securities laws or regulations (securities violation parachute payment).

Section 280G(b)(1) defines the term *excess parachute payment* as an amount equal to the excess of any parachute payment over the portion of the disqualified individual's base amount that is allocated to such payment. For this purpose, the portion of the base amount allocated to a parachute payment is the amount that bears the same ratio to the base amount as the present value of the parachute payment bears to the aggregate present value of all such payments to the same disqualified individual.

Generally, excess parachute payments may be reduced by certain amounts of reasonable compensation. Section 280G(b)(4)(B) provides that, except in the case of securities violation parachute payments, the amount of an excess parachute payment is reduced by any portion of the payment that the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services actually rendered by the disqualified individual before the date of the change in ownership or control. Such reasonable compensation is first offset against the portion of the base amount allocated to the payment.

Exempt Payments

Section 280G specifically exempts from the definition of the term *parachute payment* several types of payments that would otherwise constitute parachute payments. Deductions for payments exempt from the definition of *parachute payment* are not disallowed by section 280G, and such exempt payments are not subject to the 20-percent excise tax of section 4999. In addition, such exempt payments are not taken into account in applying the 3-times-base-amount test of section 280G(b)(2)(A)(ii).

1. Tax-Exempt Entities

Q/A-6 of the 2002 proposed regulations provides that a payment with respect to a tax-exempt entity that would otherwise constitute a parachute payment is exempt from the definition of the term *parachute payment* if certain conditions are satisfied. First, the payment must

be made by a corporation undergoing a change in ownership or control that is a *tax-exempt organization*. As defined in the 2002 proposed regulations, a *tax-exempt organization* is any organization described in section 501(c) that is subject to any express statutory prohibition against inurement of net earnings to the benefit of any private shareholder or individual, an organization described in sections 501(c)(1) or 501(c)(21), any religious or apostolic organization described in section 501(d), or any qualified tuition program described in section 529. Second, the organization must meet the definition of *tax-exempt organization*, as defined in the 2002 proposed regulations, both immediately before and immediately after the change in ownership or control.

One commentator requested the elimination of the requirement that the payment must be made by a tax-exempt organization. Instead, the commentator suggested that the regulations require only that the payment be approved by the tax-exempt organization. The exemption included in Q/A-6 of the 2002 proposed regulations for certain tax-exempt entities described in section 501(c) is premised on the fact that those entities are subject to a statutory prohibition on private inurement. Requiring merely the approval of a tax-exempt organization would allow corporations not subject to the inurement prohibition to make the payments and, thus, to avoid the application of section 280G. Thus, these regulations retain the requirements contained in the 2002 proposed regulations.

2. Small Corporation Exemption

Under section 280G and the 2002 proposed regulations, the term *parachute payment* does not include any payment to a disqualified individual with respect to a corporation which (immediately before the change in ownership or control) was a small business corporation (as defined in section 1361(b) but without regard to section 1361(b)(1)(C) thereof). See also, Q/A-6(a)(1).

Commentators indicated that the 2002 proposed regulations do not clearly address whether a corporation that does not elect to be treated as an S Corporation, but could make the election (because aside from the election the corporation otherwise meets the requirements to be treated

as an S corporation), may use the exemption under Q/A-6(a)(1). These regulations clarify that a corporation that could elect to be treated as an S Corporation under the Code, but does not do so, may nevertheless use the exemption of Q/A-6(a)(1) for any payments to a disqualified individual.

In addition, commentators recommended that the final regulations provide that a corporation domiciled outside the United States can qualify for both the small business corporation exception and the shareholder approval exception. With respect to the small business corporation exception, Treasury and the IRS do not have the authority to expand this exception to include foreign corporations. Section 280G(b)(5)(A)(i) refers to "a small business corporation (as defined in section 1361(b) but without regard to paragraph (1)(C) thereof)." A small business corporation as defined in section 1361(b) must be a domestic corporation, and section 1361(b)(1)(C) merely addresses the existence of a nonresident alien as a shareholder. It is clear from the statute that the small business corporation exception cannot apply to a foreign corporation.

On the other hand, Treasury and the IRS believe that a foreign corporation may qualify for the shareholder approval exception, discussed below, if all of the applicable requirements are satisfied. Because the statute and regulations permit this result, it is not necessary to specify the treatment in the final regulations.

3. Shareholder Approval

Additionally, under section 280G and the 2002 proposed regulations, the term *parachute payment* does not include any payment to a disqualified individual with respect to a corporation if (i) immediately before the change in ownership or control, no stock in such corporation was readily tradeable on an established securities market or otherwise, and (ii) certain shareholder approval requirements are met.

Section 280G(b)(5)(B) provides that the shareholder approval requirements are met if two conditions are satisfied. First, the payment is approved by a vote of the persons who owned, immediately before the change in ownership or control, more than 75 percent of the voting power of all outstanding stock of the corporation. Second, there is adequate disclosure to

shareholders of all material facts concerning all payments which (but for this rule) would be parachute payments with respect to a disqualified individual.

Q/A-7(b) of the 2002 proposed regulations provides rules to determine the shareholders who are entitled to vote. In response to comments, Q/A-7(b)(1) is revised to clarify that only stock that would otherwise be entitled to vote is considered outstanding and is entitled to vote for purposes of Q/A-7(b). Thus, for example, because an individual who only holds options generally would not be entitled to vote, such individual will not be considered to hold outstanding stock entitled to vote for purposes of Q/A-7.

Q/A-7(b)(2) of the 2002 proposed regulations includes a rule of administrative convenience allowing the corporation to identify shareholders eligible to vote for this purpose using the shareholders of record at the time of any vote taken in connection with a transaction or event giving rise to the change in ownership or control within the three-month period ending on the date of the change in ownership or control.

Several commentators suggested that the final regulations permit corporations to determine the shareholders of record at any time during the three months prior to the change in ownership or control. Other commentators requested that the time be expanded in the final regulations. In response to these comments, these regulations expand this rule to allow corporations to determine the shareholders of record on any day during the six-month period ending on the date of the change in ownership or control, regardless of whether there was a vote on that day.

Q/A-7(b)(4) is revised to clarify that stock held (directly or indirectly) by a disqualified individual who would receive a parachute payment if the shareholder approval requirements of Q/A-7 are not met is not entitled to vote with respect to a payment to be made to any disqualified individual. For example, assume E is a disqualified individual with respect to Corporation X. E's base amount is \$100,000, and on a change in ownership or control of X, E will receive contingent payments of \$295,000. Corporation X undergoes a change in ownership or control. In determining the persons who are entitled to vote under Q/A-7(b), any stock held by E is

considered outstanding and E is entitled to vote. If E would receive contingent payments of \$305,000 on the change in ownership or control, any stock held by E is not considered outstanding and is not entitled to vote under Q/A-7 with respect to payments to any disqualified individual.

An entity shareholder is not entitled to vote stock that it holds that is constructively owned by a disqualified person who would receive a parachute payment if the shareholder approval requirements of Q/A-7 are not met. Additionally, these regulations provide in Q/A-7(b)(4) that if the person authorized to vote the stock of an entity shareholder is a disqualified individual who would receive a parachute payment if the requirements of Q/A-7 are not met, such person is not permitted to vote any of the shares held by the entity shareholder. However, the entity shareholder is permitted to authorize another equity interest holder in the entity shareholder to vote the otherwise eligible shares or, in the case of a trust, another person eligible to vote on behalf of the trust. Thus, for example, assume a partner owns one-third of a partnership; the partner is authorized to vote on behalf of the partnership; the partnership owns stock in a corporation; the partner is a disqualified individual with respect to the corporation; and the corporation undergoes a change in ownership or control. Under these circumstances, none of the stock held by the partnership is entitled to vote under Q/A-7. However, the partnership is permitted to appoint an equity interest holder in the entity shareholder (who is not a disqualified individual who would receive parachute payments if the shareholder approval requirements of Q/A-7 are not met) to vote two-thirds of the stock.

More generally, several commentators requested significant revisions to Q/A-7 to reflect certain business practices. The revisions suggested by commentators include, among other things, treating approval of a compensation agreement when the agreement is executed as sufficient for Q/A-7 or deeming shareholders who acquire stock after approval of any compensation agreements to consent to any parachute payments contained in these agreements. While the Treasury Department and IRS understand that the requirements of Q/A-7 may not coincide with certain business practices, the requirements of Q/A-7 are

based on the statutory framework provided by Congress. The golden parachute provisions are intended to protect equity shareholders whose interest in the corporation could be impaired by parachute payments to disqualified individuals by discouraging these types of payments. The basic structure of section 280G does not permit any approval or shareholder vote for a publicly traded corporation. The exception for corporations that are not publicly traded is based on a vote of those persons who hold shares immediately before the change in ownership or control after adequate disclosure. The suggested revisions to the shareholder approval requirements are inconsistent with these requirements and, accordingly, no changes are made in these regulations.

Payment of the Excise Tax under section 4999

Q/A-11(c) of the 2002 proposed regulations provided a mechanism to allow a disqualified individual to prepay the excise tax under section 4999 in certain circumstances. Thus, the requirements of section 4999 may be satisfied in the year of the change in ownership or control (or the first year for which a payment contingent on a change in ownership or control is certain to be made) even though the payment is not yet includible in income (or otherwise received).

These regulations continue to allow the prepayment of the excise tax in the year of the change in ownership or control. These regulations also provide that a taxpayer may prepay the excise tax in a later year. For purposes of prepayment, these regulations require the payor and disqualified individual to treat the payment of the excise tax consistently and require the payor to satisfy its obligations under section 4999. These regulations clarify that the prepayment of the excise tax is based on the present value of the excise tax that would be due in the year the excess parachute payment would actually be paid. For purposes of determining the present value of the excise tax due, the discount rate is determined in accordance with Q/A-32.

Thus, for example, assume that E is a disqualified individual with respect to Corporation X, that X undergoes a change in ownership or control, and that E receives parachute payments, including a series of

annual payments to be made for the next 10 years. Assume further that all other parachute payments to E are made in the year of the change in ownership or control (with payment of the excise tax and compliance by X with section 4999(c)). Under these regulations, if three years after a change in ownership or control, X and E agree that E will prepay the excise tax related to the remaining annual payments, and that X will satisfy its obligations under section 4999(c) related to these payments, E is permitted to prepay the excise tax with respect to the remaining payments.

The 2002 proposed regulations provided that the prepayment of the excise tax would not be available with respect to certain payments, including payments related to health benefits or coverage. Commenters requested that the prepayment option be expanded to include health benefits or coverage. Treasury and the IRS do not consider the available valuation methods sufficient to allow projections of individual payments related to health coverage or health benefits for this purpose. In the event that valuation methods change or there is otherwise greater certainty with respect to the valuation of such benefits, Treasury and the IRS may consider additional guidance that would make prepayment of the excise tax with respect to such benefits available.

Treatment of Options

Q/A-13 of the 2002 proposed regulations provides that the transfer of an option is treated as a payment when the option becomes substantially vested without regard to whether the option has an ascertainable fair market value under §1.83-7(b) of the regulations. Thus, the vesting of an option is treated as a payment in the nature of compensation for purposes of section 280G. Vested is defined in these regulations as substantially vested within the meaning of §1.83-3(b) and (j) or the right to the payment is not otherwise subject to a substantial risk of forfeiture within the meaning of section 83(c).

The 2002 proposed regulations, and the 1989 proposed regulations, provided that options must be valued under the facts and circumstances of a particular case. Factors relevant to the determination include, but are not limited to: the difference between the option's exercise price and the value

of the option property, the probability of the value of the option property increasing or decreasing, and the length of the period during which the option can be exercised.

In coordination with the issuance of the 2002 proposed regulations, the Commissioner issued two revenue procedures under section 280G providing additional guidance on the valuation of options, Rev. Proc. 2002-13, 2002-1 C.B. 549, and Rev. Proc. 2002-45, 2002-2 C.B. 40. These revenue procedures provide guidance on the use of option valuation methods, and provide that using only the spread between the exercise price and the value of the option property is not an adequate method for valuing an option. The revenue procedures also provide a safe harbor method of valuation based on a table. Comments received in response to these revenue procedures raised issues related to the difficulty of valuing options in the context of a change in ownership or control, particularly with respect to assumptions regarding the term of the option and the volatility. In coordination with the issuance of these regulations, the IRS is issuing a revenue procedure restating the previous revenue procedures and addressing these comments.

Disqualified Individuals

The 2002 proposed regulations provide that an individual is a disqualified individual if, at any time during the disqualified individual determination period, the individual is an employee or independent contractor of the corporation and is, with respect to the corporation, a shareholder (see Q/A-17), an officer (see Q/A-18), or a highly-compensated individual (see Q/A-19). The 2002 proposed regulations provide that whether an individual is an officer with respect to a corporation is determined based on all the facts and circumstances in the particular case (such as 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).

These regulations retain this rule concerning officers. However, under Q/A-18 of these regulations any individual who has the title of officer is presumed to be an officer unless the facts and circumstances

demonstrate that the individual does not have the authority of an officer. However, an individual who does not have the title of officer may nevertheless be considered an officer if the facts and circumstances demonstrate that the individual should be considered to be an officer.

Nonvested Payments under Q/A-24

Under Q/A-24(c) of the 2002 proposed regulations, only a portion of certain nonvested payments is treated as contingent on a change in ownership or control. Specifically, Q/A-24(c) applies to a payment that becomes vested as a result of a change in ownership or control to the extent that (i) without regard to the change in ownership or control, the payment was contingent only on the continued performance of services for the corporation for a specified period of time; and (ii) the payment is attributable, at least in part, to the performance of services before the date the payment is made or becomes certain to be made.

These regulations retain these rules regarding the calculation of the amount of the payment that is considered contingent on a change in ownership or control, with one revision. Under the 2002 proposed regulations, the payment calculation under Q/A-24(c) could not exceed the amount of the accelerated payment. A portion of a payment is contingent on a change in ownership or control if there is accelerated vesting, even if there is no accelerated payment. In that case, the amount attributable to the lapse of the obligation to perform services is 1 percent of the present value of the future payment multiplied by the number of full months between the date that the individual's right to receive the payment is vested and the date that, absent the acceleration, the payment would have been vested. Under these final regulations, the total portion of such payment treated as contingent on the change in ownership or control cannot exceed the present value of the accelerated payment.

Change in Ownership or Control

A change in ownership or control is defined in Q/A-27, 28, and 29 of the 2002 proposed regulations. Under Q/A-27 of

the 2002 proposed regulations, a change in control of a corporation occurs on the date that any one person (or persons acting as a group) acquires ownership or stock of the corporation that, together with stock held by such person or group, has more than 50 percent of the total fair market value or total voting power of the corporation.

Under Q/A-28 of the 2002 proposed regulations, a change in the effective control of a corporation is presumed to occur on the date that either (1) any one person (or more than one person acting as a group) acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition by such person or persons) ownership of stock of the corporation possessing 20 percent or more of the total voting power of the stock of such corporation, or (2) a majority of members of the corporation's board of directors is replaced during any 12-month period by directors whose appointment or election is not endorsed by a majority of the members of the corporation's board of directors prior to the date of the appointment or election.

Under Q/A-29 of the 2002 proposed regulations, a change in the ownership of a substantial portion of a corporation's assets occurs on the date that any one person (or more than one person acting as a group) acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition by such person) assets from the corporation that have a total gross fair market value equal to or more than one third of the total gross fair market value of all of the assets of the corporation immediately prior to such acquisition.

These regulations generally follow the same approach as the 2002 proposed regulations. Some commenters suggested that these three provisions explicitly address whether more than one change in ownership or control can occur in a single transaction. In response to these comments, these regulations explicitly adopt the "one change" rule that historically has been applied by the IRS. These regulations provide that if a corporation undergoes a change in ownership or control as described in either Q/A-27 or Q/A-29, the

other corporation involved in the transaction does not undergo a change in ownership or control.¹ As these regulations apply, in any transaction involving two corporations, if one has a change in ownership or control under Q/A-27 or 29, the other corporation does not also have a change in ownership or control, under either Q/A-27 or 29. Under these regulations, Q/A-28, which relates to effective control, provides that there is no change in effective control of a corporation in a transaction in which the other corporation has a change of control under Q/A-27 or 29.

Commentators also requested that the final regulations define gross fair market value for purposes of Q/A-29. Under Q/A-29 of these regulations, *gross fair market value* is defined as the value of the assets of the corporation, or the value of the assets being disposed of, determined without regard to any liabilities associated with such assets. This definition is used throughout these regulations.

For purposes of determining whether there is a change in ownership or control under Q/A-27 through Q/A-29 of the 2002 proposed regulations, two or more persons may be considered as acting as a group. The 2002 proposed regulations provide that, for purposes of determining whether two or more persons are acting as a group, a person who owns stock in both corporations involved in a transaction (an overlapping shareholder) is treated as acting as a group with respect to the other shareholders in a corporation only to the extent of such person's ownership of stock in that corporation prior to the transaction, and not with respect to his or her ownership in the other corporation. This rule is consistent with the interpretation of the 1989 proposed regulations by the IRS.

Commentators suggested different alternatives to the overlapping shareholder rule of Q/A-27 through Q/A-29 of the 2002 proposed regulations. One commentator suggested eliminating the overlapping shareholder rule and instead relying on the presumption of Q/A-28 for all transactions. Under this approach it would be possible for a transaction to result in one, two, or no change in ownership or control. Other commentators suggested replacing the overlapping

shareholder rule of the 2002 proposed regulations with a new rule based on section 355 or 382. Finally, another commentator requested clarification of the application of the overlapping shareholder rule of the 2002 proposed regulations under the 1989 proposed regulations.

These regulations retain the overlapping shareholder rule of the 2002 proposed regulations. The group concepts in section 355 or 382 do not fit well with the overall purpose of section 280G. Finally, these regulations are effective with respect to changes in ownership or control that occur after January 1, 2004, and to payments that are contingent on such changes. These regulations do not provide any transitional rules for the application of the overlapping shareholder rules for prior periods both because these regulations are not effective for prior periods and because the positions set forth in 2002 proposed regulations are merely clarifications of the positions taken by the IRS under section 280G (illustrated by the 1989 proposed regulations).

International Issues

Commentators recommended that the final regulations provide that a disqualified individual who, during the disqualified individual determination period, was a non-resident alien and was not subject to income tax in the United States on wages earned from the affiliated group, not be subject to the excise tax. Treasury and the IRS do not believe that they have the authority to preclude application of the excise tax to a nonresident alien under these circumstances. Accordingly, the final regulations do not include any special rules for excess parachute payments received by nonresident aliens.

Commentators also requested clarification that, even though parachute payments made by a foreign subsidiary of a U.S. corporation may not be deductible, such payments reduce the foreign subsidiary's earnings and profits. Because this issue has implications beyond section 280G and foreign subsidiaries, it is not addressed in these regulations.

Effective Date and Reliance

These regulations apply to any payments that are contingent on a change in ownership or control if the change in ownership or control occurs on or after January 1, 2004.

Under the 2002 proposed regulations, taxpayers are permitted to rely on the 2002 proposed regulations until January 1, 2004. Taxpayers are permitted to rely on the 1989 proposed regulations with respect to payments contingent on a change in ownership or control if that change occurs before January 1, 2004. A clarification in the 2002 proposed regulations does not support reliance on the 1989 proposed regulations for a position contrary to the provisions of the 2002 proposed regulations.

Taxpayers are permitted to rely on the 2002 proposed regulations, including for purposes of amended returns with respect to the following: (1) that a shareholder who owns stock with a fair market value of \$1 million is not a disqualified individual and (2) that the base amount includes the amount of compensation included in gross income under section 83(b).

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. Section 1.280G-1 of these proposed regulations provides for the collection of information. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that, as indicated in the Paperwork Reduction Act section earlier in the preamble, only 800 small entities are expected to be affected by the regulations annually, and it is unlikely that any small entity would be affected by these regulations more than once or twice in its existence. Therefore, an analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the

¹ Because Q/A-46 provides that all members of an affiliated group are treated as one corporation, even transactions involving multiple entities generally are treated as only two corporations for purposes of section 280G.

Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Erinn Madden, Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR is amended as follows:

PART I — INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1986.

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

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

Section 1.280G-1 also issued under 26 U.S.C. 280G (b) and (e). * * *

Par. 2. Section §1.280G-1 is added to read as follows:

§1.280G-1 Golden parachute payments.

The following questions and answers relate to the treatment of golden parachute payments under section 280G of the Internal Revenue Code of 1986, as added by section 67 of the Tax Reform Act of 1984 (Public Law No. 98-369; 98 Stat. 585) and amended by section 1804(j) of the Tax Reform Act of 1986 (Public Law No. 99-514; 100 Stat. 2807), section 1018(d)(6)-(8) of the Technical and Miscellaneous Revenue Act of 1988 (Public Law No. 100-647; 102 Stat. 3581), and section 1421 of the Small Business Job Protection Act of 1996 (Public Law No. 104-188; 110 Stat. 1755). The following is a table of contents of subjects in this section:

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Overview

Q-1: What is the effect of Internal Revenue Code section 280G?

A-1: (a) Section 280G disallows a deduction for any excess parachute payment paid or accrued. For rules relating to the imposition of a nondeductible 20-percent excise tax on the recipient of any excess parachute payment, see Internal Revenue Code sections 4999, 275(a)(6), and 3121(v)(2)(A).

(b) The disallowance of a deduction under section 280G is not contingent on the imposition of the excise tax under section 4999. The imposition of the excise tax under section 4999 is not contingent on the disallowance of a deduction under section 280G. Thus, for example, because the imposition of the excise tax under section 4999 is not contingent on the disallowance of a deduction under section 280G, a payee may be subject to the 20-percent excise tax under section 4999 even though the disallowance of the deduction for the excess parachute payment may not directly affect the federal taxable income of the payor.

Q-2: What is a parachute payment for purposes of section 280G?

A-2: (a) The term *parachute payment* means any payment (other than an exempt payment described in Q/A-5) that —

- (1) Is in the nature of compensation;
- (2) Is made or is to be made to (or for the benefit of) a disqualified individual;
- (3) Is contingent on a change —

- (i) In the ownership of a corporation;
 - (ii) In the effective control of a corporation; or
 - (iii) In the ownership of a substantial portion of the assets of a corporation; and
- (4) Has (together with other payments described in paragraphs (a)(1), (2), and (3) of this A-2 with respect to the same disqualified individual) an aggregate present value of at least 3 times the individual's base amount.

(b) Hereinafter, a change referred to in paragraph (a)(3) of this A-2 is generally referred to as a change in ownership or control. For a discussion of the application of paragraph (a)(1), see Q/A-11 through Q/A-14; paragraph (a)(2), Q/A-15 through Q/A-21; paragraph (a)(3), Q/A-22 through Q/A-29; and paragraph (a)(4), Q/A-30 through Q/A-36.

(c) The term *parachute payment* also includes any payment in the nature of compensation to (or for the benefit of) a disqualified individual that is pursuant to an agreement that violates a generally enforced securities law or regulation. This type of parachute payment is referred to in this section as a securities violation parachute payment. See Q/A-37 for the definition and treatment of securities violation parachute payments.

Q-3: What is an excess parachute payment for purposes of section 280G?

A-3: The term *excess parachute payment* means an amount equal to the excess of any parachute payment over the portion of the base amount allocated to such payment. Subject to certain exceptions and limitations, an excess parachute payment is reduced by any portion of the payment which the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services actually rendered by the disqualified individual before the date of the change in ownership or control. For a discussion of the nonreduction of a securities violation parachute payment by reasonable compensation, see Q/A-37. For a discussion of the computation of excess parachute payments and their reduction by reasonable compensation, see Q/A-38 through Q/A-44.

Q-4: What is the effective date of section 280G and this section?

A-4: In general, section 280G applies to payments under agreements entered into

or renewed after June 14, 1984. Section 280G also applies to certain payments under agreements entered into on or before June 14, 1984, and amended or supplemented in significant relevant respect after that date. This section applies to any payment that is contingent on a change in ownership or control and the change in ownership or control occurs on or after January 1, 2004. For a discussion of the application of the effective date, see Q/A-47 and Q/A-48.

Exempt Payments

Q-5: Are some types of payments exempt from the definition of the term *parachute payment*?

A-5: (a) Yes, the following five types of payments are exempt from the definition of *parachute payment* —

(1) Payments with respect to a small business corporation (described in Q/A-6 of this section);

(2) Certain payments with respect to a corporation no stock in which is readily tradeable on an established securities market (or otherwise) (described in Q/A-6 of this section);

(3) Payments to or from a qualified plan (described in Q/A-8 of this section);

(4) Certain payments made by a corporation undergoing a change in ownership or control that is described in any of the following sections of the Internal Revenue Code: section 501(c) (but only if such organization is subject to an express statutory prohibition against inurement of net earnings to the benefit of any private shareholder or individual, or if the organization is described in section 501(c)(1) or section 501(c)(21)), section 501(d), or section 529, collectively referred to as *tax-exempt organizations* (described in Q/A-6 of this section); and

(5) Certain payments of reasonable compensation for services to be rendered on or after the change in ownership or control (described in Q/A-9 of this section).

(b) Deductions for payments exempt from the definition of *parachute payment* are not disallowed by section 280G, and such exempt payments are not subject to the 20-percent excise tax of section 4999. In addition, such exempt payments are not taken into account in applying the 3-times-base-amount test of Q/A-30 of this section.

Q-6: Which payments with respect to a corporation referred to in paragraph (a)(1), (a)(2), or (a)(4) of Q/A-5 of this section are exempt from the definition of *parachute payment*?

A-6: (a) The term *parachute payment* does not include —

(1) Any payment to a disqualified individual with respect to a corporation which (immediately before the change in ownership or control) would qualify as a small business corporation (as defined in section 1361(b) but without regard to section 1361(b)(1)(C) thereof), without regard to whether the corporation had an election to be treated as a corporation under section 1361 in effect on the date of the change in ownership or control;

(2) Any payment to a disqualified individual with respect to a corporation (other than a small business corporation described in paragraph (a)(1) of this A-6) if —

(i) Immediately before the change in ownership or control, no stock in such corporation was readily tradeable on an established securities market or otherwise; and

(ii) The shareholder approval requirements described in Q/A-7 of this section are met with respect to such payment; or

(3) Any payment to a disqualified individual made by a corporation which is a tax-exempt organization (as defined in paragraph (a)(4) of Q/A-5 of this section), but only if the corporation meets the definition of a tax-exempt organization both immediately before and immediately after the change in ownership or control.

(b) For purposes of paragraph (a)(1) of this A-6, the members of an affiliated group are not treated as one corporation.

(c) The requirements of paragraph (a)(2)(i) of this A-6 are not met with respect to a corporation if a substantial portion of the assets of any entity consists (directly or indirectly) of stock in such corporation and any ownership interest in such entity is readily tradeable on an established securities market or otherwise. For this purpose, such stock constitutes a substantial portion of the assets of an entity if the total fair market value of the stock is equal to or exceeds one third of the total gross fair market value of all of the assets of the entity. For this purpose, *gross fair market value* means the value of the assets of the entity, determined

without regard to any liabilities associated with such assets. If a corporation is a member of an affiliated group (which group is treated as one corporation under A-46 of this section), the requirements of paragraph (a)(2)(i) of this A-6 are not met if any stock in any member of such group is readily tradeable on an established securities market or otherwise.

(d) For purposes of paragraph (a)(2)(i) of this A-6, the term *stock* does not include stock described in section 1504(a)(4) if the payment does not adversely affect the redemption and liquidation rights of any shareholder owning such stock.

(e) For purposes of paragraph (a)(2)(i) of this A-6, stock is treated as readily tradeable if it is regularly quoted by brokers or dealers making a market in such stock.

(f) For purposes of paragraph (a)(2)(i) of this A-6, the term *established securities market* means an established securities market as defined in §1.897-1(m).

(g) The following examples illustrate the application of this exemption:

Example 1. A small business corporation (within the meaning of paragraph (a)(1) of this A-6) operates two businesses. The corporation sells the assets of one of its businesses, and these assets represent a substantial portion of the assets of the corporation. Because of the sale, the corporation terminates its employment relationship with persons employed in the business the assets of which are sold. Several of these employees are highly-compensated individuals to whom the owners of the corporation make severance payments in excess of 3 times each employee's base amount. Since the corporation is a small business corporation immediately before the change in ownership or control, the payments are not parachute payments.

Example 2. Assume the same facts as in *Example 1*, except that the corporation is not a small business corporation within the meaning of paragraph (a)(1) of this A-6. If no stock in the corporation is readily tradeable on an established securities market (or otherwise) immediately before the change in ownership or control and the shareholder approval requirements described in Q/A-7 of this section are met, the payments are not parachute payments.

Example 3. Stock of Corporation S is owned by Corporation P, stock in which is readily tradeable on an established securities market. The Corporation S stock equals or exceeds one third of the total gross fair market value of the assets of Corporation P, and thus, represents a substantial portion of the assets of Corporation P. Corporation S makes severance payments to several of its highly-compensated individuals that are parachute payments under section 280G and Q/A-2 of this section. Because stock in Corporation P is readily tradeable on an established securities market, the payments are not exempt from the definition of *parachute payments* under this A-6.

Example 4. A is a corporation described in section 501(c)(3), and accordingly, its net earnings are prohibited from inuring to the benefit of any private shareholder or individual. A transfers substantially all of its assets to another corporation resulting in a change in ownership or control. Contingent on the change in ownership or control, A makes a payment that, but for the potential application of the exemption described in A-5(a)(4), would constitute a *parachute payment*. However, one or more aspects of the transaction that constitutes the change in ownership or control causes A to fail to be described in section 501(c)(3). Accordingly, A fails to meet the definition of a *tax-exempt organization* both immediately before and immediately after the change in ownership or control, as required by this A-6. As a result, the payment made by A that was contingent on the change in ownership or control is not exempt from the definition of *parachute payment* under this A-6.

Example 5. B is a corporation described in section 501(c)(15). B does not meet the definition of a *tax-exempt organization* because section 501(c)(15) does not expressly prohibit inurement of B's net earnings to the benefit of any private shareholder or individual. Accordingly, if B has a change in ownership or control and makes a payment that would otherwise meet the definition of a *parachute payment*, such payment is not exempt from the definition of the term *parachute payment* for purposes of this A-6.

Q-7: How are the shareholder approval requirements referred to in paragraph (a)(2)(ii) of Q/A-6 of this section met?

A-7: (a) *General rule.* The shareholder approval requirements referred to in paragraph (a)(2)(ii) of Q/A-6 of this section are met with respect to any payment if —

(1) Such payment is approved by more than 75 percent of the voting power of all outstanding stock of the corporation entitled to vote (as described in this A-7) immediately before the change in ownership or control; and

(2) Before the vote, there was adequate disclosure to all persons entitled to vote (as described in this A-7) of all material facts concerning all material payments which (but for Q/A-6 of this section) would be parachute payments with respect to a disqualified individual.

(b) *Voting requirements* — (1) *General rule.* The vote described in paragraph (a)(1) of this A-7 must determine the right of the disqualified individual to receive the payment, or, in the case of a payment made before the vote, the right of the disqualified individual to retain the payment. Except as otherwise provided in this A-7, the normal voting rules of the corporation are applicable. Thus, for example, an optionholder is generally not permitted to vote for purposes of this A-7. For purposes of this A-7, the vote can be on less than

the full amount of the payment(s) to be made. Shareholder approval can be a single vote on all payments to any one disqualified individual, or on all payments to more than one disqualified individual. The total payment(s) submitted for shareholder approval, however, must be separately approved by the shareholders. The requirements of this paragraph (b)(1) are not satisfied if approval of the change in ownership or control is contingent, or otherwise conditioned, on the approval of any payment to a disqualified individual that would be a parachute payment but for Q/A-6 of this section.

(2) *Special rule.* A vote to approve the payment does not fail to be a vote of the outstanding stock of the corporation entitled to vote immediately before the change in ownership or control merely because the determination of the shareholders entitled to vote on the payment is based on the shareholders of record as of any day within the six-month period immediately prior to and ending on date of the change in ownership or control, provided the disclosure requirements described in paragraph (c) of this A-7 are met.

(3) *Entity shareholder.* (i) Approval of a payment by any shareholder that is not an individual (an entity shareholder) generally must be made by the person authorized by the entity shareholder to approve the payment. See paragraph (b)(4) of this A-7 if the person so authorized by the entity shareholder is a disqualified individual who would receive a parachute payment if the shareholder approval requirements of this A-7 are not met.

(ii) However, if a substantial portion of the assets of an entity shareholder consists (directly or indirectly) of stock in the corporation undergoing the change in ownership or control, approval of the payment by that entity shareholder must be made by a separate vote of the persons who hold, immediately before the change in ownership or control, more than 75 percent of the voting power of the entity shareholder entitled to vote. The preceding sentence does not apply if the value of the stock of the corporation owned, directly or indirectly, by or for the entity shareholder does not exceed 1 percent of the total value of the outstanding stock of the corporation undergoing a change in ownership or control. Where approval of a payment by an entity shareholder must be made by a separate vote of

the owners of the entity shareholder, the normal voting rights of the entity shareholder determine which owners shall vote. For purposes of this (b)(3)(ii), stock represents a substantial portion of the assets of an entity shareholder if the total fair market value of the stock held by the entity shareholder in the corporation undergoing the change in ownership or control is equal to or exceeds one third of the total gross fair market value of all of the assets of the entity shareholder. For this purpose, *gross fair market value* means the value of the assets of the entity, determined without regard to any liabilities associated with such assets.

(4) *Disqualified individuals and attribution of stock ownership.* In determining the persons entitled to vote referred to in paragraph (a)(1) or (b)(3) of this A-7, stock that would otherwise be entitled to vote is not counted as outstanding stock and is not considered in determining whether the more than 75 percent vote has been obtained under this A-7 if the stock is actually owned or constructively owned under section 318(a) by or for a disqualified individual who receives (or is to receive) payments that would be parachute payments if the shareholder approval requirements described in paragraph (a) of this A-7 are not met. Likewise, stock is not counted as outstanding stock if the owner is considered under section 318(a) to own any part of the stock owned directly or indirectly by or for a disqualified individual described in the preceding sentence. In addition, if the person authorized to vote the stock of an entity shareholder is a disqualified individual who would receive a parachute payment if the shareholder approval requirements described in this A-7 are not met, such person is not permitted to vote such shares, but the entity shareholder is permitted to appoint an equity interest holder in the entity shareholder, or in the case of a trust another person eligible to vote on behalf of the trust, to vote the otherwise eligible shares. However, if all persons who hold voting power in the corporation undergoing the change in ownership or control are disqualified individuals or related persons described in this paragraph (b)(4), then such stock is counted as outstanding stock and votes by such persons are considered in determining whether the more than 75 percent vote has been obtained.

(c) *Adequate disclosure.* To be adequate disclosure for purposes of paragraph (a)(2) of this A-7, disclosure must be full and truthful disclosure of the material facts and such additional information as is necessary to make the disclosure not materially misleading at the time the disclosure is made. Disclosure of such information must be made to every shareholder of the corporation entitled to vote under this A-7. For each disqualified individual, material facts that must be disclosed include, but are not limited to, the event triggering the payment or payments, the total amount of the payments that would be parachute payments if the shareholder approval requirements described in paragraph (a) of this A-7 are not met, and a brief description of each payment (e.g., accelerated vesting of options, bonus, or salary). An omitted fact is considered a material fact if there is a substantial likelihood that a reasonable shareholder would consider it important.

(d) *Corporation without shareholders.* If a corporation does not have shareholders, the exemption described in Q/A-6(a)(2) of this section and the shareholder approval requirements described in this A-7 do not apply. Solely for purposes of this paragraph (d), a shareholder does not include a member in an association, joint stock company, or insurance company.

(e) *Examples.* The following examples illustrate the application of this A-7:

Example 1. Corporation S has two shareholders — Corporation P, which owns 76 percent of the stock of Corporation S, and A, a disqualified individual who would receive a parachute payment if the shareholder approval requirements of this A-7 are not met. No stock of Corporation P or S is readily tradeable on an established securities market (or otherwise). The value of the stock of Corporation S equals or exceeds one third of the gross fair market value of the assets of Corporation P, and thus, represents a substantial portion of the assets of Corporation P. All of the stock of Corporation S is sold to Corporation M. Contingent on the change in ownership of Corporation S, severance payments are made to certain officers of Corporation S in excess of 3 times each officer's base amount. If the payments are approved by a separate vote of the persons who hold, immediately before the sale, more than 75 percent of the voting power of the outstanding stock entitled to vote of Corporation P and the disclosure rules of paragraph (a)(2) of this A-7 are complied with, the shareholder approval requirements of this A-7 are met, and the payments are exempt from the definition of *parachute payment* pursuant to A-6 of this section.

Example 2. (i) Stock of Corporation X, none of which is traded on an established market, is acquired by Corporation Y. In the voting ballot concerning the

sale, the Corporation X shareholders are asked to vote either "yes" on the sale and "yes" to paying parachute payments to A, a disqualified individual with respect to Corporation A, or "no" on the sale and "no" to paying parachute payments to A.

(ii) Because the approval of the change in ownership or control is conditioned on the approval of the payments to A, the shareholder approval requirements of this A-7 are not satisfied. If the payments are made to A, the payments are not exempt from the definition of *parachute payment* pursuant to Q/A-6 of this section.

(iii) Assume the same facts as in paragraph (i) of this *Example 2*, except that the acquisition agreement between Corporation X and Corporation Y states that the acquisition is approved only if there are no parachute payments made to A. If the shareholder approval and the disclosure requirements described in this A-7 are met, the payments will not be parachute payments. Alternatively, if the shareholders do not approve the payments, the payments can not be made (or retained). Thus, the transaction is not conditioned on the approval of the parachute payments. If the payments are made and the requirements of this A-7 are met, the payments are exempt from the definition of *parachute payment* pursuant to Q/A-6 of this section.

Example 3. Corporation M is wholly owned by Partnership P. No interest in either M or P is readily tradeable on an established securities market (or otherwise). The value of the stock of Corporation M equals or exceeds one third of the gross fair market value of the assets of Partnership P, and thus, represents a substantial portion of the assets of Partnership P. Corporation M undergoes a change in ownership or control. Partnership P has one general partner and 200 limited partners. The general partner is not a disqualified individual. None of the limited partners are entitled to vote on issues involving the management of the partnership investments. If the payments that would be parachute payments if the shareholder approval requirements of this A-7 are not met are approved by the general partner and the disclosure rules of paragraph (a)(2) of this A-7 are complied with, the shareholder approval requirements of this A-7 are met, and the payments are exempt from the definition of *parachute payment* pursuant to A-6 of this section.

Example 4. Corporation A has several shareholders including X and Y, who are disqualified individuals with respect to Corporation A and would receive parachute payments if the shareholder approval requirements of this A-7 are not met. No stock of Corporation A is readily tradeable on an established securities market (or otherwise). Corporation A undergoes a change in ownership or control. Contingent on the change in ownership or control, severance payments are payable to X and Y that are in excess of 3 times each individual's base amount. To determine whether the shareholder approval requirements of paragraph (a)(1) of this A-7 are satisfied regarding the payments to X and Y, the stock of X and Y is not considered outstanding, and X and Y are not entitled to vote.

Example 5. Assume the same facts as in *Example 4*, except that after adequate disclosure of all material facts (within the meaning of paragraph (a)(2) of this A-7) to all shareholders entitled to vote, 60 percent of the shareholders who are entitled to vote approve the payments to X and Y. Because more than 75 percent

of the shareholders holding outstanding stock who were entitled to vote did not approve the payments to X and Y, the payments cannot be made.

Example 6. Assume the same facts as in *Example 4* except that disclosure of all the material facts (within the meaning of paragraph (a)(2) of this A-7) regarding the payments to X and Y is made to two of Corporation A's shareholders, who collectively own 80 percent of Corporation A's stock entitled to vote and approve the payment. Both shareholders approve the payments. Assume further that no adequate disclosure of the material facts regarding the payments to X and Y is made to other Corporation A shareholders who are entitled to vote within the meaning of this A-7. Notwithstanding that 80 percent of the shareholders entitled to vote approve the payments, because disclosure regarding the payments to X and Y is not made to all of Corporation A's shareholders who were entitled to vote, the disclosure requirements of paragraph (a)(2) of this A-7 are not met, and the payments are not exempt from the definition of *parachute payment* pursuant to Q/A-6.

Example 7. Corporation C has three shareholders – Partnership, which owns 20 percent of the stock of Corporation C; A, an individual who owns 60 percent of the stock of Corporation C; and B, an individual who owns 20 percent of Corporation C. Stock of Corporation C does not represent a substantial portion of the assets of Partnership. No interest in either Partnership or Corporation C is readily tradeable on an established securities market (or otherwise). P, a one-third partner in Partnership, is a disqualified individual with respect to Corporation C. Corporation C undergoes a change in ownership or control. Contingent on the change, a severance payment is payable to P in excess of 3 times P's base amount. To determine the persons who are entitled to vote referred to in paragraph (a)(1) of this A-7, one-third of the stock held by Partnership is not considered outstanding stock. If P is the person authorized by Partnership to approve the payment, none of the shares of Partnership are considered outstanding stock. However, Partnership is permitted to appoint an equity interest holder in Partnership (who is not a disqualified individual who would receive a parachute payment if the requirements of this A-7 are not met), to vote the two-thirds of the shares held by Partnership that are otherwise entitled to be voted.

Example 8. X, Y, and Z are all employees and disqualified individuals with respect to Corporation E. No stock in Corporation E is readily tradeable on an established securities market (or otherwise). Each individual has a base amount of \$100,000. Corporation E undergoes a change in ownership or control. Contingent on the change, a severance payment of \$400,000 is payable to X; \$600,000 is payable to Y; and \$1,000,000 is payable to Z. Corporation E provides each Corporation E shareholder entitled to vote (as determined under this A-7) with a ballot listing and describing the payments of \$400,000 to X; \$600,000 to Y; and \$1,000,000 to Z and the triggering event that generated the payments. Next to each name and corresponding amount on the ballot, Corporation E requests approval (with a "yes" and "no" box) of each total payment to be made to each individual and states that if the payment is not approved the payment will not be made. Adequate disclosure, within the meaning of this A-7 is made to each shareholder entitled to vote under this A-7. More than 75

percent of the Corporation E shareholders who are entitled to vote under paragraph (a)(1) of this A-7 approve each payment to each individual. The shareholder approval requirements of this A-7 are met, and the payments are exempt from the definition of *parachute payment* pursuant to A-6 of this section.

Example 9. Assume the same facts as in *Example 8* except that the ballot does not request approval of each total payment to each individual separately. Instead, the ballot states that \$2,000,000 in payments will be made to X, Y, and Z and requests approval of the \$2,000,000 payments. Assuming the triggering event and amount of the payments to X, Y, and Z are separately described to the shareholders entitled to vote under this A-7, the shareholder approval requirements of paragraph (a)(1) of this A-7 are met, and the payments are exempt from the definition of *parachute payment* pursuant to A-6 of this section.

Example 10. B, an employee of Corporation X, is a disqualified individual with respect to Corporation X. Stock of Corporation X is not readily tradeable on an established securities market (or otherwise). Corporation X undergoes a change in ownership or control. B's base amount is \$205,000. Under B's employment agreement with Corporation X, in the event of a change in ownership or control, B's stock options will vest and B will receive severance and bonus payments. Contingent on the change in ownership or control, B's stock options with a fair market value of \$500,000 immediately vest, \$200,000 of which is contingent on the change, and B will receive a \$200,000 bonus payment and a \$400,000 severance payment. Corporation X distributes a ballot to every shareholder of Corporation X who immediately before the change is entitled to vote as described in this A-7. The ballot contains adequate disclosure of all material facts and lists the following payments to be made to B: the contingent payment of \$200,000 attributable to options, a \$200,000 bonus payment, and a \$400,000 severance payment. The ballot requests shareholder approval of the \$200,000 bonus payment to B and states that whether or not the \$200,000 bonus payment is approved, B will receive \$200,000 attributable to options and a \$400,000 severance payment. More than 75 percent of the shareholders entitled to vote as described by this A-7 approve the \$200,000 bonus payment to B. The shareholder approval requirements of this A-7 are met, and the \$200,000 payment is exempt from the definition of *parachute payment* pursuant to A-6 of this section.

Q-8: Which payments under a qualified plan are exempt from the definition of *parachute payment*?

A-8: The term *parachute payment* does not include any payment to or from —

(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 simplified employee pension (as defined in section 408(k)); or

(d) A simple retirement account (as defined in section 408(p)).

Q-9: Which payments of reasonable compensation are exempt from the definition of *parachute payment*?

A-9: Except in the case of securities violation parachute payments, the term *parachute payment* does not include any payment (or portion thereof) which the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services to be rendered by the disqualified individual on or after the date of the change in ownership or control. See Q/A-37 of this section for the definition and treatment of securities violation parachute payments. See Q/A-40 through Q/A-44 of this section for rules on determining amounts of reasonable compensation.

Payor of Parachute Payments

Q-10: Who may be the payor of parachute payments?

A-10: Parachute payments within the meaning of Q/A-2 of this section may be paid, directly or indirectly, by—

(i) The corporation referred to in paragraph (a)(3) of Q/A-2 of this section;

(ii) A person acquiring ownership or effective control of that corporation or ownership of a substantial portion of that corporation's assets; or

(iii) Any person whose relationship to such corporation or other person is such as to require attribution of stock ownership between the parties under section 318(a).

Payments in the Nature of Compensation

Q-11: What types of payments are in the nature of compensation?

A-11: (a) *General rule.* For purposes of this section, all payments — in whatever form — are payments in the nature of compensation if they arise out of an employment relationship or are associated with the performance of services. For this purpose, the performance of services includes holding oneself out as available to perform services and refraining from performing services (such as under a covenant not to compete or similar arrangement). Payments in the nature of compensation include (but are not limited to) wages and salary, bonuses, severance pay, fringe benefits, life insurance, pension benefits, and other deferred compensation (including any amount characterized by the parties as interest thereon). A payment in the

nature of compensation also includes cash when paid, the value of the right to receive cash (including the value of accelerated vesting under Q/A-24(c)), or a transfer of property. However, payments in the nature of compensation do not include attorney's fees or court costs paid or incurred in connection with the payment of any amount described in paragraphs (a)(1), (2), and (3) of Q/A-2 of this section or a reasonable rate of interest accrued on any amount during the period the parties contest whether a payment will be made.

(b) *When payment is considered to be made.* Except as otherwise provided in A-11 through Q/A-13 of this section, a payment in the nature of compensation is considered made (and is subject to the excise tax under section 4999) in the taxable year in which it is includible in the disqualified individual's gross income or, in the case of fringe benefits and other benefits excludible from income, in the taxable year the benefits are received.

(c) *Prepayment rule.* Notwithstanding the general rule described in paragraph (b) of this A-11, a disqualified individual may, in the year of the change in ownership or control, or any later year, prepay the excise tax under section 4999, provided that the payor and disqualified individual treat the payment of the excise tax consistently and the payor satisfies its obligations under section 4999(c) in the year of prepayment. The prepayment of the excise tax for purposes of section 4999 must be based on the present value of the excise tax that would be due in the year the excess parachute payment would actually be paid (calculated using the discount rate equal to 120 percent of the applicable federal rate (determined under section 1274(d) and regulations thereunder; see Q/A-32)). For purposes of projecting the future value of a payment that provides for interest to be credited at a variable interest rate, it is permissible to make a reasonable assumption regarding this variable rate. A disqualified individual is not required to adjust the excise tax paid under this paragraph (c) merely because the interest rates in the future are not the same as the rate used for purposes of projecting the future value of the payment. However, a disqualified individual may not apply this paragraph (c) of this A-11 to a payment to be made in cash if the present value of the

payment would be considered not reasonably ascertainable under section 3121(v) and §31.3121(v)(2)-1(e)(4) of this Chapter or to a payment related to health benefits or coverage. The Commissioner may provide additional guidance regarding the applicability of this paragraph (c) to certain payments in published guidance of general applicability under §601.601(d)(2) of this Chapter.

(d) *Transfers of property.* Transfers of property are treated as payments for purposes of this A-11. See Q/A-12 of this section for rules on determining when such payments are considered made and the amount of such payments. See Q/A-13 of this section for special rules on transfers of stock options.

(e) The following example illustrates the principles of this A-11:

Example. D is a disqualified individual with respect to Corporation X. D has a base amount of \$100,000 and is entitled to receive two parachute payments, one of \$200,000 and the other of \$400,000. A change in ownership or control of Corporation X occurs on May 1, 2005, and the \$200,000 payment is made to D at the time of the change in ownership or control. The \$400,000 payment is to be made on October 1, 2010. Corporation X and D agree that D will prepay the excise tax and X will satisfy its obligations under section 4999(c) with respect to the \$400,000 payment. Using discount rate determined under Q/A-32, Corporation X and D determine that the present value of the \$400,000 payment is \$300,000 on the date of the change in ownership or control. The portions of the base amount allocated to these payments are \$40,000 ($(\$200,000/\$500,000) \times \$100,000$) and \$60,000 ($(\$300,000/\$500,000) \times \$100,000$), respectively. Thus, the amount of the first excess parachute payment is \$160,000 ($\$200,000 - \$40,000$) and that of the second excess parachute payment is \$340,000 ($\$400,000 - \$60,000$). The excise tax on the \$400,000 payment is \$68,000 ($\$340,000 \times 20$ percent). Assume the present value (calculated in accordance with paragraph (c) of this A-11) of \$68,000 is \$50,000. To prepay the excise tax due on the \$400,000 payment, Corporation X must satisfy its obligations under section 4999 with respect to the \$50,000, in addition to the \$32,000 withholding required with respect to the \$200,000 payment.

Q-12: If a property transfer to a disqualified individual is a payment in the nature of compensation, when is the payment considered made (or to be made), and how is the amount of the payment determined?

A-12: (a) Except as provided in this A-12 and Q/A-13 of this section, a transfer of property is considered a payment made (or to be made) in the taxable year in which the property transferred is includible in the gross income of the disqualified individual under section 83 and the

regulations thereunder. Thus, in general, such a payment is considered made (or to be made) when the property is transferred (as defined in §1.83-3(a)) to the disqualified individual and becomes substantially vested (as defined in §1.83-3(b) and (j)) in such individual. The amount of the payment is determined under section 83 and the regulations thereunder. Thus, in general, the amount of the payment is equal to the excess of the fair market value of the transferred property (determined without regard to any lapse restriction, as defined in §1.83-3(i)) at the time that the property becomes substantially vested, over the amount (if any) paid for the property.

(b) An election made by a disqualified individual under section 83(b) with respect to transferred property will not apply for purposes of this A-12. Thus, even if such an election is made with respect to a property transfer that is a payment in the nature of compensation, for purposes of this section, the payment is generally considered made (or to be made) when the property is transferred to and becomes substantially vested in such individual.

(c) See Q/A-13 of this section for rules on applying this A-12 to transfers of stock options.

(d) The following example illustrates the principles of this A-12:

Example. On January 1, 2006, Corporation M gives to A, a disqualified individual, a bonus of 100 shares of Corporation M stock in connection with the performance of services to Corporation M. Under the terms of the bonus arrangement A is obligated to return the Corporation M stock to Corporation M unless the earnings of Corporation M double by January 1, 2009, or there is a change in ownership or control of Corporation M before that date. A's rights in the stock are treated as substantially nonvested (within the meaning of §1.83-3(b)) during that period because A's rights in the stock are subject to a substantial risk of forfeiture (within the meaning of §1.83-3(c)) and are nontransferable (within the meaning of §1.83-3(d)). On January 1, 2008, a change in ownership or control of Corporation M occurs. On that day, the fair market value of the Corporation M stock is \$250 per share. Because A's rights in the Corporation M stock become substantially vested (within the meaning of §1.83-3(b)) on that day, the payment is considered made on that day, and the amount of the payment for purposes of this section is equal to \$25,000 ($100 \times \250). See Q/A-38 through 41 for rules relating to the reduction of the excess parachute payment by the portion of the payment which is established to be reasonable compensation for personal services actually rendered before the date of a change in ownership or control.

Q-13: How are transfers of statutory and nonstatutory stock options treated?

A-13: (a) For purposes of this section, an option (including an option to which section 421 applies) is treated as property that is transferred when the option becomes vested (regardless of whether the option has a readily ascertainable fair market value as defined in §1.83-7(b)). For purposes of this A-13, *vested* means substantially vested within the meaning of §1.83-3(b) and (j) or the right to the payment is not otherwise subject to a substantial risk of forfeiture within the meaning of section 83(c). Thus, for purposes of this section, the vesting of such an option is treated as a payment in the nature of compensation. The value of an option at the time the option vests is determined under all the facts and circumstances in the particular case. Factors relevant to such a determination include, but are not limited to: the difference between the option's exercise price and the value of the property subject to the option at the time of vesting; the probability of the value of such property increasing or decreasing; and the length of the period during which the option can be exercised. Thus, an option is treated as a payment in the nature of compensation on the date of grant or vesting, as applicable, without regard to whether such option has an ascertainable fair market value. For purposes of this A-13, valuation may be determined by any method prescribed by the Commissioner in published guidance of general applicability under §601.601(d)(2) of this Chapter.

(b) Any money or other property transferred to the disqualified individual on the exercise, or as consideration on the sale or other disposition, of an option described in paragraph (a) of this A-13 after the time such option vests is not treated as a payment in the nature of compensation to the disqualified individual under Q/A-11 of this section. Nonetheless, the amount of the otherwise allowable deduction under section 162 or 212 with respect to such transfer is reduced by the amount of the payment described in paragraph (a) of this A-13 treated as an excess parachute payment.

Q-14: Are payments in the nature of compensation reduced by consideration paid by the disqualified individual?

A-14: Yes, to the extent not otherwise taken into account under Q/A-12 and

Q/A-13 of this section, the amount of any payment in the nature of compensation is reduced by the amount of any money or the fair market value of any property (owned by the disqualified individual without restriction) that is (or will be) transferred by the disqualified individual in exchange for the payment. For purposes of the preceding sentence, the fair market value of property is determined as of the date the property is transferred by the disqualified individual.

Disqualified Individuals

Q-15: Who is a disqualified individual?

A-15: (a) For purposes of this section, an individual is a disqualified individual with respect to a corporation if, at any time during the *disqualified individual determination period* (as defined in Q/A-20 of this section), the individual is an employee or independent contractor of the corporation and is, with respect to the corporation —

(1) A shareholder (but see Q/A-17 of this section);

(2) An officer (see Q/A-18 of this section); or

(3) A highly-compensated individual (see Q/A-19 of this section).

(b) For purposes of this A-15, a director is a disqualified individual with respect to a corporation if, at any time during the *disqualified individual determination period*, the director is, with respect to the corporation, a shareholder (see Q/A-17 of this section), an officer (see Q/A-18 of this section), or a highly-compensated individual (see Q/A-19 of this section).

(c) For purposes of this A-15, an individual who is an employee or independent contractor of a corporation other than the corporation undergoing a change in ownership or control is disregarded for purposes of determining who is a disqualified individual if such individual is employed by the corporation undergoing the change in ownership or control only on the last day of the disqualified individual determination period. Thus, for example, assume that E is an employee of Corporation X, that Y is acquired by Corporation X, and that Y undergoes a change in ownership or control. If E becomes an employee of Y on the date of the acquisition, in determining the disqualified individuals with respect to Y, E is disregarded under this paragraph (c).

Q-16: Is a personal service corporation treated as an individual?

A-16: (a) Yes. For purposes of this section, a personal service corporation (as defined in section 269A(b)(1)), or a noncorporate entity that would be a personal service corporation if it were a corporation, is treated as an individual.

(b) The following example illustrates the principles of this A-16:

Example. Corporation N, a personal service corporation (as defined in section 269A(b)(1)), has a single individual as its sole shareholder and employee. Corporation N performs personal services for Corporation M. The compensation paid to Corporation N by Corporation M puts Corporation N within the group of highly-compensated individuals of Corporation M as determined under A-19 of this section. Thus, Corporation N is treated as a highly-compensated individual with respect to Corporation M.

Q-17: Are all shareholders of a corporation considered shareholders for purposes of paragraphs (a)(1) and (b) of Q/A-15 of this section?

A-17: (a) No. Only an individual who owns stock of a corporation with a fair market value that exceeds 1 percent of the fair market value of the outstanding shares of all classes of the corporation's stock is treated as a disqualified individual with respect to the corporation by reason of stock ownership. An individual who owns a lesser amount of stock may, however, be a disqualified individual with respect to the corporation if such individual is an officer (see Q/A-18) or highly-compensated individual (see Q/A-19) with respect to the corporation.

(b) For purposes of determining the amount of stock owned by an individual for purposes of paragraph (a) of this A-17, the constructive ownership rules of section 318(a) apply. Stock underlying a vested option is considered owned by an individual who holds the vested option (and the stock underlying an unvested option is not considered owned by an individual who holds the unvested option). For purposes of the preceding sentence, however, if the option is exercisable for stock that is not substantially vested (as defined by §§1.83-3(b) and (j)), the stock underlying the option is not treated as owned by the individual who holds the option. Solely for purposes of determining the amount of stock owned by an individual for purposes of this A-17, mutual and cooperative corporations are treated as having stock.

(c) The following examples illustrates the principles of this A-17:

Example 1. E, an employee of Corporation A, received options under Corporation A's Stock Option Plan. E's stock options vest three years after the date of grant. E is not an officer or highly compensated individual during the disqualified individual determination period. E does not own, and is not considered to own under section 318, any other Corporation A stock. Two years after the options are granted to E, all of Corporation A's stock is acquired by Corporation B. Under Corporation A's Stock Option Plan, E's options are converted to Corporation B options and the vesting schedule remains the same. Under paragraph (b) of this A-17, the stock underlying the unvested options held by E on the date of the change in ownership or control is not considered owned by E. Because E is not considered to own Corporation A stock with a fair market value exceeding 1 percent of the total fair market value of all of the outstanding shares of all classes of Corporation A and E is not an officer or highly-compensated individual during the disqualified individual determination period, E is not a disqualified individual within the meaning of Q&A-15 of this section with respect to Corporation A.

Example 2. Assume the same facts as in *Example 1*, except that Corporation A's Stock Option Plan provides that all unvested options will vest immediately on a change in ownership or control. Under paragraph (b) of this A-17, the stock underlying the options that vest on the change in ownership or control is considered owned by E. If the stock considered owned by E exceeds 1 percent of the total fair market value of all of the outstanding shares of all classes of Corporation A stock (including for this purpose, all stock owned or constructively owned by all shareholders, provided that no share of stock is counted more than once), E is a disqualified individual within the meaning of Q/A-15 of this section with respect to Corporation A.

Example 3. Assume the same facts as in *Example 1* except that E received nonstatutory stock options that are exercisable for stock subject to a substantial risk of forfeiture under section 83. Assume further that under Corporation A's Stock Option Plan, the nonstatutory options will vest on a change in ownership or control. Under paragraph (b) of this A-17, E is not considered to own the stock underlying the options that vest on the change in ownership or control because the options are exercisable for stock subject to a substantial risk of forfeiture within the meaning of section 83. Because E is not considered to own Corporation A stock with a fair market value exceeding 1 percent of the total fair market value of all of the outstanding shares of all classes of Corporation A stock and E is not an officer or highly compensated individual during the disqualified individual determination period, E is not a disqualified individual within the meaning of Q/A-15 of this section with respect to Corporation A.

Q-18: Who is an officer?

A-18: (a) For purposes of this section, whether an individual is an officer with respect to a corporation is determined on the basis of all the facts and circumstances in the particular case (such as 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). Any individual who has the title of officer is presumed to be an officer unless the facts and circumstances demonstrate that the individual does not have the authority of an officer. However, an individual who does not have the title of officer may nevertheless be considered an officer if the facts and circumstances demonstrate that the individual has the authority of an officer. Generally, the term officer means an administrative executive who is in regular and continued service. The term officer implies continuity of service and excludes those employed for a special and single transaction.

(b) An individual who is an officer with respect to any member of an affiliated group that is treated as one corporation pursuant to Q/A-46 of this section is treated as an officer of such one corporation.

(c) No more than 50 employees (or, if less, the greater of 3 employees, or 10 percent of the employees (rounded up to the nearest integer)) of the corporation (in the case of an affiliated group treated as one corporation, each member of the affiliated group) are treated as disqualified individuals with respect to a corporation by reason of being an officer of the corporation. For purposes of the preceding sentence, the number of employees of the corporation is the greatest number of employees the corporation has during the disqualified individual determination period (as defined in Q/A-20 of this section). If the number of officers of the corporation exceeds the number of employees who may be treated as officers under the first sentence of this paragraph (c), then the employees who are treated as officers for purposes of this section are the highest paid 50 employees (or, if less, the greater of 3 employees, or 10 percent of the employees (rounded up to the nearest integer)) of the corporation when ranked on the basis of compensation (as determined under Q/A-21 of this section) paid during the disqualified individual determination period.

(d) In determining the total number of employees of a corporation for purposes of this A-18, employees are not counted if they normally work less than 17½ hours per week (as defined in section 414(q)(5)(B) and the regulations thereunder) or if they normally work during

not more than 6 months during any year (as defined in section 414(q)(5)(C) and the regulations thereunder). However, an employee who is not counted for purposes of the preceding sentence may still be an officer.

Q-19: Who is a highly-compensated individual?

A-19: (a) For purposes of this section, a highly-compensated individual with respect to a corporation is any individual who is, or would be if the individual were an employee, a member of the group consisting of the lesser of the highest paid 1 percent of the employees of the corporation (rounded up to the nearest integer), or the highest paid 250 employees of the corporation, when ranked on the basis of compensation (as determined under Q/A-21 of this section) earned during the disqualified individual determination period (as defined in Q/A-20 of this section). For purposes of the preceding sentence, the number of employees of the corporation is the greatest number of employees the corporation has during the disqualified individual determination period (as defined in Q/A-20 of this section). However, no individual whose annualized compensation during the disqualified individual determination period is less than the amount described in section 414(q)(1)(B)(i) for the year in which the change in ownership or control occurs will be treated as a highly-compensated individual.

(b) An individual who is not an employee of the corporation is not treated as a highly-compensated individual with respect to the corporation on account of compensation received for performing services (such as brokerage, legal, or investment banking services) in connection with a change in ownership or control of the corporation, if the services are performed in the ordinary course of the individual's trade or business and the individual performs similar services for a significant number of clients unrelated to the corporation.

(c) The total number of employees of a corporation for purposes of this A-19 is determined in accordance with Q/A-18(d) of this section. However, an employee who is not counted for purposes of the preceding sentence may still be a highly-compensated individual.

Q-20: What is the disqualified individual determination period?

A-20: The disqualified individual termination period is the twelve-month period prior to and ending on the date of the change in ownership or control of the corporation.

Q-21: How is *compensation* defined for purposes of determining who is a disqualified individual?

A-21: (a) For purposes of determining who is a disqualified individual, the term *compensation* means the compensation which was earned by the individual for services performed for the corporation with respect to which the change in ownership or control occurs (changed corporation), for a predecessor entity, or for a related entity. Such compensation is determined without regard to sections 125, 132(f)(4), 402(e)(3), and 402(h)(1)(B). Thus, for example, compensation includes elective or salary reduction contributions to a cafeteria plan, cash or deferred arrangement or tax-sheltered annuity, and amounts credited under a nonqualified deferred compensation plan.

(b) For purposes of this A-21, a predecessor entity is any entity which, as a result of a merger, consolidation, purchase or acquisition of property or stock, corporate separation, or other similar business transaction transfers some or all of its employees to the changed corporation or to a related entity or to a predecessor entity of the changed corporation. The term *related entity* includes—

(1) All members of a controlled group of corporations (as defined in section 414(b)) that includes the changed corporation or a predecessor entity;

(2) All trades or businesses (whether or not incorporated) that are under common control (as defined in section 414(c)) if such group includes the changed corporation or a predecessor entity;

(3) All members of an affiliated service group (as defined in section 414(m)) that includes the changed corporation or a predecessor entity; and

(4) Any other entities required to be aggregated with the changed corporation or a predecessor entity pursuant to section 414(o) and the regulations thereunder (except leasing organizations as defined in section 414(n)).

(c) For purposes of Q/A-18 and Q/A-19 of this section, compensation

that was contingent on the change in ownership or control and that was payable in the year of the change is not treated as compensation.

Contingent on Change in Ownership or Control

Q-22: When is a payment contingent on a change in ownership or control?

A-22: (a) In general, a payment is treated as contingent on a change in ownership or control if the payment would not, in fact, have been made had no change in ownership or control occurred, even if the payment is also conditioned on the occurrence of another event. A payment generally is treated as one which would not, in fact, have been made in the absence of a change in ownership or control unless it is substantially certain, at the time of the change, that the payment would have been made whether or not the change occurred. (But see Q/A-23 of this section regarding payments under agreements entered into after a change in ownership or control.) A payment that becomes vested as a result of a change in ownership or control is not treated as a payment which was substantially certain to have been made whether or not the change occurred. For purposes of this A-22, *vested* means the payment is substantially vested within the meaning of §1.83-3(b) and (j) or the right to the payment is not otherwise subject to a substantial risk of forfeiture as defined by section 83(c).

(b)(1) For purposes of paragraph (a), a payment is treated as contingent on a change in ownership or control if —

(i) The payment is contingent on an event that is closely associated with a change in ownership or control;

(ii) A change in ownership or control actually occurs; and

(iii) The event is materially related to the change in ownership or control.

(2) For purposes of paragraph (b)(1)(i) of this A-22, a payment is treated as contingent on an event that is closely associated with a change in ownership or control unless it is substantially certain, at the time of the event, that the payment would have been made whether or not the event occurred. An event is considered closely associated with a change in ownership or control if the event is of a type often preliminary or subsequent to, or otherwise

closely associated with, a change in ownership or control. For example, the following events are considered closely associated with a change in the ownership or control of a corporation: The onset of a tender offer with respect to the corporation; a substantial increase in the market price of the corporation's stock that occurs within a short period (but only if such increase occurs prior to a change in ownership or control); the cessation of the listing of the corporation's stock on an established securities market; the acquisition of more than 5 percent of the corporation's stock by a person (or more than one person acting as a group) not in control of the corporation; the voluntary or involuntary termination of the disqualified individual's employment; a significant reduction in the disqualified individual's job responsibilities; and a change in ownership or control as defined in the disqualified individual's employment agreement (or elsewhere) that does not meet the definition of a change in ownership or control described in Q/A-27, 28, or 29 of this section. Whether other events are treated as closely associated with a change in ownership or control is based on all the facts and circumstances of the particular case.

(3) For purposes of determining whether an event (as described in paragraph (b)(2) of this A-22) is materially related to a change in ownership or control, the event is presumed to be materially related to a change in ownership or control if such event occurs within the period beginning one year before and ending one year after the date of the change in ownership or control. If such event occurs outside of the period beginning one year before and ending one year after the date of change in ownership or control, the event is presumed not materially related to the change in ownership or control. A payment does not fail to be contingent on a change in ownership or control merely because it is also contingent on the occurrence of a second event (without regard to whether the second event is closely associated with or materially related to a change in ownership or control). Similarly, a payment that is treated as contingent on a change in ownership or control because it is contingent on a closely associated event does not fail to be treated as contingent on a change in ownership or control merely

because it is also contingent on the occurrence of a second event (without regard to whether the second event is closely associated with or materially related to a change in ownership or control).

(c) A payment that would in fact have been made had no change in ownership or control occurred is treated as contingent on a change in ownership or control if the change in ownership or control (or the occurrence of an event that is closely associated with and materially related to a change in ownership or control within the meaning of paragraph (b)(1) of this A-22), accelerates the time at which the payment is made. Thus, for example, if a change in ownership or control accelerates the time of payment of deferred compensation that is vested without regard to the change in ownership or control, the payment may be treated as contingent on the change. See Q/A-24 of this section regarding the portion of a payment that is so treated. See also Q/A-8 of this section regarding the exemption for certain payments under qualified plans and Q/A-40 of this section regarding the treatment of a payment as reasonable compensation.

(d) A payment is treated as contingent on a change in ownership or control even if the employment or independent contractor relationship of the disqualified individual is not terminated (voluntarily or involuntarily) as a result of the change.

(e) The following examples illustrate the principles of this A-22:

Example 1. A corporation grants a stock appreciation right to a disqualified individual, A, more than one year before a change in ownership or control. After the stock appreciation right vests and becomes exercisable, a change in ownership or control of the corporation occurs, and A exercises the right. Assuming neither the granting nor the vesting of the stock appreciation right is contingent on a change in ownership or control, the payment made on exercise is not contingent on the change in ownership or control.

Example 2. A contract between a corporation and B, a disqualified individual, provides that a payment will be made to B if the corporation undergoes a change in ownership or control and B's employment with the corporation is terminated at any time over the succeeding 5 years. Eighteen months later, a change in the ownership of the corporation occurs. Two years after the change in ownership, B's employment is terminated and the payment is made to B. Because it was not substantially certain that the corporation would have made the payment to B on B's termination of employment if there had not been a change in ownership, the payment is treated as contingent on the change in ownership under paragraph (a) of this A-22. This is true even though B's termination of employment is presumed not to be, and in fact may

not be, materially related to the change in ownership or control.

Example 3. A contract between a corporation and C, a disqualified individual, provides that a payment will be made to C if C's employment is terminated at any time over the succeeding 3 years (without regard to whether or not there is a change in ownership or control). Eighteen months after the contract is entered into, a change in the ownership or control of the corporation occurs. Six months after the change in ownership or control, C's employment is terminated and the payment is made to C. Termination of employment is considered an event closely associated with a change in ownership or control. Because the termination occurred within one year after the date of the change in ownership or control, the termination of C's employment is presumed to be materially related to the change in ownership or control under paragraph (b)(3) of this A-22. If this presumption is not successfully rebutted, the payment will be treated as contingent on the change in ownership or control under paragraph (b) of this A-22.

Example 4. A contract between a corporation and a disqualified individual, D, provides that a payment will be made to D upon the onset of a tender offer for shares of the corporation's stock. A tender offer is made on December 1, 2008, and the payment is made to D. Although the tender offer is unsuccessful, it leads to a negotiated merger with another entity on June 1, 2009, which results in a change in the ownership or control of the corporation. It was not substantially certain, at the time of the onset of the tender offer, that the payment would have been made had no tender offer taken place. The onset of a tender offer is considered closely associated with a change in ownership or control. Because the tender offer occurred within one year before the date of the change in ownership or control of the corporation, the onset of the tender offer is presumed to be materially related to the change in ownership or control. If this presumption is not rebutted, the payment will be treated as contingent on the change in ownership or control. If no change in ownership or control had occurred, the payment would not be treated as contingent on a change in ownership or control; however, the payment still could be a parachute payment under Q/A-37 of this section if the contract violated a generally enforced securities law or regulation.

Example 5. A contract between a corporation and a disqualified individual, E, provides that a payment will be made to E if the corporation's level of product sales or profits reaches a specified level. At the time the contract was entered into, the parties had no reason to believe that such an increase in the corporation's level of product sales or profits would be preliminary or subsequent to, or otherwise closely associated with, a change in ownership or control of the corporation. Eighteen months later, a change in the ownership or control of the corporation occurs and within one year after the date of the change of ownership or control, the corporation's level of product sales or profits reaches the specified level. Under these facts and circumstances (and in the absence of contradictory evidence), the increase in product sales or profits of the corporation is not an event closely associated with the change in ownership or control of the corporation. Accordingly, even if the increase is

materially related to the change in ownership or control, the payment will not be treated as contingent on a change in ownership or control.

Q-23: May a payment be treated as contingent on a change in ownership or control if the payment is made under an agreement entered into after the change?

A-23: (a) No. Payments are not treated as contingent on a change in ownership or control if they are made (or are to be made) pursuant to an agreement entered into after the change (a post-change agreement). For this purpose, an agreement that is executed after a change in ownership or control pursuant to a legally enforceable agreement that was entered into before the change is considered to have been entered into before the change. (See Q/A-9 of this section regarding the exemption for reasonable compensation for services rendered on or after a change in ownership or control.) If an individual has a right to receive a payment that would be a parachute payment if made under an agreement entered into prior to a change in ownership or control (pre-change agreement) and gives up that right as bargained-for consideration for benefits under a post-change agreement, the agreement is treated as a post-change agreement only to the extent the value of the payments under the agreement exceed the value of the payments under the pre-change agreement. To the extent payments under the agreement have the same value as the payments under the pre-change agreement, such payments retain their character as parachute payments subject to this section.

(b) The following examples illustrate the principles of this A-23:

Example 1. Assume that a disqualified individual is an employee of a corporation. A change in ownership or control of the corporation occurs, and thereafter the individual enters into an employment agreement with the acquiring company. Because the agreement is entered into after the change in ownership or control occurs, payments to be made under the agreement are not treated as contingent on the change.

Example 2. Assume the same facts as in *Example 1*, except that the agreement between the disqualified individual and the acquiring company is executed after the change in ownership or control, pursuant to a legally enforceable agreement entered into before the change. Payments to be made under the agreement may be treated as contingent on the change in ownership or control pursuant to Q/A-22 of this section. However, see Q/A-9 of this section regarding the exemption from the definition of parachute payment for certain amounts of reasonable compensation.

Example 3. Assume the same facts as in *Example 1*, except that prior to the change in ownership or control, the individual and corporation enter

into an agreement under which the individual will receive parachute payments in the event of a change in ownership or control of the corporation. After the change, the individual agrees to give up the right to payments under the pre-change agreement that would be parachute payments if made, in exchange for compensation under a new agreement with the acquiring corporation. Because the individual gave up the right to parachute payments under the pre-change agreement in exchange for other payments under the post-change agreement, payments in an amount equal to the parachute payments under the pre-change agreement are treated as contingent on the change in ownership or control under this A-23. Because the post-change agreement was entered into after the change, payments in excess of this amount are not treated as parachute payments.

Q-24: If a payment is treated as contingent on a change in ownership or control, is the full amount of the payment so treated?

A-24: (a)(1) *General rule.* Yes. If the payment is a transfer of property, the amount of the payment is determined under Q/A-12 or Q/A-13 of this section. For all other payments, the amount of the payment is determined under Q/A-11 of this section. However, in certain circumstances, described in paragraphs (b) and (c) of this A-24, only a portion of the payment is treated as contingent on the change. Paragraph (b) of this A-24 applies to a payment that is vested, without regard to the change in ownership or control, and is treated as contingent on the change in ownership or control because the change accelerates the time at which the payment is made. Paragraph (c) of this A-24 applies to a payment that becomes vested as a result of the change in ownership or control if, without regard to the change in ownership or control, the payment was contingent only on the continued performance of services for the corporation for a specified period of time and if the payment is attributable, at least in part, to services performed before the date the payment becomes vested. Paragraph (b) or (c) does not apply to any payment (or portion thereof) if the payment is treated as contingent on the change in ownership or control pursuant to Q/A-25 of this section. For purposes of this A-24, *vested* has the same meaning as provided in Q/A-22(a).

(2) *Reduction by reasonable compensation.* The amount of a payment under paragraph (a)(1) of this A-24 is reduced by any portion of such payment that the taxpayer establishes by clear and convincing evidence is reasonable compensation

for personal services rendered by the disqualified individual on or after the date of the change of control. See Q/A-9 and Q/A-38 through 44 of this section for rules concerning reasonable compensation. The portion of an amount treated as contingent under paragraph (b) or (c) of this A-24 may not be reduced by reasonable compensation.

(b) *Vested payments.* This paragraph (b) applies if a payment is vested, without regard to the change in ownership or control, and is treated as contingent on the change in ownership or control because the change accelerates the time at which the payment is made. In such a case, the portion of the payment, if any, that is treated as contingent on the change in ownership or control is the amount by which the amount of the accelerated payment exceeds the present value of the payment absent the acceleration. If the value of such a payment absent the acceleration is not reasonably ascertainable, and the acceleration of the payment does not significantly increase the present value of the payment absent the acceleration, the present value of the payment absent the acceleration is treated as equal to the amount of the accelerated payment. If the value of the payment absent the acceleration is not reasonably ascertainable, but the acceleration significantly increases the present value of the payment, the future value of such payment is treated as equal to the amount of the accelerated payment. For rules on determining present value, see paragraph (e) of this A-24, Q/A-32, and Q/A-33 of this section.

(c)(1) *Nonvested payments.* This paragraph (c) applies to a payment that becomes vested as a result of the change in ownership or control to the extent that —

(i) Without regard to the change in ownership or control, the payment was contingent only on the continued performance of services for the corporation for a specified period of time; and

(ii) The payment is attributable, at least in part, to the performance of services before the date the payment is made or becomes certain to be made.

(2) The portion of the payment subject to paragraph (c) of this A-24 that is treated as contingent on the change in ownership or control is the amount described in paragraph (b) of this A-24, plus an amount,

as determined in paragraph (c)(4) of this A-24, to reflect the lapse of the obligation to continue to perform services. In no event can the portion of the payment treated as contingent on the change in ownership or control under this paragraph (c) exceed the amount of the accelerated payment, or, if the payment is not accelerated, the present value of the payment.

(3) For purposes of this paragraph (c) of this A-24, the acceleration of the vesting of a stock option or the lapse of a restriction on restricted stock is considered to significantly increase the value of a payment.

(4) The amount reflecting the lapse of the obligation to continue to perform services (described in paragraph (c)(2) of this A-24) is 1 percent of the amount of the accelerated payment multiplied by the number of full months between the date that the individual's right to receive the payment is vested and the date that, absent the acceleration, the payment would have been vested. This paragraph (c)(4) applies to the accelerated vesting of a payment in the nature of compensation even if the time at which the payment is made is not accelerated. In such a case, the amount reflecting the lapse of the obligation to continue to perform services is 1 percent of the present value of the future payment multiplied by the number of full months between the date that the individual's right to receive the payment is vested and the date that, absent the acceleration, the payment would have been vested.

(d) *Application of this A-24 to certain payments.*— (1) *Benefits under a nonqualified deferred compensation plan.* In the case of a payment of benefits under a nonqualified deferred compensation plan, paragraph (b) of this A-24 applies to the extent benefits under the plan are vested without regard to the change in ownership or control. Paragraph (c) of this A-24 applies to the extent benefits under the plan become vested as a result of the change in ownership or control and are attributable, at least in part, to the performance of services prior to vesting. Any other payment of benefits under a nonqualified deferred compensation plan is a payment in the nature of compensation subject to the general rule of paragraph (a) of this A-24 and the rules in Q/A-11 of this section.

(2) *Employment agreements.* The general rule of paragraph (a) of this A-24 (and

not the rules in paragraphs (b) or (c) applies to the payment of amounts due under an employment agreement on a termination of employment or a change in ownership or control that otherwise would be attributable to the performance of services (or refraining from the performance of services) during any period that begins after the date of termination of employment or change in ownership or control, as applicable. For purposes of this paragraph (d)(2) of this A-24, an employment agreement means an agreement between an employee or independent contractor and employer or service recipient which describes, among other things, the amount of compensation or remuneration payable to the employee or independent contractor. See Q/A-42(b) and 44 of this section for the treatment of the remaining amounts of salary under an employment agreement.

(3) *Vesting due to an event other than services.* Neither paragraph (b) nor (c) of this A-24 applies to a payment if (without regard to the change in ownership or control) vesting of the payment depends on an event other than the performance of services, such as the attainment of a performance goal, and the event does not occur prior to the change in ownership or control. In such circumstances, the full amount of the accelerated payment is treated as contingent on the change in ownership or control under paragraph (a) of this A-24. However, see Q/A-39 of this section for rules relating to the reduction of the excess parachute payment by the portion of the payment which is established to be reasonable compensation for personal services actually rendered before the date of a change in ownership or control.

(e) *Present value.* For purposes of this A-24, the present value of a payment is determined as of the date on which the accelerated payment is made.

(f) *Examples.* The following examples illustrate the principles of this A-24:

Example 1. (i) Corporation maintains a qualified plan and a nonqualified supplemental retirement plan (SERP) for its executives. Benefits under the SERP are not paid to participants until retirement. E, a disqualified individual with respect to Corporation, has a vested account balance of \$500,000 under the SERP. A change in ownership or control of Corporation occurs. The SERP provides that in the event of a change in ownership or control, all vested accounts will be paid to SERP participants.

(ii) Because E was vested in \$500,000 of benefits under the SERP prior to the change in ownership or control and the change merely accelerated the time

at which the payment was made to E, only a portion of the payment, as determined under paragraph (b) of this A-24, is treated as contingent on the change. Thus, the portion of the payment that is treated as contingent on the change is the amount by which the amount of the accelerated payment (\$500,000) exceeds the present value of the payment absent the acceleration.

(iii) Assume the same facts as in paragraph (i) of this *Example 1*, except that E's account balance of \$500,000 is not vested. Instead, assume that E will vest in E's account balance of \$500,000 in 2 years if E continues to perform services for the next 2 years. Assume further that the SERP provides that all unvested SERP benefits vest immediately on a change in ownership or control and are paid to the participants. Because the vesting of the SERP payment, without regard to the change, depends only on the performance of services for a specified period of time and the payment is attributable, in part, to the performance of services before the change in ownership or control, only a portion of the \$500,000 payment, as determined under paragraph (c) of this A-24, is treated as contingent on the change. The portion of the payment that is treated as contingent on the change is the lesser of the amount of the accelerated payment or the amount by which the accelerated payment exceeds the present value of the payment absent the acceleration, plus an amount to reflect the lapse of the obligation to continue to perform services.

(iv) Assume the same facts as in paragraph (i) of this *Example 1*, except that in addition to the payout of the vested account balance of \$500,000 on the change in ownership or control, an additional \$70,000 will be credited to E's account and included in the payment to E. Because the \$500,000 was vested without regard to the change in ownership or control, paragraph (b) of this A-24 applies to the \$500,000 payment. Because the \$70,000 is not vested, without regard to the change, and is not attributable to the performance of services prior to the change, the entire \$70,000 payment is contingent on the change in ownership or control under paragraph (a) of this A-24.

(v) Assume the same facts as in paragraph (i) of this *Example 1*, except that the benefit under the SERP is calculated using a percentage of final average compensation multiplied by years of service. If, contingent on the change in ownership or control, E is credited with additional years of service, an adjustment to final average compensation, or an increase in the applicable percentage, any increase in the benefit payable under the SERP is not attributable to the performance of services prior to the change, and the entire increase in the benefit is contingent on the change in ownership or control under paragraph (a) of this A-24.

Example 2. As a result of a change in the effective control of a corporation D, a disqualified individual with respect to the corporation, receives accelerated payment of D's vested account balance in a nonqualified deferred compensation account plan. Actual interest and other earnings on the plan assets are credited to each account as earned before distribution. Investment of the plan assets is not restricted in such a manner as would prevent the earning of a market rate of return on the plan assets. The date on which D would have received D's vested account balance absent the change in ownership or control is uncertain, and the rate of earnings on the plan assets is not

fixed. Thus, the amount of the payment absent the acceleration is not reasonably ascertainable. Under these facts, acceleration of the payment does not significantly increase the present value of the payment absent the acceleration, and the present value of the payment absent the acceleration is treated as equal to the amount of the accelerated payment. Accordingly, no portion of the payment is treated as contingent on the change.

Example 3. (i) On January 15, 2006, a corporation and a disqualified individual, F, enter into a contract providing for a retention bonus of \$500,000 to be paid to F on January 15, 2011. The payment of the bonus will be forfeited by F if F does not remain employed by the corporation for the entire 5-year period. However, the contract provides that the full amount of the payment will be made immediately on a change in ownership or control of the corporation during the 5-year period. On January 15, 2009, a change in ownership or control of the corporation occurs and the full amount of the payment (\$500,000) is made on that date to F. Under these facts, the payment of \$500,000 was contingent only on F's performance of services for a specified period and is attributable, in part, to the performance of services before the change in ownership or control. Therefore, only a portion of the payment, as determined under paragraph (c) of this A-24 is treated as contingent on the change. The portion of the payment that is treated as contingent on the change is the amount by which the amount of the accelerated payment (*i.e.*, \$500,000, the amount paid to the individual because of the change in ownership) exceeds the present value of the payment that was expected to have been made absent the acceleration (*i.e.*, \$406,838, the present value on January 15, 2009, of a \$500,000 payment on January 15, 2011), plus \$115,000 (1 percent x 23 months x \$500,000) which is the amount reflecting the lapse of the obligation to continue to perform services. Accordingly, the amount of the payment treated as contingent on the change in ownership or control is \$208,162, the sum of \$93,162 (\$500,000 - \$406,838) + \$115,000. This result does not change if F actually remains employed until the end of the 5-year period.

(ii) Assume the same facts as in paragraph (i) of this *Example 3*, except that the retention bonus will vest on the change in ownership or control, but will not be paid until January 15, 2011 (the original date in the contract). Because the payment of \$500,000 was contingent only on F's performance of services for a specified period and is attributable, in part, to the performance of services before the change in ownership or control, only a portion of the \$500,000 payment is treated as contingent on the change in ownership or control as determined under paragraph (c) of this A-24. Because there is accelerated vesting of the bonus, the portion of the payment treated as contingent on the change is the amount described in paragraph (b) of this A-27, which is \$0 under these facts, plus an amount reflecting the lapse of the obligation to continue to perform services which is \$93,573 (1 percent x 23 months x \$406,838 (the present value of a \$500,000 payment)).

Example 4. (i) On January 15, 2006, a corporation gives to a disqualified individual, in connection with her performance of services to the corporation, a bonus of 1,000 shares of the corporation's stock. Under the terms of the bonus arrangement, the individual is obligated to return the stock to the corporation if

she terminates her employment for any reason prior to January 15, 2011. However, if there is a change in the ownership or effective control of the corporation prior to January 15, 2011, she ceases to be obligated to return the stock. The individual's rights in the stock are treated as substantially nonvested (within the meaning of §1.83-3(b) and (j)) during that period. On January 15, 2009, a change in the ownership of the corporation occurs. On that day, the fair market value of the stock is \$500,000.

(ii) Under these facts, the payment was contingent only on performance of services for a specified period and is attributable, in part, to the performance of services before the change in ownership or control. Thus, only a portion of the payment, as determined under paragraph (c) of this A-24, is treated as contingent on the change in ownership or control. The portion of the payment that is treated as contingent on the change is the amount by which the present value of the accelerated payment on January 15, 2009 (\$500,000), exceeds the present value of the payment that was expected to have been made on January 15, 2011, plus an amount reflecting the lapse of the obligation to continue to perform services. At the time of the change, it cannot be reasonably ascertained what the value of the stock would have been on January 15, 2011. The acceleration of the lapse of a restriction on stock is treated as significantly increasing the value of the payment. Therefore, the value of such stock on January 15, 2011, is deemed to be \$500,000, the amount of the accelerated payment. The present value on January 15, 2009, of a \$500,000 payment to be made on January 15, 2011, is \$406,838. Thus, the portion of the payment treated as contingent on the change is \$208,162, the sum of \$93,162 (\$500,000 - \$406,838), plus \$115,000 (1 percent x 23 months x \$500,000), the amount reflecting the lapse of the obligation to continue to perform services.

Example 5. (i) On January 15, 2006, a corporation grants to a disqualified individual nonqualified stock options to purchase 30,000 shares of the corporation's stock. The options will be forfeited by the individual if he fails to perform personal services for the corporation until January 15, 2009. The options will, however, vest in the individual at an earlier date if there is a change in ownership or control of the corporation. On January 16, 2008, a change in the ownership or control of the corporation occurs and the options become vested in the individual. The value of the options on January 16, 2008, determined in accordance with Q/A-13, is \$600,000.

(ii) The payment of the options to purchase 30,000 shares was contingent only on performance of services for the corporation until January 15, 2009, and is attributable, in part, to the performance of services before the change in ownership or control. Therefore, only a portion of the payment is treated as contingent on the change. The portion of the payment that is treated as contingent on the change is the amount by which the accelerated payment on January 16, 2008 (\$600,000) exceeds the present value on January 16, 2008, of the payment that was expected to have been made on January 15, 2009, absent the acceleration, plus an amount reflecting the lapse of the obligation to continue to perform services. At the time of the change, it cannot be reasonably ascertained what the value of the options would have been on January 15, 2009. The

acceleration of vesting in the options is treated as significantly increasing the value of the payment. Therefore, the value of such options on January 15, 2009, is deemed to be \$600,000, the amount of the accelerated payment. The present value on January 16, 2008, of a \$600,000 payment to be made on January 15, 2009, is \$549,964. Thus, the portion of the payment treated as contingent on the change is \$116,036, the sum of \$50,036 (\$600,000 - \$549,964), plus an amount reflecting the lapse of the obligation to continue to perform services which is \$66,000 (1 percent x 11 months x \$600,000).

Example 6. (i) Assume the same facts as in *Example 5*, except that the options become vested periodically (absent a change in ownership or control), with one-third of the options vesting on January 15, 2007, 2008, and 2009, respectively. Thus, options to purchase 20,000 shares vest independently of the January 16, 2008, change in ownership or control and the options to purchase the remaining 10,000 shares vest as a result of the change in ownership or control.

(ii) The payment of the options to purchase 10,000 shares was contingent only on performance of services for the corporation until January 15, 2009, and is attributable, in part, to the performance of services before the change in ownership or control. Therefore, only a portion of the payment as determined under paragraph (c) of this A-24 is treated as contingent on the change in ownership or control. The portion of the payment that is treated as contingent on the change in ownership or control is the amount by which the accelerated payment on January 16, 2008 (\$200,000) exceeds the present value on January 16, 2008, of the payment that was expected to have been made on January 15, 2009, absent the acceleration, plus an amount reflecting the lapse of the obligation to perform services. At the time of the change in ownership or control, it cannot be reasonably ascertained what the value of the options would have been on January 15, 2009. The acceleration of vesting in the options is treated as significantly increasing the value of the payment. Therefore, the value of such options on January 15, 2009, is deemed to be \$200,000, the amount of the accelerated payment. The present value on January 16, 2008, of a \$200,000 payment to be made on January 15, 2009, is \$183,328.38. Thus, the portion of the payment treated as contingent on the change is \$38,671.62, the sum of \$16,671.62 (\$200,000 - \$183,328.38), plus an amount reflecting the lapse of the obligation to continue to perform services which is \$22,000 (1 percent x 11 months x \$200,000).

Example 7. Assume the same facts as in *Example 5*, except that the option agreement provides that the options will vest either on the corporation's level of profits reaching a specified level, or if earlier, on the date on which there is a change in ownership or control of the corporation. The corporation's level of profits do not reach the specified level prior to January 16, 2008. In such case, the full amount of the payment, \$600,000, is treated as contingent on the change in ownership or control under paragraph (a) of this A-24. Because the payment was not contingent only on the performance of services for the corporation for a specified period, the rules of paragraph (b) and (c) of this A-24 do not apply. See Q/A-39 of this section for rules relating to the reduction of the

excess parachute payment by the portion of the payment which is established to be reasonable compensation for personal services actually rendered before the date of a change in ownership or control.

Example 8. On January 1, 2005, E, a disqualified individual with respect to Corporation X, enters into an employment agreement with Corporation X under which E will be paid wages of \$200,000 each year during the 5-year employment agreement. The employment agreement provides that if a change in ownership or control of Corporation X occurs, E will be paid the present value of the remaining salary under the employment agreement. On January 1, 2006, a change in ownership or control of Corporation X occurs, E is terminated, and E receives a payment of the present value of \$200,000 for each of the 4 years remaining under the employment agreement. Because the payment represents future salary under an employment agreement (*i.e.*, amounts otherwise attributable to the performance of services for periods that begin after the termination of employment), the general rule of paragraph (a) of this A-24 applies to the payment and not the rules of paragraphs (b) and (c) of this A-24. See Q/A-42(c) and 44 of this section for the treatment of the remaining payments under an employment agreement.

Presumption That Payment Is Contingent on Change

Q-25: Is there a presumption that certain payments are contingent on a change in ownership or control?

A-25: Yes, for purposes of this section, any payment is presumed to be contingent on such a change unless the contrary is established by clear and convincing evidence if the payment is made pursuant to —

(a) An agreement entered into within one year before the date of a change in ownership or control; or

(b) An amendment that modifies a previous agreement in any significant respect, if the amendment is made within one year before the date of a change in ownership or control. In the case of an amendment described in paragraph (b) of this A-25, only the portion of any payment that exceeds the amount of such payment that would have been made in the absence of the amendment is presumed, by reason of the amendment, to be contingent on the change in ownership or control.

Q-26: How may the presumption described in Q/A-25 of this section be rebutted?

A-26: (a) To rebut the presumption described in Q/A-25 of this section, the taxpayer must establish by clear and convincing evidence that the payment is not contingent on the change in ownership or control. Whether the payment is contingent

on such change is determined on the basis of all the facts and circumstances of the particular case. Factors relevant to such a determination include, but are not limited to, the content of the agreement or amendment and the circumstances surrounding the execution of the agreement or amendment, such as whether it was entered into at a time when a takeover attempt had commenced and the degree of likelihood that a change in ownership or control would actually occur. However, even if the presumption is rebutted with respect to an agreement, some or all of the payments under the agreement may still be contingent on the change in ownership or control pursuant to Q/A-22 of this section.

(b) In the case of an agreement described in Q/A-25 of this section, clear and convincing evidence that the agreement is one of the three following types will generally rebut the presumption that payments under the agreement are contingent on the change in ownership or control —

(1) A *nondiscriminatory employee plan or program* as defined in paragraph (c) of this A-26;

(2) A contract between a corporation and an individual that replaces a prior contract entered into by the same parties more than one year before the change in ownership or control, if the new contract does not provide for increased payments (apart from normal increases attributable to increased responsibilities or cost of living adjustments), accelerate the payment of amounts due at a future time, or modify (to the individual's benefit) the terms or conditions under which payments will be made; or

(3) A contract between a corporation and an individual who did not perform services for the corporation prior to the one year period before the change in ownership or control occurs, if the contract does not provide for payments that are significantly different in amount, timing, terms, or conditions from those provided under contracts entered into by the corporation (other than contracts that themselves were entered into within one year before the change in ownership or control and in contemplation of the change) with individuals performing comparable services.

(c) For purposes of this section, the term *nondiscriminatory employee plan or program* means: a group term life insurance plan that meets the requirements

of section 79(d); a self insured medical reimbursement plan that meets the requirements of section 105(h); a cafeteria plan (within the meaning of section 125); an educational assistance program (within the meaning of section 127); a dependent care assistance program (within the meaning of section 129); a no-additional-cost service (within the meaning of section 132(b)) or qualified employee discount (within the meaning of section 132(c)); a qualified retirement planning services program under section 132(m); an adoption assistance program (within the meaning of section 137); and such other items as provided by the Commissioner in published guidance of general applicability under §601.601(d)(2). Payments under certain other plans are exempt from the definition of *parachute payment* under Q/A-8 of this section.

(d) The following examples illustrate the application of the presumption:

Example 1. A corporation and a disqualified individual who is an employee of the corporation enter into an employment contract. The contract replaces a prior contract entered into by the same parties more than one year before the change in ownership or control and the new contract does not provide for any increased payments other than a cost of living adjustment, does not accelerate the payment of amounts due at a future time, and does not modify (to the individual's benefit) the terms or conditions under which payments will be made. Clear and convincing evidence of these facts rebuts the presumption described in A-25 of this section. However, payments under the contract still may be contingent on the change in ownership or control pursuant to Q/A-22 of this section.

Example 2. Assume the same facts as in *Example 1*, except that the contract is entered into after a tender offer for the corporation's stock had commenced and it was likely that a change in ownership or control would occur and the contract provides for a substantial bonus payment to the individual upon his signing the contract. The individual has performed services for the corporation for many years, but previous employment contracts between the corporation and the individual did not provide for a similar signing bonus. One month after the contract is entered into, a change in the ownership or control of the corporation occurs. All payments under the contract are presumed to be contingent on the change in ownership or control even though the bonus payment would have been legally required even if no change had occurred. Clear and convincing evidence of these facts rebuts the presumption described in A-25 of this section with respect to all of the payments under the contract with the exception of the bonus payment (which is treated as contingent on the change). However, payments other than the bonus under the contract still may be contingent on the change in ownership or control pursuant to Q/A-22 of this section.

Example 3. A corporation and a disqualified individual, who is an employee of the corporation, enter into an employment contract within one year of a change in ownership or control of the corporation. Under the contract, in the event of a change in ownership or control and subsequent termination of employment, certain payments will be made to the individual. A change in ownership or control occurs, but the individual is not terminated until 2 years after the change in ownership or control. If clear and convincing evidence does not rebut the presumption described in A-25 of this section, because the payment is made pursuant to an agreement entered into within one year of the date of the change in ownership or control, the payment is presumed contingent on the change under A-25 of this section. This is true even though A's termination of employment is presumed not to be materially related to the change in ownership or control under Q/A-22 of this section.

Change in Ownership or Control

Q-27: When does a change in the ownership of a corporation occur?

A-27: (a) For purposes of this section, a change in the ownership of a corporation occurs on the date that any one person, or more than one person acting as a group (as defined in paragraph (b) of this A-27), acquires ownership of stock of the corporation that, together with stock held by such person or group, has more than 50 percent of the total fair market value or total voting power of the stock of such corporation. However, if any one person, or more than one person acting as a group, is considered to own more than 50 percent of the total fair market value or total voting power of the stock of a corporation, the acquisition of additional stock by the same person or persons is not considered to cause a change in the ownership of the corporation (or to cause a change in the effective control of the corporation (within the meaning of Q/A-28 of this section)). An increase in the percentage of stock owned by any one person, or persons acting as a group, as a result of a transaction in which the corporation acquires its stock in exchange for property will be treated as an acquisition of stock for purposes of this section. This A-27 applies only when there is a transfer of stock of a corporation (or issuance of stock of a corporation) and stock in such corporation remains outstanding after the transaction. (See Q/A-29 for rules regarding the transfer of assets of a corporation).

(b) For purposes of paragraph (a) of this A-27, persons will not be considered to be acting as a group merely because they happen to purchase or own stock of the same

corporation at the same time, or as a result of the same public offering. However, persons will be considered to be acting as a group if they are owners of a corporation that enters into a merger, consolidation, purchase or acquisition of stock, or similar business transaction with the corporation. If a person, including an entity shareholder, owns stock in both corporations that enter into a merger, consolidation, purchase or acquisition of stock, or similar transaction, such shareholder is considered to be acting as a group with other shareholders in a corporation only with respect to the ownership in that corporation prior to the transaction giving rise to the change and not with respect to the ownership interest in the other corporation.

(c) For purposes of this A-27 (and Q/A-28 and 29), section 318(a) applies to determine stock ownership. Stock underlying a vested option is considered owned by the individual who holds the vested option (and the stock underlying an unvested option is not considered owned by the individual who holds the unvested option). For purposes of the preceding sentence, however, if the option is exercisable for stock that is not substantially vested (as defined by sections 1.83-3(b) and (j)), the stock underlying the option is not treated as owned by the individual who holds the option. In addition, mutual and cooperative corporations are treated as having stock for purposes of this A-27.

(d) The following examples illustrate the principles of this A-27:

Example 1. Corporation M has owned stock with a fair market value equal to 19 percent of the value of the stock of Corporation N (an otherwise unrelated corporation) for many years prior to 2006. Corporation M acquires additional stock with a fair market value equal to 15 percent of the value of the stock of Corporation N on January 1, 2006, and an additional 18 percent on February 21, 2007. As of February 21, 2007, Corporation M has acquired stock with a fair market value greater than 50 percent of the value of the stock of Corporation N. Thus, a change in the ownership of Corporation N is considered to occur on February 21, 2007 (assuming that Corporation M did not have effective control of Corporation N immediately prior to the acquisition on that date).

Example 2. All of the corporation's stock is owned by the founders of the corporation. The board of directors of the corporation decides to offer shares of the corporation to the public. After the public offering, the founders of the corporation own a total of 40 percent of the corporation's stock, and members of the public own 60 percent. If no one person (or more than one person acting as a group) owns more than 50 percent of the corporation's stock (by value

or voting power) after the public offering, there is no change in the ownership of the corporation.

Example 3. Corporation P merges into Corporation O (a previously unrelated corporation). In the merger, the shareholders of Corporation P receive Corporation O stock in exchange for their Corporation P stock. Immediately after the merger, the former shareholders of Corporation P own stock with a fair market value equal to 60 percent of the value of the stock of Corporation O, and the former shareholders of Corporation O own stock with a fair market value equal to 40 percent of the value of the stock of Corporation O. The former shareholders of Corporation P will be treated as acting as a group in their acquisition of Corporation O stock. Thus, a change in the ownership of Corporation O occurs on the date of the merger. See Q/A-29, *Example 3*, regarding whether there is a change in ownership or control of P.

Example 4. Assume the same facts as in *Example 3*, except that immediately after the change, the former shareholders of Corporation P own stock with a fair market value of 51 percent of the value of Corporation O stock and the former shareholders of Corporation O own stock with a fair market value equal to 49 percent of the value of Corporation O stock. Assume further that prior to the merger several Corporation O shareholders also owned Corporation P stock (overlapping shareholders). In the merger, those O shareholders received additional O stock by virtue of their ownership of P stock with a fair market value of 5 percent of the value of Corporation O stock. Including the O stock attributable to the P shares, the O shareholders hold 54 percent of O after the transaction. However, those overlapping shareholders that owned both Corporation O stock and Corporation P stock prior to the merger are treated as acting as a group with the Corporation O shareholders only with respect to their ownership interest in Corporation O prior to the transaction. Therefore, because the Corporation O shareholders owned 49 percent of the value of Corporation O stock, a change in the ownership of Corporation O occurs on the date of the merger. See Q/A-29, *Example 3*, regarding whether there is a change in ownership or control of P.

Example 5. A, an individual, owns stock with a fair market value equal to 20 percent of the value of the stock of Corporation Q. On January 1, 2007, Corporation Q acquires in a redemption for cash all of the stock held by shareholders other than A. Thus, A is left as the sole shareholder of Corporation O. A change in ownership of Corporation O is considered to occur on January 1, 2007 (assuming that A did not have effective control of Corporation Q immediately prior to the redemption).

Example 6. Assume the same facts as in *Example 5*, except that A owns stock with a fair market value equal to 51 percent of the value of all the stock of Corporation Q immediately prior to the redemption. There is no change in the ownership of Corporation Q as a result of the redemption.

Q-28: When does a change in the effective control of a corporation occur?

A-28: (a) Notwithstanding that a corporation has not undergone a change in ownership under Q/A-27, for purposes of this section, a change in the effective control of a corporation is presumed to occur on the date that either —

(1) Any one person, or more than one person acting as a group (as determined under paragraph (e) of this A-28), acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition by such person or persons) ownership of stock of the corporation possessing 20 percent or more of the total voting power of the stock of such corporation; or

(2) A majority of members of the corporation's board of directors is replaced during any 12-month period by directors whose appointment or election is not endorsed by a majority of the members of the corporation's board of directors prior to the date of the appointment or election.

(b) The presumption of paragraph (a) of this A-28 may be rebutted by establishing that such acquisition or acquisitions of the corporation's stock, or such replacement of the majority of the members of the corporation's board of directors, does not transfer the power to control (directly or indirectly) the management and policies of the corporation from any one person (or more than one person acting as a group) to another person (or group). For purposes of this section, in the absence of an event described in paragraph (a)(1) or (2) of this A-28, a change in the effective control of a corporation is presumed not to have occurred.

(c) In no event does a change in effective control under this A-28 occur in any transaction in which either of the two corporations involved in the transaction has a change in ownership or control under Q/A-27 or 29 of this section. Thus, for example, assume Corporation P transfers more than one-third of the total gross fair market value of its assets to Corporation O in exchange for 20 percent of O's stock. Because P has undergone a change in ownership of a substantial portion of its assets under Q/A-29 of this section, O does not have a change in effective control under Q/A-28.

(d) If any one person, or more than one person acting as a group, is considered to effectively control a corporation (within the meaning of this A-28), the acquisition of additional control of the corporation by the same person or persons is not considered to cause a change in the effective control of the corporation (or to cause a change in the ownership of the corporation within the meaning of Q/A-27 of this section).

(e) For purposes of this A-28, persons will not be considered to be acting as a group merely because they happen to purchase or own stock of the same corporation at the same time, or as a result of the same public offering. However, persons will be considered to be acting as a group if they are owners of a corporation that enters into a merger, consolidation, purchase or acquisition of stock, or similar business transaction with the corporation. If a person, including an entity shareholder, owns stock in both corporations that enter into a merger, consolidation, purchase or acquisition of stock, or similar transaction, such shareholder is considered to be acting as a group with other shareholders in a corporation only with respect to the ownership in that corporation prior to the transaction giving rise to the change and not with respect to the ownership interest in the other corporation.

(f) For purposes of determining stock ownership, see Q/A-27(c).

(g) The following examples illustrate the principles of this A-28:

Example 1. Shareholder A acquired the following percentages of the voting stock of Corporation M (an otherwise unrelated corporation) on the following dates: 16 percent on January 1, 2005; 10 percent on January 10, 2006; 8 percent on February 10, 2006; 11 percent on March 1, 2007; and 8 percent on March 10, 2007. Thus, on March 10, 2007, A owns a total of 53 percent of M's voting stock. Because A did not acquire 20 percent or more of M's voting stock during any 12-month period, there is no presumption of a change in effective control pursuant to paragraph (a)(1) of this A-28. In addition, under these facts there is a presumption that no change in the effective control of Corporation M occurred. If this presumption is not rebutted (and thus no change in effective control of Corporation M is treated as occurring prior to March 10, 2007), a change in the ownership of Corporation M is treated as having occurred on March 10, 2007 (pursuant to Q/A-27 of this section) because A had acquired more than 50 percent of Corporation M's voting stock as of that date.

Example 2. A minority group of shareholders of a corporation opposes the practices and policies of the corporation's current board of directors. A proxy contest ensues. The minority group presents its own slate of candidates for the board at the next annual meeting of the corporation's shareholders, and candidates of the minority group are elected to replace a majority of the current members of the board. A change in the effective control of the corporation is presumed to have occurred on the date the election of the new board of directors becomes effective.

Q-29: When does a change in the ownership of a substantial portion of a corporation's assets occur?

A-29: (a) For purposes of this section, a change in the ownership of a substantial portion of a corporation's assets occurs on the date that any one person, or more than one person acting as a group (as determined in paragraph (c) of this A-29), acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition by such person or persons) assets from the corporation that have a total gross fair market value equal to or more than one-third of the total gross fair market value of all of the assets of the corporation immediately prior to such acquisition or acquisitions. For this purpose, *gross fair market value* means the value of the assets of the corporation, or the value of the assets being disposed of, determined without regard to any liabilities associated with such assets. This A-29 applies in any situation other than one involving the transfer of stock (or issuance of stock) in a parent corporation and stock in such corporation remains outstanding after the transaction. Thus, this A-29 applies to the sale of stock in a subsidiary (when that subsidiary is treated as a single corporation with the parent pursuant to Q/A-46) and to mergers involving the creation of a new corporation or with respect to the corporation that is not surviving entity.

(b)(1) There is no change in ownership or control under this A-29 when there is a transfer to an entity that is controlled by the shareholders of the transferring corporation immediately after the transfer, as provided in this paragraph (b). A transfer of assets by a corporation is not treated as a change in the ownership of such assets if the assets are transferred to —

(i) A shareholder of the corporation (immediately before the asset transfer) in exchange for or with respect to its stock;

(ii) An entity, 50 percent or more of the total value or voting power of which is owned, directly or indirectly, by the corporation;

(iii) A person, or more than one person acting as a group, that owns, directly or indirectly, 50 percent or more of the total value or voting power of all the outstanding stock of the corporation; or

(iv) An entity, at least 50 percent of the total value or voting power is owned, directly or indirectly, by a person described in paragraph (b)(1)(iii) of this A-29.

(2) For purposes of paragraph (b) and except as otherwise provided, a person's

status is determined immediately after the transfer of the assets. For example, a transfer to a corporation in which the transferor corporation has no ownership interest in before the transaction, but which is a majority-owned subsidiary of the transferor corporation after the transaction is not treated as a change in the ownership of the assets of the transferor corporation.

(c) For purposes of this A-29, persons will not be considered to be acting as a group merely because they happen to purchase assets of the same corporation at the same time, or as a result of the same public offering. However, persons will be considered to be acting as a group if they are owners of a corporation that enters into a merger, consolidation, purchase or acquisition of assets, or similar business transaction with the corporation. If a person, including an entity shareholder, owns stock in both corporations that enter into a merger, consolidation, purchase or acquisition of stock, or similar transaction, such shareholder is considered to be acting as a group with other shareholders in a corporation only to the extent of the ownership in that corporation prior to the transaction giving rise to the change and not with respect to the ownership interest in the other corporation.

(d) For purposes of determining stock ownership, see Q/A-27(c).

(e) The following examples illustrate the principles of this A-29:

Example 1. Corporation M acquires assets having a gross fair market value of \$500,000 from Corporation N (an unrelated corporation) on January 1, 2006. The total gross fair market value of Corporation N's assets immediately prior to the acquisition was \$3 million. Since the value of the assets acquired by Corporation M is less than one-third of the total gross fair market value of Corporation N's total assets immediately prior to the acquisition, the acquisition does not represent a change in the ownership of a substantial portion of Corporation N's assets.

Example 2. Assume the same facts as in *Example 1*. Also assume that on November 1, 2006, Corporation M acquires from Corporation N additional assets having a fair market value of \$700,000. Thus, Corporation M has acquired from Corporation N assets worth a total of \$1.2 million during the 12-month period ending on November 1, 2006. Since \$1.2 million is more than one-third of the total gross fair market value of all of Corporation N's assets immediately prior to the earlier of these acquisitions (\$3 million), a change in the ownership of a substantial portion of Corporation N's assets is considered to have occurred on November 1, 2006.

Example 3. (i) All of the assets of Corporation P are transferred to Corporation O (an unrelated corporation). In exchange, the shareholders of Corporation P receive Corporation O stock. Immediately after the transfer, the former shareholders of Corporation P own 60 percent of the fair market value of the outstanding stock of Corporation O and the former shareholders of Corporation O own 40 percent of the fair market value of the outstanding stock of Corporation O. Because Corporation O is an entity more than 50 percent of the fair market value of the outstanding stock of which is owned by the former shareholders of Corporation P (based on ownership of Corporation P prior to the change), the transfer of assets is not treated as a change in ownership of a substantial portion of the assets of Corporation P. However, a change in the ownership (within the meaning of Q/A-27) of Corporation O occurs.

(ii) The result in paragraph (i) would be the same if immediately after the change, the former shareholders of Corporation P own stock with a fair market value of 51 percent of the value of Corporation O stock because Corporation O is an entity more than 50 percent of the fair market value of the outstanding stock of which is owned by the former shareholders of Corporation P. See Q/A-27, *Example 4*, regarding whether there is a change in ownership or control of O.

Example 4. Corporation P sells all of the stock of its wholly-owned subsidiary, S, to Corporation Y. The fair market value of the affiliated group, determined without regard to its liabilities, is \$210 million. The fair market value of S, determined without regard to its liabilities, is \$80 million. Because there is a change in more than one-third of the gross fair market value of the total assets of the affiliated group, there is a change in the ownership of a substantial portion of the assets of the affiliated group.

Three-Times-Base-Amount Test for Parachute Payments

Q-30: Are all payments that are in the nature of compensation, are made to a disqualified individual, and are contingent on a change in ownership or control, parachute payments?

A-30: (a) No. To determine whether such payments are parachute payments, they must be tested against the individual's *base amount* (as defined in Q/A-34 of this section). To do this, the aggregate present value of all payments in the nature of compensation that are made or to be made to (or for the benefit of) the same disqualified individual and are contingent on the change in ownership or control must be determined. If this aggregate present value equals or exceeds the amount equal to 3 times the individual's base amount, the payments are parachute payments. If this aggregate present value is less than the amount equal to 3 times the individual's base amount, no portion of

the payment is a parachute payment. See Q/A-31, Q/A-32, and Q/A-33 of this section for rules on determining present value. Parachute payments that are securities violation parachute payments are not included in the foregoing computation if they are not contingent on a change in ownership or control. See Q/A-37 of this section for the definition and treatment of securities violation parachute payments.

(b) The following examples illustrate the principles of this A-30:

Example 1. A is a disqualified individual with respect to Corporation M. A's base amount is \$100,000. Payments in the nature of compensation that are contingent on a change in the ownership or control of Corporation M totaling \$400,000 are made to A on the date of the change in ownership or control. The payments are parachute payments because they have an aggregate present value at least equal to 3 times A's base amount of \$100,000 ($3 \times \$100,000 = \$300,000$).

Example 2. Assume the same facts as in *Example 1*, except that the payments contingent on the change in the ownership or control of Corporation M total \$290,000. Because the payments do not have an aggregate present value at least equal to 3 times A's base amount, no portion of the payments is a parachute payment.

Q-31: As of what date is the present value of a payment determined?

A-31: (a) Except as provided in this section, the present value of a payment is determined as of the date on which the change in ownership or control occurs, or, if a payment is made prior to such date, the date on which the payment is made.

(b)(1) For purposes of determining whether a payment is a parachute payment, if a payment in the nature of compensation is the right to receive payments in a year (or years) subsequent to the year of the change in ownership or control, the value of the payment is the present value of such payment (or payments) calculated in accordance with Q/A-32 of this section and based on reasonable actuarial assumptions.

(2) If the payment in the nature of compensation is an obligation to provide health care, then for purposes of this A-31 and for applying the 3-times-base-amount test under Q/A-30 of this section, the present value of such obligation should be calculated in accordance with generally accepted accounting principles. For purposes of Q/A-30 and this A-31, the obligation to provide health care is permitted to be measured by projecting the cost of

premiums for purchased health care insurance, even if no health care insurance is actually purchased. If the obligation to provide health care is made in coordination with a health care plan that the corporation makes available to a group, then the premiums used for this purpose may be group premiums.

Q-32: What discount rate is to be used to determine present value?

A-32: For purposes of this section, present value generally is determined by using a discount rate equal to 120 percent of the applicable federal rate (determined under section 1274(d) and the regulations thereunder) compounded semiannually. The applicable federal rate to be used for this purpose is the federal rate that is in effect on the date as of which the present value is determined, using the period until the payment would have been made without regard to the change in ownership or control as the term of the debt instrument under section 1274(d). See Q/A-24 and 31 of this section. However, for any payment, the corporation and the disqualified individual may elect to use the applicable federal rate that is in effect on the date that the contract which provides for the payment is entered into, if such election is made in the contract.

Q-33: If the present value of a payment to be made in the future is contingent on an uncertain future event or condition, how is the present value of the payment determined?

A-33: (a) In certain cases, it may be necessary to apply the 3-times-base-amount test of Q/A-30 of this section, or to allocate a portion of the base amount to a payment described in paragraphs (a)(1), (2), and (3) of Q/A-2 of this section, at a time when the aggregate present value of all such payments cannot be determined with certainty because the time, amount, or right to receive one or more such payments is contingent on the occurrence of an uncertain future event or condition. For example, a disqualified individual's right to receive a payment may be contingent on the involuntary termination of such individual's employment with the corporation. In such a case, it must be reasonably estimated whether the payment will be made. If it is reasonably estimated that there is a 50-percent or greater probability that the payment will be made, the full amount of the payment is considered

for purposes of the 3-times-base-amount test and the allocation of the base amount. Conversely, if it is reasonably estimated that there is a less than 50-percent probability that the payment will be made, the payment is not considered for either purpose.

(b) If the estimate made under paragraph (a) of this A-33 is later determined to be incorrect, the 3-times-base-amount test described in Q/A-30 of this section must be reapplied (and the portion of the base amount allocated to previous payments must be reallocated (if necessary) to such payments) to reflect the actual time and amount of the payment. Whenever the 3-times-base-amount test is applied (or whenever the base amount is allocated), the aggregate present value of the payments received or to be received by the disqualified individual is redetermined as of the date described in A-31 of this section, using the discount rate described in A-32 of this section. This redetermination may affect the amount of any excess parachute payment for a prior taxable year. Alternatively, if, based on the application of the 3-times-base-amount test without regard to the payment described in paragraph (a) of this A-33, a disqualified individual is determined to have an excess parachute payment or payments, then the 3-times-base-amount test does not have to be reapplied when a payment described in paragraph (a) of this A-33 is made (or becomes certain to be made) if no base amount is allocated to such payment.

(c) To the extent provided in published guidance of general applicability under §601.601(d)(2) of this Chapter, an initial estimate of the value of an option subject to Q/A-13 of this section is permitted to be made, with the valuation subsequently redetermined, and the three-times-base-amount test reapplied.

(d) The following examples illustrate the principles of this A-33:

Example 1. A, a disqualified individual with respect to Corporation M, has a base amount of \$100,000. Under A's employment agreement with Corporation M, A is entitled to receive a payment in the nature of compensation in the amount of \$250,000 contingent on a change in ownership or control of Corporation M. In addition, the agreement provides that if A's employment is terminated within 1 year after the change in ownership or control, A will receive an additional payment in the nature of compensation in the amount of \$150,000, payable 1 year after the date of the change in ownership or control. A change in ownership or control of Corporation M

occurs and A receives the first payment of \$250,000. Corporation M reasonably estimates that there is a 50-percent probability that, as a result of the change, A's employment will be terminated within 1 year of the date of the change. For purposes of applying the 3-times-base-amount test (and if the first payment is determined to be a parachute payment, for purposes of allocating a portion of A's base amount to that payment), because M reasonably estimates that there is a 50-percent or greater probability that, as a result of the change, A's employment will be terminated within 1 year of the date of the change, Corporation M must assume that the \$150,000 payment will be made to A as a result of the change in ownership or control. The present value of the additional payment is determined under Q/A-31 and Q/A-32 of this section.

Example 2. Assume the same facts as in *Example 1*, except that Corporation M reasonably estimates that there is a less than 50-percent probability that, as a result of the change, A's employment will be terminated within 1 year of the date of the change. For purposes of applying the 3-times-base-amount test, because Corporation M reasonably estimates that there is a less than 50-percent probability that, as a result of the change, A's employment will be terminated within 1 year of the date of the change, Corporation M must assume that the \$150,000 payment will not be made to A as a result of the change in ownership or control.

Example 3. B, a disqualified individual with respect to Corporation P, has a base amount of \$200,000. Under B's employment agreement with Corporation P, if there is a change in ownership or control of Corporation P, B will receive a severance payment of \$600,000 and a bonus payment of \$400,000. In addition, the agreement provides that if B's employment is terminated within 1 year after the change, B will receive an additional payment in the nature of compensation of \$500,000. A change in ownership or control of Corporation P occurs, and B receives the \$600,000 and \$400,000 payments. At the time of the change in ownership or control, Corporation P reasonably estimates that there is a less than 50-percent probability that B's employment will be terminated within 1 year of the change. For purposes of applying the 3-times-base-amount test, because Corporation P reasonably estimates that there is a less than 50-percent probability that B's employment will be terminated within 1 year of the date of the change, Corporation P assumes that the \$500,000 payment will not be made to B. Eleven months after the change in ownership or control, B's employment is terminated, and the \$500,000 payment is made to B. Because B was determined to have excess parachute payments without regard to the \$500,000 payment, the 3-times-base-amount test is not reapplied and the base amount is not reallocated to include the \$500,000 payment. The entire \$500,000 payment is treated as an excess parachute payment.

Q-34: What is the base amount?

A-34: (a) The base amount of a disqualified individual is the average annual compensation for services performed for the corporation with respect to which the change in ownership or control occurs (or for a predecessor entity or a related entity

as defined in Q/A-21 of this section) which was includible in the gross income of such individual for taxable years in the base period (including amounts that were excluded under section 911), or which would have been includible in such gross income if such person had been a United States citizen or resident. See Q/A-35 of this section for the definition of base period and for examples of base amount computations.

(b) If the base period of a disqualified individual includes a short taxable year or less than all of a taxable year, compensation for such short or incomplete taxable year must be annualized before determining the average annual compensation for the base period. In annualizing compensation, the frequency with which payments are expected to be made over an annual period must be taken into account. Thus, any amount of compensation for such a short or incomplete taxable year that represents a payment that will not be made more often than once per year is not annualized.

(c) Because the base amount includes only compensation that is includible in gross income, the base amount does not include certain items that constitute parachute payments. For example, payments in the form of excludible fringe benefits are not included in the base amount but may be treated as parachute payments.

(d) The base amount includes the amount of compensation included in income under section 83(b) during the base period. See Q/A-35 for the definition of *base period*.

(e) The following example illustrates the principles of this A-34:

Example. A disqualified individual, D, receives an annual salary of \$500,000 per year during the 5-year base period. D defers \$100,000 of D's salary each year under the corporation's nonqualified deferred compensation plan. D's base amount is \$400,000 ($\$400,000 \times (5/5)$).

Q-35: What is the base period?

A-35: (a) The base period of a disqualified individual is the most recent 5 taxable years of the individual ending before the date of the change in ownership or control. For this purpose, the date of the change in ownership or control is the date the corporation experiences one of the events described in Q/A-27, Q/A-28, or Q/A-29 of this section. However, if the disqualified individual was not an employee or independent contractor of the corporation with

respect to which the change in ownership or control occurs (or a predecessor entity or a related entity as defined in Q/A-21 of this section) for this entire 5-year period, the individual's base period is the portion of such 5-year period during which the individual performed personal services for the corporation or predecessor entity or related entity.

(b) The following examples illustrate the principles of Q/A-34 of this section and this Q/A-35:

Example 1. A disqualified individual, D, was employed by a corporation for 2 years and 4 months preceding the taxable year in which a change in ownership or control of the corporation occurs. D's includible compensation income from the corporation was \$30,000 for the 4-month period, \$120,000 for the first full year, and \$150,000 for the second full year. D's base amount is $\$120,000, ((3 \times \$30,000) + \$120,000 + \$150,000) / 3$.

Example 2. Assume the same facts as in *Example 1*, except that D also received a \$60,000 signing bonus when D's employment with the corporation commenced at the beginning of the 4-month period. D's base amount is $\$140,000, ((\$60,000 + (3 \times \$30,000)) + \$120,000 + \$150,000) / 3$. Since the bonus will not be paid more often than once per year, the amount of the bonus is not increased in annualizing D's compensation for the 4-month period.

Example 3. E is a disqualified individual with respect to Corporation X who was not an employee or independent contractor for the full 5-year base period. In 2004 and 2005, E is a director of X and receives \$30,000 per year for E's services. In 2006, E becomes an officer of X. E's includible compensation from Corporation X is \$250,000 for 2006 and 2007, and \$300,000 for 2008. In 2008, X undergoes a change in ownership or control. E's base amount is $\$140,000 ((2 \times \$250,000) + (2 \times \$30,000)) / 4$.

Q-36: How is the base amount determined in the case of a disqualified individual who did not perform services for the corporation (or a predecessor entity or a related entity as defined in Q/A-21 of this section), prior to the individual's taxable year in which the change in ownership or control occurs?

A-36: (a) In such a case, the individual's base amount is the annualized compensation for services performed for the corporation (or a predecessor entity or related entity) which —

(1) Was includible in the individual's gross income for that portion, prior to such change, of the individual's taxable year in which the change occurred (including amounts that were excluded under section 911), or would have been includible in such gross income if such person had been a United States citizen or resident;

(2) Was not contingent on the change in ownership or control; and

(3) Was not a securities violation parachute payment.

(b) The following examples illustrate the principles of this A-36:

Example 1. On January 1, 2006, A, an individual whose taxable year is the calendar year, enters into a 4-year employment contract with Corporation M as an officer of the corporation. A has not previously performed services for Corporation M (or any predecessor entity or related entity as defined in Q/A-21 of this section). Under the employment contract, A is to receive an annual salary of \$120,000 for each of the 4 years that he remains employed by Corporation M with any remaining unpaid balance to be paid immediately in the event that A's employment is terminated without cause. On July 1, 2006, after A has received compensation of \$60,000, a change in the ownership or control of Corporation M occurs. Because of the change, A's employment is terminated without cause, and he receives a payment of \$420,000. It is established by clear and convincing evidence that the \$60,000 in compensation is not contingent on the change in ownership or control, but the presumption that the \$420,000 payment is contingent on the change is not rebutted. Thus, the payment of \$420,000 is treated as contingent on the change in ownership or control of Corporation M. In this case, A's base amount is $\$120,000 (2 \times \$60,000)$. Since the present value of the payment which is contingent on the change in ownership of Corporation M (\$420,000) is more than 3 times A's base amount of $\$120,000 (3 \times \$120,000 = \$360,000)$, the payment is a parachute payment.

Example 2. Assume the same facts as in *Example 1*, except that A also receives a signing bonus of \$50,000 from Corporation M on January 1, 2006. It is established by clear and convincing evidence that the bonus is not contingent on the change in ownership or control. When the change in ownership or control occurs on July 1, 2006, A has received compensation of \$110,000 (the \$50,000 bonus plus \$60,000 in salary). In this case, A's base amount is $\$170,000 (\$50,000 + (2 \times \$60,000))$. Because the \$50,000 bonus will not be paid more than once per year, the amount of the bonus is not increased in annualizing A's compensation. The present value of the potential parachute payment (\$420,000) is less than 3 times A's base amount of $\$170,000 (3 \times \$170,000 = \$510,000)$, and therefore no portion of the payment is a parachute payment.

Securities Violation Parachute Payments

Q-37: Must a payment be contingent on a change in ownership or control in order to be a parachute payment?

A-37: (a) No, the term *parachute payment* also includes any payment (other than a payment exempted under Q/A-6 or Q/A-8 of this section) that is in the nature of compensation and is to (or for the benefit of) a disqualified individual, if such payment is a securities violation payment. A securities violation payment is a payment made or to be made —

(1) Pursuant to an agreement that violates any generally enforced federal or state securities laws or regulations; and

(2) In connection with a potential or actual change in ownership or control.

(b) A violation is not taken into account under paragraph (a)(1) of this A-37 if it is merely technical in character or is not materially prejudicial to shareholders or potential shareholders. Moreover, a violation will be presumed not to exist unless the existence of the violation has been determined or admitted in a civil or criminal action (or an administrative action by a regulatory body charged with enforcing the particular securities law or regulation) which has been resolved by adjudication or consent. Parachute payments described in this A-37 are referred to in this section as securities violation payments.

(c) Securities violation parachute payments that are not contingent on a change in ownership or control within the meaning of Q/A-22 of this section are not taken into account in applying the 3-times-base-amount test of Q/A-30 of this section. Such payments are considered parachute payments regardless of whether such test is met with respect to the disqualified individual (and are included in allocating base amount under Q/A-38 of this section). Moreover, the amount of a securities violation parachute payment treated as an excess parachute payment shall not be reduced by the portion of such payment that is reasonable compensation for personal services actually rendered before the date of a change in ownership or control if such payment is not contingent on such change. Likewise, the amount of a securities violation parachute payment includes the portion of such payment that is reasonable compensation for personal services to be rendered on or after the date of a change in ownership or control if such payment is not contingent on such change.

(d) The rules in paragraph (b) of this A-37 also apply to securities violation parachute payments that are contingent on a change in ownership or control if the application of these rules results in greater total excess parachute payments with respect to the disqualified individual than would result if the payments were treated simply as payments contingent on a change in ownership or control (and hence were taken into account in applying the 3-times-base-amount test and

were reduced by, or did not include, any applicable amount of reasonable compensation).

(e) The following examples illustrate the principles of this A-37:

Example 1. A, a disqualified individual with respect to Corporation M, receives two payments in the nature of compensation that are contingent on a change in the ownership or control of Corporation M. The present value of the first payment is equal to A's base amount and is not a securities violation parachute payment. The present value of the second payment is equal to 1.5 times A's base amount and is a securities violation parachute payment. Neither payment includes any reasonable compensation. If the second payment is treated simply as a payment contingent on a change in ownership or control, the amount of A's total excess parachute payments is zero because the aggregate present value of the payments does not equal or exceed 3 times A's base amount. If the second payment is treated as a securities violation parachute payment subject to the rules of paragraph (b) of this A-37, the amount of A's total excess parachute payments is 0.5 times A's base amount. Thus, the second payment is treated as a securities violation parachute payment.

Example 2. Assume the same facts as in *Example 1*, except that the present value of the first payment is equal to 2 times A's base amount. If the second payment is treated simply as a payment contingent on a change in ownership or control, the total present value of the payments is 3.5 times A's base amount, and the amount of A's total excess parachute payments is 2.5 times A's base amount. If the second payment is treated as a securities violation parachute payment, the amount of A's total excess parachute payments is 0.5 times A's base amount. Thus, the second payment is treated simply as a payment contingent on a change in ownership or control.

Example 3. B, a disqualified individual with respect to Corporation N, receives two payments in the nature of compensation that are contingent on a change in the control of Corporation N. The present value of the first payment is equal to 4 times B's base amount and is a securities violation parachute payment. The present value of the second payment is equal to 2 times B's base amount and is not a securities violation parachute payment. B establishes by clear and convincing evidence that the entire amount of the first payment is reasonable compensation for personal services to be rendered after the change in ownership or control. If the first payment is treated simply as a payment contingent on a change in ownership or control, it is exempt from the definition of *parachute payment* pursuant to Q/A-9 of this section. Thus, the amount of B's total excess parachute payment is zero because the present value of the second payment does not equal or exceed three times B's base amount. However, if the first payment is treated as a securities violation parachute payment, the amount of B's total excess parachute payments is 3 times B's base amount. Thus, the first payment is treated as a securities violation parachute payment.

Example 4. Assume the same facts as in *Example 3*, except that B does not receive the second payment and B establishes by clear and convincing evidence that the first payment is reasonable compensation for services actually rendered before the change

in the control of Corporation N. If the payment is treated simply as a payment contingent on a change in ownership or control, the amount of B's excess parachute payment is zero because the amount treated as an excess parachute payment is reduced by the amount that B establishes as reasonable compensation. However, if the payment is treated as a securities violation parachute payment, the amount of B's excess parachute payment is 3 times B's base amount. Thus, the payment is treated as a securities violation parachute payment.

Computation and Reduction of Excess Parachute Payments

Q-38: How is the amount of an excess parachute payment computed?

A-38: (a) The amount of an excess parachute payment is the excess of the amount of any parachute payment over the portion of the disqualified individual's base amount that is allocated to such payment. For this purpose, the portion of the base amount allocated to any parachute payment is the amount that bears the same ratio to the base amount as the present value of such parachute payment bears to the aggregate present value of all parachute payments made or to be made to (or for the benefit of) the same disqualified individual. Thus, the portion of the base amount allocated to any parachute payment is determined by multiplying the base amount by a fraction, the numerator of which is the present value of such parachute payment and the denominator of which is the aggregate present value of all such payments. See Q/A-31, Q/A-32, and Q/A-33 of this section for rules on determining present value and Q/A-34 of this section for the definition of *base amount*.

(b) The following example illustrates the principles of this A-38:

Example. An individual with a base amount of \$100,000 is entitled to receive two parachute payments, one of \$200,000 and the other of \$400,000. The \$200,000 payment is made at the time of the change in ownership or control, and the \$400,000 payment is to be made at a future date. The present value of the \$400,000 payment is \$300,000 on the date of the change in ownership or control. The portions of the base amount allocated to these payments are \$40,000 ($(\$200,000/\$500,000) \times \$100,000$) and \$60,000 ($(\$300,000/\$500,000) \times \$100,000$), respectively. Thus, the amount of the first excess parachute payment is \$160,000 ($\$200,000 - \$40,000$) and that of the second is \$340,000 ($\$400,000 - \$60,000$).

Q-39: May the amount of an excess parachute payment be reduced by reasonable compensation for personal services actually rendered before the change in ownership or control?

A-39: (a) Generally, yes. Except in the case of payments treated as securities violation parachute payments or when the portion of a payment that is treated as contingent on the change in ownership or control is determined under paragraph (b) or (c) of Q/A-24 of this section, the amount of an excess parachute payment is reduced by any portion of the payment that the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services actually rendered by the disqualified individual before the date of the change in ownership or control. Services reasonably compensated for by payments that are not parachute payments (for example, because the payments are not contingent on a change in ownership or control and are not securities violation parachute payments, or because the payments are exempt from the definition of parachute payment under Q/A-6 through Q/A-9 of this section) are not taken into account for this purpose. The portion of any parachute payment that is established as reasonable compensation is first reduced by the portion of the disqualified individual's base amount that is allocated to such parachute payment; any remaining portion of the parachute payment established as reasonable compensation then reduces the excess parachute payment.

(b) The following examples illustrate the principles of this A-39:

Example 1. Assume that a parachute payment of \$600,000 is made to a disqualified individual, and the portion of the individual's base amount that is allocated to the parachute payment is \$100,000. Also assume that \$300,000 of the \$600,000 parachute payment is established as reasonable compensation for personal services actually rendered by the disqualified individual before the date of the change in ownership or control. Before the reasonable compensation is taken into account, the amount of the excess parachute payment is \$500,000 ($\$600,000 - \$100,000$). In reducing the excess parachute payment by reasonable compensation, the portion of the parachute payment that is established as reasonable compensation (\$300,000) is first reduced by the portion of the disqualified individual's base amount that is allocated to the parachute payment (\$100,000), and the remainder (\$200,000) then reduces the excess parachute payment. Thus, in this case, the excess parachute payment of \$500,000 is reduced by \$200,000 of reasonable compensation.

Example 2. Assume the same facts as in *Example 1*, except that the full amount of the \$600,000 parachute payment is established as reasonable compensation. In this case, the excess parachute payment of \$500,000 is reduced to zero by \$500,000 of reasonable compensation. As a result, no portion of any

deduction for the payment is disallowed by section 280G, and no portion of the payment is subject to the 20-percent excise tax of section 4999.

Determination of Reasonable Compensation

Q-40: How is it determined whether payments are reasonable compensation?

A-40: (a) In general, whether payments are reasonable compensation for personal services actually rendered, or to be rendered, by the disqualified individual is determined on the basis of all the facts and circumstances of the particular case. Factors relevant to such a determination include, but are not limited to, the following—

(1) The nature of the services rendered or to be rendered;

(2) The individual's historic compensation for performing such services; and

(3) The compensation of individuals performing comparable services in situations where the compensation is not contingent on a change in ownership or control.

(b) For purposes of section 280G, reasonable compensation for personal services includes reasonable compensation for holding oneself out as available to perform services and refraining from performing services (such as under a covenant not to compete).

Q-41: Is any particular type of evidence generally considered clear and convincing evidence of reasonable compensation for personal services?

A-41: Yes. A showing that payments are made under a nondiscriminatory employee plan or program (as defined in Q/A-26 of this section) generally is considered to be clear and convincing evidence that the payments are reasonable compensation. This is true whether the personal services for which the payments are made are actually rendered before, or are to be rendered on or after, the date of the change in ownership or control. Q/A-46 of this section (relating to the treatment of an affiliated group as one corporation) does not apply for purposes of this A-41. No determination of reasonable compensation is needed for payments under qualified plans to be exempt from the definition of *parachute payment* under Q/A-8 of this section.

Q-42: Is any particular type of evidence generally considered clear and convincing evidence of reasonable compensation for personal services to be rendered on or after the date of a change in ownership or control?

A-42: (a) Yes, if payments are made or to be made to (or on behalf of) a disqualified individual for personal services to be rendered on or after the date of a change in ownership or control, a showing of the following generally is considered to be clear and convincing evidence that the payments are reasonable compensation for services to be rendered on or after the date of the change in ownership or control—

(1) The payments were made or are to be made only for the period the individual actually performs such personal services; and

(2) If the individual's duties and responsibilities are substantially the same after the change in ownership or control, the individual's annual compensation for such services is not significantly greater than such individual's annual compensation prior to the change in ownership or control, apart from normal increases attributable to increased responsibilities or cost of living adjustments. If the scope of the individual's duties and responsibilities are not substantially the same, the annual compensation after the change is not significantly greater than the annual compensation customarily paid by the employer or by comparable employers to persons performing comparable services. However, except as provided in paragraph (b) and (c) of this A-42, such clear and convincing evidence will not exist if the individual does not, in fact, perform the services contemplated in exchange for the compensation.

(b) Generally, an agreement under which the disqualified individual must refrain from performing services (*e.g.*, a covenant not to compete) is an agreement for the performance of personal services for purposes of this A-42 to the extent that it is demonstrated by clear and convincing evidence that the agreement substantially constrains the individual's ability to perform services and there is a reasonable likelihood that the agreement will be enforced against the individual. In the absence of clear and convincing evidence, payments under the agreement are treated as severance payments under Q/A-44 of this section.

(c) If the employment of a disqualified individual is involuntarily terminated before the end of a contract term and the individual is paid damages for breach of contract, a showing of the following factors generally is considered clear and convincing evidence that the payment is reasonable compensation for personal services to be rendered on or after the date of change in ownership or control—

(1) The contract was not entered into, amended, or renewed in contemplation of the change in ownership or control;

(2) The compensation the individual would have received under the contract would have qualified as reasonable compensation under section 162;

(3) The damages do not exceed the present value (determined as of the date of receipt) of the compensation the individual would have received under the contract if the individual had continued to perform services for the employer until the end of the contract term;

(4) The damages are received because an offer to provide personal services was made by the disqualified individual but was rejected by the employer (including involuntary termination or constructive discharge); and

(5) The damages are reduced by mitigation. Mitigation will be treated as occurring when such damages are reduced (or any payment of such damages is returned) to the extent of the disqualified individual's earned income (within the meaning of section 911(d)(2)(A)) during the remainder of the period in which the contract would have been in effect. See Q/A-44 of this section for rules regarding damages for a failure to make severance payments.

(d) The following examples illustrate the principles of this A-42:

Example 1. A, a disqualified individual, has a three-year employment contract with Corporation M, a publicly traded corporation. Under this contract, A is to receive a salary for \$100,000 for the first year of the contract and, for each succeeding year, an annual salary that is 10 percent higher than the prior year's salary. During the third year of the contract, Corporation N acquires all the stock of Corporation M. Prior to the change in ownership, Corporation N arranges to retain A's services by entering into an employment contract with A that is essentially the same as A's contract with Corporation M. Under the new contract, Corporation N is to fulfill Corporation M's obligations for the third year of the old contract, and, for each of the succeeding years, pay A an annual salary that is 10 percent higher than A's prior year's salary.

Amounts are payable under the new contract only for the portion of the contract term during which A remains employed by Corporation N. A showing of the facts described above (and in the absence of contradictory evidence) is regarded as clear and convincing evidence that all payments under the new contract are reasonable compensation for personal services to be rendered on or after the date of the change in ownership. Therefore, the payments under this agreement are exempt from the definition of *parachute payment* pursuant to Q/A-9 of this section.

Example 2. Assume the same facts as in *Example 1*, except that A does not perform the services described in the new contract, but receives payment under the new contract. Because services were not rendered after the change, the payments under this contract are not exempt from the definition of *parachute payment* pursuant to Q/A-9 of this section.

Example 3. Assume the same facts as in *Example 1*, except that under the new contract A agrees to perform consulting services to Corporation N, when and if Corporation N requires A's services. Assume further that when Corporation N does not require A's services, the contract provides that A must not perform services for any other competing company. Corporation N previously enforced similar contracts against former employees of Corporation N. Because A is substantially constrained under this contract and Corporation N is reasonably likely to enforce the contract against A, the agreement is an agreement for the performance of services under paragraph (b) of this A-42. Assuming the requirements of paragraph (a) of this A-42 are met and there is clear and convincing evidence that all payments under the new contract are reasonable compensation for personal services to be rendered on or after the date of the change in ownership, the payments under this contract are exempt from the definition of *parachute payment* pursuant to Q/A-9 of this section.

Example 4. Assume the same facts as in *Example 1*, except that instead of agreeing not to compete with Corporation N, under the new agreement A agrees not to disparage either Corporation M or Corporation N. Because the nondisparagement agreement does not substantially constrain A's ability to perform services, no amount of the payments under this contract are reasonable compensation for the nondisparagement agreement.

Example 5. Assume the same facts as in *Example 1*, except that the employment contract with Corporation N does not provide that amounts are payable under the contract only for the portion of the term for which A remains employed by Corporation N. Shortly after the change in ownership, and despite A's request to remain employed by Corporation N, A's employment with Corporation N is involuntarily terminated. Shortly thereafter, A obtains employment with Corporation O. A commences a civil action against Corporation N, alleging breach of the employment contract. In settlement of the litigation, A receives an amount equal to the present value of the compensation A would have received under the contract with Corporation N, reduced by the amount of compensation A otherwise receives from Corporation O during the period that the contract would have been in effect. A showing of the facts described above (and in the absence of contradictory evidence) is regarded as clear and convincing evidence that the

amount A receives as damages is reasonable compensation for personal services to be rendered on or after the date of the change in ownership. Therefore, the amount received by A is exempt from the definition of *parachute payment* pursuant to Q/A-9 of this section.

Q-43: Is any particular type of payment generally considered reasonable compensation for personal services actually rendered before the date of a change in ownership or control?

A-43: Yes, payments of compensation earned before the date of a change in ownership or control generally are considered reasonable compensation for personal services actually rendered before the date of a change in ownership or control if they qualify as reasonable compensation under section 162.

Q-44: May severance payments be treated as reasonable compensation?

A-44: (a) No, severance payments are not treated as reasonable compensation for personal services actually rendered before, or to be rendered on or after, the date of a change in ownership or control. Moreover, any damages paid for a failure to make severance payments are not treated as reasonable compensation for personal services actually rendered before, or to be rendered on or after, the date of such change. For purposes of this section, the term *severance payment* means any payment that is made to (or for the benefit of) a disqualified individual on account of the termination of such individual's employment prior to the end of a contract term, but does not include any payment that otherwise would be made to (or for the benefit of) such individual on the termination of such individual's employment, whenever occurring.

(b) The following example illustrates the principles of this A-44:

Example. A, a disqualified individual, has a three-year employment contract with Corporation X. Under the contract, A will receive a salary of \$200,000 for the first year of the contract, and for each succeeding year, an annual salary that is \$100,000 higher than the previous year. In the event of A's termination of employment following a change in ownership or control, the contract provides that A will receive the remaining salary due under the employment contract. At the beginning of the second year of the contract, Corporation Y acquires all of the stock of Corporation X, A's employment is terminated, and A receives \$700,000 (\$300,000 for the second year of the contract plus \$400,000 for the third year of the contract) representing the remaining salary due under the employment contract. Because the \$700,000 payment is treated as a severance payment, it is not reasonable compensation for personal services on or after

the date of the change in ownership or control. Thus, the full amount of the \$700,000 is a parachute payment.

Miscellaneous Rules

Q-45: How is the term *corporation* defined?

A-45: For purposes of this section, the term *corporation* has the meaning prescribed by section 7701(a)(3) and §301.7701-2(b) of this Chapter. For example, a *corporation*, for purposes of this section, includes a publicly traded partnership treated as a corporation under section 7704(a); an entity described in §301.7701-3(c)(1)(v)(A) of this Chapter; a real estate investment trust under section 856(a); a corporation that has mutual or cooperative (rather than stock) ownership, such as a mutual insurance company, a mutual savings bank, or a cooperative bank (as defined in section 7701(a)(32)), and a foreign corporation as defined under section 7701(a)(5).

Q-46: How is an affiliated group treated?

A-46: For purposes of this section, and except as otherwise provided in this section, all members of the same affiliated group (as defined in section 1504, determined without regard to section 1504(b)) are treated as one corporation. Rules affected by this treatment of an affiliated group include (but are not limited to) rules relating to exempt payments of certain corporations (Q/A-6, Q/A-7 of this section (except as provided therein)), payor of parachute payments (Q/A-10 of this section), disqualified individuals (Q/A-15 through Q/A-21 of this section (except as provided therein)), rebuttal of the presumption that payments are contingent on a change (Q/A-26 of this section (except as provided therein)), change in ownership or control (Q/A-27, 28, and 29 of this section), and reasonable compensation (Q/A-42, 43, and 44 of this section).

Effective Date

Q-47: What is the general effective date of section 280G?

A-47: (a) Generally, section 280G applies to payments under agreements entered into or renewed after June 14, 1984. Any agreement that is entered into before June 15, 1984, and is renewed after June

14, 1984, is treated as a new contract entered into on the day the renewal takes effect.

(b) For purposes of paragraph (a) of this A-47, a contract that is terminable or cancellable unconditionally at will by either party to the contract without the consent of the other, or by both parties to the contract, is treated as a new contract entered into on the date any such termination or cancellation, if made, would be effective. However, a contract is not treated as so terminable or cancellable if it can be terminated or cancelled only by terminating the employment relationship or independent contractor relationship of the disqualified individual.

(c) Section 280G applies to payments under a contract entered into on or before June 14, 1984, if the contract is amended or supplemented after June 14, 1984, in significant relevant respect. For this purpose, a *supplement* to a contract is defined as a new contract entered into after June 14, 1984, that affects the trigger, amount, or time of receipt of a payment under an existing contract.

(d)(1) Except as otherwise provided in paragraph (e) of this A-47, a contract is considered to be amended or supplemented in significant relevant respect if provisions for payments contingent on a change in ownership or control (parachute provisions), or provisions in the nature of parachute provisions, are added to the contract, or are amended or supplemented

to provide significant additional benefits to the disqualified individual. Thus, for example, a contract generally is treated as amended or supplemented in significant relevant respect if it is amended or supplemented —

(i) To add or modify, to the disqualified individual's benefit, a change in ownership or control trigger;

(ii) To increase amounts payable that are contingent on a change in ownership or control (or, where payment is to be made under a formula, to modify the formula to the disqualified individual's advantage); or

(iii) To accelerate, in the event of a change in ownership or control, the payment of amounts otherwise payable at a later date.

(2) For purposes of paragraph (a) of this A-47, a payment is not treated as being accelerated in the event of a change in ownership or control if the acceleration does not increase the present value of the payment.

(e) A contract entered into on or before June 14, 1984, is not treated as amended or supplemented in significant relevant respect merely by reason of normal adjustments in the terms of employment relationship or independent contractor relationship of the disqualified individual. Whether an adjustment in the terms of such a relationship is considered normal for this purpose depends on all of the facts and circumstances of the particular case. Relevant factors include, but are not limited to, the following—

(1) The length of time between the adjustment and the change in ownership or control;

(2) The extent to which the corporation, at the time of the adjustment, viewed itself as a likely takeover candidate;

(3) A comparison of the adjustment with historical practices of the corporation;

(4) The extent of overlap between the group receiving the benefits of the adjustment and those members of that group who are the beneficiaries of pre-June 15, 1984, parachute contracts; and

(5) The size of the adjustment, both in absolute terms and in comparison with the benefits provided to other members of the group receiving the benefits of the adjustment.

Q-48: What is the effective date of this section?

A-48: This section applies to any payments that are contingent on a change in ownership or control if the change in ownership or control occurs on or after January 1, 2004. Taxpayers may rely on these regulations after August 4, 2003, for the treatment of any parachute payment.

Par 3. In §602.101, paragraph (b) is amended by adding an entry in numerical order to the table to read as follows:

§602.101 OMB Control numbers.

* * * * *
(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.280G-1.....	1545-1851
* * * * *	

Robert E. Wenzel,
Deputy Commissioner for Services and Enforcement.

Approved July 14, 2003.

Pamela F. Olson,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on August 1, 2003, 8:45 a.m., and published in the issue of the Federal Register for August 4, 2003, 68 F.R. 45745)

Section 301.—Distributions of Property

26 CFR 1.301-1: Rules applicable with respect to distributions of money and other property.

Certain previously published revenue rulings are obsolete with respect to the taxation of split-dollar life insurance arrangements entered into or materially modified after September 17, 2003. See Rev. Rul. 2003-105, page 696.

Section 316.—Dividend Defined

26 CFR 1.316-1: Dividends.

Certain previously published revenue rulings are obsolete with respect to the taxation of split-dollar life insurance arrangements entered into or materially modified after September 17, 2003. See Rev. Rul. 2003-105, page 696.

Section 419A.—Qualified Asset Account; Limitation on Additions to Account

26 CFR 1.419A(f)(6)–1: Exception for 10 or more employer plan.

T.D. 9079

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

10 or More Employer Plans

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulation.

SUMMARY: This document contains final regulations that provide rules regarding the requirements for a welfare benefit fund that is part of a 10 or more employer plan. The regulations affect certain employers that provide welfare benefits to employees through a plan to which more than one employer contributes.

DATES: *Effective Date:* These regulations are effective July 17, 2003.

Applicability Date: For dates of applicability, see §1.419A(f)(6)–1(g).

FOR FURTHER INFORMATION CONTACT: Betty J. Clary, (202) 622–6080 (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 1545–1795. Responses to these collections of information are required to obtain a benefit (to be treated as a 10 or more employer plan excepted from the deduction limits for employer contributions to a welfare benefit fund).

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 assigned by the Office of Management and Budget.

The estimated annual burden per respondent and/or recordkeeper varies, depending on individual circumstances, with an estimated average of 25 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, W:CAR:MP:T:T:SP 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 these collections of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains amendments to the Income Tax Regulations under section 419A of the Internal Revenue Code (Code). Sections 419 and 419A, which were added to the Code by section 511 of the Deficit Reduction Act of 1984 (Public Law 98–369, 98 Stat. 494) set forth special rules limiting the deduction of employer contributions to a welfare benefit fund. Pursuant to section 419A(f)(6), the rules of sections 419 and 419A do not apply in the case of a welfare benefit fund that is part of a plan to which more than one employer contributes and to which no employer normally contributes more than 10 percent of the contributions of all employers under the plan, but only if the plan does not maintain experience-rating arrangements with respect to individual employers.

Section 419A(i) of the Code provides that the Secretary shall prescribe regulations as may be appropriate to carry out the purposes of sections 419 and 419A. Section 419A(i) further provides that the regulations may provide that the plan administrator of any welfare benefit fund to which more than one employer contributes shall submit such information to the employers

contributing to the fund as may be necessary to enable the employers to comply with the provisions of section 419A.

The legislative history of sections 419 and 419A of the Code explains that the principal purpose of the deduction limits for contributions to welfare benefit funds “is to prevent employers from taking premature deductions, for expenses which have not yet been incurred, by interposing an intermediary organization which holds assets which are used to provide benefits to the employees of the employer.” H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 1155 (1984), 1984–3 C.B. (Vol. 2) 1, 409.

The legislative history of section 419A(f)(6) of the Code explains that the reason the deduction limits of sections 419 and 419A do not generally apply to a fund that is part of a 10 or more employer plan is that “the relationship of a participating employer to [such a] plan often is similar to the relationship of an insured to an insurer.” H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 1159 (1984), 1984–3 C.B. (Vol. 2) 1, 413. Thus, the premise underlying the exception is that no special limitation on deductions is necessary in situations where a payment by an employer in excess of the minimum necessary to currently provide for the benefits under the plan is effectively lost to that employer, because the economics of the plan will discourage excessive contributions.

The 10 or more employer plan exception to the deduction limitation does not apply, however, where the plan maintains experience-rating arrangements with respect to individual employers. The reason for excluding these plans from the exception is that an experience-rating arrangement with respect to an individual employer changes the economics of the plan and allows an employer to contribute an amount in excess of the minimum amount necessary to provide for the current benefits with the confidence that the excess will inure to the benefit of that employer as the excess is used to provide benefits to its employees. The legislative history notes that making the exception to the deduction limits unavailable to plans that determine contributions on the basis of experience rating is consistent with the general rules relating to the definition of fund because “the employer’s interest with respect to such a plan is more similar to the relationship of an employer to a fund

than an insured to an insurer.” H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 1159 (1984), 1984-3 C.B. (Vol. 2) 1, 413.

In Notice 95-34, 1995-1 C.B. 309, the IRS identified certain types of arrangements that do not satisfy the requirements of section 419A(f)(6). Those arrangements typically require large employer contributions relative to the cost of the coverage for the benefits to be provided under the plan. The plans identified in the notice often maintain separate accounting of the assets attributable to the contributions made by each participating employer.¹ In some cases an employer’s contributions are related to the claims experience of its employees, while in other cases benefits are reduced if assets derived from an employer’s contributions are insufficient to fund the benefits to that employer’s employees. Thus, a particular employer’s contributions or its employees’ benefits may be determined in a way that insulates the employer to a significant extent from the experience of other participating employers.

The arrangements described in Notice 95-34 and similar arrangements do not satisfy the requirements of section 419A(f)(6) of the Code and do not provide the tax deductions claimed by their promoters for any of several reasons. For example, such an arrangement may be providing deferred compensation; the arrangement may be separate plans maintained for each employer; or the plan may be maintaining, in form or in operation, experience-rating arrangements with respect to individual employers (*e.g.*, where the employers have reason to expect that, at least for the most part, their contributions will benefit only their own employees). The notice also states that even if an arrangement satisfies the requirements of section 419A(f)(6), so that the deduction limits of sections 419 and 419A do not apply to the arrangement, the employer contributions may represent expenses that are not deductible under other sections of the Code.

Transactions that are the same as or substantially similar to the transactions described in Notice 95-34 are listed transactions for purposes of the tax shelter disclosure, registration, and list maintenance requirements. See Notice 2000-15,

2000-1 C.B. 826, (supplemented and superseded by Notice 2001-51, 2001-2 C.B. 190), §1.6011-4(b)(2) of the Income Tax Regulations, and §§301.6111-2(b)(2) and 301.6112-1(b)(2) of the Procedure and Administration Regulations.

On July 11, 2002, a notice of proposed rulemaking (REG-165868-01, 2002-2 C.B. 270 [67 FR 45933]) relating to whether a welfare benefit fund is part of a 10 or more employer plan (as defined in section 419A(f)(6) of the Internal Revenue Code) was published in the **Federal Register**. Written and electronic comments responding to the notice of proposed rulemaking were received. A public hearing was held on November 14, 2002. After consideration of all the comments, the proposed regulations are adopted as amended by this Treasury decision. The revisions are discussed below.

Explanation of Provisions

Overview of Rules

These regulations provide guidance under section 419A(f)(6) of the Code regarding the requirements that a welfare benefit fund must satisfy in order for an employer’s contribution to the fund to be excepted from the rules of sections 419 and 419A.

Section 419A(f)(6) of the Code provides that sections 419 and 419A do not apply in the case of a welfare benefit fund that is part of a 10 or more employer plan that does not maintain experience-rating arrangements with respect to individual employers. A *10 or more employer plan* is a plan to which more than one employer contributes and to which no employer normally contributes more than 10 percent of the total contributions contributed under the plan by all employers. The regulations provide that an employer is determined by aggregating all of the entities required to be aggregated under the rules under section 414(b), (c), or (m). This is particularly relevant for purposes of determining how many employers contribute, whether an employer normally contributes more than 10 percent of the total contributions under the plan, and whether the plan maintains experience-rating arrangements with respect to individual employers.

In addition, the regulations make clear that in order to be eligible for the exception from the deduction limits of sections 419 and 419A, a plan must satisfy the requirements of section 419A(f)(6) and these regulations both in form and operation. The determination of whether a plan is described in section 419A(f)(6) is based on the totality of the arrangement and all related facts and circumstances, including any related insurance contracts. Thus, all agreements and understandings (including promotional materials and policy illustrations) will be taken into account in determining whether the requirements of section 419A(f)(6) are satisfied in form and in operation. For example, if promotional materials indicate that an employer or its employees can be expected to receive a future benefit based on the employer’s accumulated contributions, the plan will be treated as maintaining experience-rating arrangements with respect to individual employers, even if the formal plan does not specifically provide for experience rating.

The regulations provide generally that a plan maintains an experience-rating arrangement with respect to an employer — making the plan ineligible for the section 419A(f)(6) exception — if any employer’s cost of coverage for any period is based, in whole or in part, either on the benefits experience or on the overall experience of that employer or one or more employees of that employer. For purposes of the regulations, an employer’s *cost of coverage* is the relationship between that employer’s contributions (including those of its employees) under the plan and the benefits or other amounts payable under the plan with respect to that employer. The term *benefits or other amounts payable* includes all amounts payable or distributable (or that will be otherwise provided), regardless of the form of the payment or distribution. *Benefits experience* refers, generally, to the benefits and other amounts incurred, paid, or distributed (or otherwise provided) in the past. The *overall experience* of an employer is the balance that would have accumulated in a welfare benefit fund if that employer were the only employer providing benefits under the plan. The *overall experience* of an employee is the balance that

¹ See *Booth v. Commissioner*, 108 T.C. 524 (1997), for an arrangement using a separate accounting system that does not qualify under the 10 or more employer plan exception.

would have accumulated in a welfare benefit fund if that employee were the only employee being provided benefits under the plan. *Overall experience* is defined similarly for a group of employers or a group of employees.

Definition of Experience Rating

A number of commentators suggested that the regulatory definition of experience-rating arrangement is inconsistent with industry usage and the discussions of experience rating set forth in *United States v. American Bar Endowment*, 477 U.S. 105 (1986) and *Sears Roebuck and Co. v. Commissioner*, 972 F.2d 858 (7th Cir. 1992). These commentators have urged that an experience-rating arrangement be narrowly defined to include only those situations in which the employer is automatically entitled to a refund of a portion of a premium payment if claims experience is better than expected.

The IRS and Treasury have reviewed these comments and have concluded that the proposed regulatory definition of experience-rating arrangement should be retained in the final regulations. Where a Code section provides an exception from the normal tax requirements, the exception must be narrowly applied and its exclusions interpreted broadly. *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46, 52 (1955). See also, *Arkansas Best Corporation v. Commissioner*, 485 U.S. 212, 219–220 (1987). Thus, the exclusion for experience-rating arrangements under the 10 or more employer plan exception should be interpreted broadly.

While both the *American Bar Endowment* case and the *Sears* case discuss a specific type of experience rating, there are other ways an insurance contract or other arrangement might take experience into account. For example, under one type of experience-rating arrangement, if the premiums paid exceed the actual cost of providing insurance to the group, the excess (the source of the dividend described in *American Bar Endowment*) is not refunded to the premium payer, but is instead used to reduce the cost of providing benefits for subsequent periods. This

reduction in the cost of providing benefits for subsequent periods can be accomplished directly by adjusting premiums or indirectly by providing additional benefits under the arrangement at no cost to the premium payer, or through a combination of premium reductions and additional benefits.

In view of the variety of ways that an arrangement might take experience into account, the regulations provide that a plan maintains an experience-rating arrangement with respect to an individual employer if the current (or future) cost of coverage of the employer is (or will be) based on either the past benefits or other amounts paid with respect to one or more of that employer's employees (or any proxy therefor) or on the balance accumulated in the fund as a result of the employer's or its employees' past contributions (or any proxy therefor). Accordingly, the process for determining whether a plan maintains an experience-rating arrangement is to inquire whether the past experience of an individual employer or its employees is used, in whole or in part, to determine the employer's cost of coverage. This determination is not intended to be purely a computational one (although actual numbers often can be used to demonstrate the existence of an experience-rating arrangement).

Some commentators suggested that the regulations equate benefits provided to the employees of an employer with a payment to the employer and that such an equation improperly ignores the existence of the employer. This comment is based on a misreading of the regulations. The regulations reflect the fact that the provision of a benefit to an employee at no cost to the employer is, in effect, a credit to the employer that offsets the employer's otherwise applicable cost of providing that benefit. Accordingly, if the amount of such a benefit is based on the experience of the employer or its employees, the plan includes an experience-rating arrangement with respect to individual employers and is ineligible for the section 419A(f)(6) exception to sections 419 and 419A.

Use of Insurance Contracts

A number of commentators expressed concern with the results under the proposed regulations when the definition of an experience-rating arrangement was applied to a plan which provides for contributions equal to the premiums on a whole life insurance contract or other life insurance contract having level premiums. These commentators asserted that the purchase of such policies is not inconsistent with the requirements of section 419A(f)(6) and that, if the premiums under the contract are established using standardized actuarial factors (including issue age), the arrangement is not experience rated.

The final regulations retain the definition of experience rating arrangement and the general results that flow from the application of that definition to a level premium life insurance policy. This analysis recognizes that if whole life insurance contracts, or other insurance contracts that provide for level premiums or otherwise generate a savings element, are purchased under an arrangement, the economic values reflected under those contracts (including cash values, reserves, and any other economic values, such as conversion credits, high dividend rates, or the right to continue coverage at a premium that is lower than the premium that would apply in the absence of that savings element) are based on the excess of the premiums paid over the underlying mortality and related expense charges for providing the insurance and, hence, reflect the overall experience of the employers and employees who participate under the plan.

If those economic values are used to determine the current cost of coverage for that employer (as opposed to being shared among all of the employers participating in the plan), the employer can anticipate that its past contributions in excess of incurred losses for claims for its employees will inure to the benefit of the employer or its employees (as opposed to the other employers participating in the plan). This assurance that the employer or its employees will benefit from favorable past experience

is the hallmark of an experience-rating arrangement.²

Furthermore, Congress' expectation that employers participating in 10 or more employer plans would have no financial incentive to over-contribute was the basis for providing the section 419A(f)(6) exception from the deduction limits of sections 419 and 419A. Allowing a 10 or more employer plan to use insurance contracts with retained values, where a participating employer can benefit directly or indirectly from the retained values generated with respect to its employees (e.g., through enhanced benefits to its employees), would provide a financial incentive for the employer to over-contribute to the plan and, thus, would be contrary to the premise underlying the intent of Congress in providing the exception. This financial incentive can be seen most clearly in a flexible premium universal life contract, which is almost indistinguishable from the welfare benefit fund that Congress intended to be subject to the deduction limitations of sections 419 and 419A. The fact that the premiums on a whole life contract or other level premium arrangement are fixed ahead of time (at least with respect to individual employees) does not alter the fact that the buildup of cash value is essentially the same as the accumulation of assets in a fund. The result is the same even where there is no cash value, if the arrangement uses overpayments in earlier years to levelize the premiums. In all these cases, the retained values of life insurance contracts relating to an employer's employees are used to determine that employer's cost of coverage, and the conclusion remains that there is an experience-rating arrangement of the type not allowed by section 419A(f)(6).

Some commentators asserted that the definition of experience-rating arrangements in the proposed regulations will preclude the use of cash value life insurance under section 419A(f)(6) and will therefore eviscerate the section 419A(f)(6) exception. Neither section 419A(f)(6)

nor these regulations regulate the investments of a welfare benefit fund, including investments by a trust in cash value policies. Instead, section 419A(f)(6) and the regulations are concerned with the economic relationship between a fund and participating employers, and whether the pass-through of premiums based on the insurance contracts associated with an employer's employees has the effect of creating experience-rating arrangements with respect to individual employers. Moreover, the IRS and Treasury also believe that the exception is still viable for many life and health benefit arrangements that are self-insured in accordance with the Employee Retirement Income Security Act of 1974 (ERISA) or state law. Under these types of arrangements, the employers contribute the expected cost of claims for their employees. Without the section 419A(f)(6) exception, the deduction for these contributions would be limited to the welfare benefit fund's qualified cost for the taxable year. The section 419A(f)(6) exception allows these employers to deduct those contributions without regard to whether the employees actually incurred claims.

A number of commentators cited to other provisions under sections 419 and 419A for support for their position that a plan can provide for accumulations within a welfare benefit fund that are effectively allocated to the employees without causing the plan to be ineligible for the section 419A(f)(6) exception. The Service and Treasury believe that these other provisions are not relevant in the determination of whether a plan provides an experience rating arrangement. For example, the fact that section 419(e)(4) specifically excludes certain insurance contracts (including contracts that provide experience rated refunds or policy dividends) from the definition of fund for purposes of section 419 does not necessarily mean that such contracts may be held within a welfare benefit fund while retaining the section 419A(f)(6) exception. Similarly, the fact

that section 419A(c)(2) permits an additional reserve for post-retirement medical and life insurance benefits does not mean that such a reserve would not cause the plan to violate the prohibition on experience rating under section 419A(f)(6).

Special Rules of Application

The final regulations retain the special rules of application relating to insurance contracts that were set forth in the proposed regulation. For example, insurance contracts under an arrangement are treated as assets of the fund, and the fund will be treated as having either a gain or loss with respect to those contracts.

Another special rule is provided in the case of a plan maintaining an experience-rating arrangement with respect to a group of participating employers or a group of employees covered under the plan (a rating group). Under that rule, a plan will not be treated as maintaining an experience-rating arrangement with respect to an individual employer merely because the cost of coverage under a plan with respect to the employer is based, in whole or in part, on the benefits experience or the overall experience (or a proxy for either type of experience) of a rating group that includes the employer or one or more of its employees, provided that the employer does not normally contribute more than 10 percent of all contributions with respect to that rating group. The effect of this rule is to allow the plan to provide for experience rating on a plan-wide basis or on the basis of a subset of the employers within the plan, provided that the subset of employers is not overweighted by the experience of one employer and is not defined based on the experience of the employers.

Characteristics Indicating a Plan Is Not Described in Section 419A(f)(6)

These regulations also identify five characteristics that are indications that an employer's interest with respect to the plan is more similar to the relationship of

² The existence of experience rating in a level premium life insurance arrangement can be viewed not only from the perspective of overall experience, but also from that of claims experience. For example, assume that Employer A and Employer B have the same number of employees, and the employees of A have the same ages and other risk factors as those of B. If, on the same day in Year 1, each employer purchases from the same insurer the same amount of level premium whole life insurance coverage for each of its employees, the aggregate premium charges for A and B will be equal. Further, assume that in Year 5, A's employee who is age 60 dies, and is replaced by individual who is also age 60 and has identical risk characteristics. A purchases a new level premium whole life insurance contract of the same amount for the new employee who has an issue age of 60. A's premiums for the new 60-year-old employee will now be higher than those of B for its employee corresponding to the 60-year-old who died, because B's premiums for its 60-year-old employee are based on an issue age of 55. A's premiums for its other employees will be the same as those for B's corresponding employees. Thus, after the death of its employee, A's aggregate premium charges are higher than those of B, and this is due solely to the fact that A's employees have incurred claims in excess of the claims of B's employees.

an individual employer to a fund than an insured to an insurer. (See, H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 1155 (1984), 1984-3 C.B. (Vol. 2) 1, 413.) The presence of some of these characteristics in a plan suggests that there are multiple plans present instead of a single plan. The presence of others tends to indicate that an employer's cost of coverage is (or will be) based on that employer's benefits experience. Others tend to indicate that the plan is expected to accumulate a surplus that ultimately will be used for the benefit of the individual employers (or their employees). One way this surplus might be used would be to reduce future contributions for the individual employers based on past contributions or claims of the employers. Another way would be to pay benefits to an employer's employees based on the employer's share of the surplus on the occasion of the withdrawal of the employer or at plan termination, thereby violating the rule that an employer's cost of coverage cannot be based on its overall experience. Accordingly, these regulations provide that a plan exhibiting any of these characteristics is not a 10 or more employer plan described in section 419A(f)(6) unless it is established to the satisfaction of the Commissioner that the plan satisfies the requirements of section 419A(f)(6) and these proposed regulations. It should be noted that the fact that a plan has none of these characteristics does not create an inference that it is a 10 or more employer plan described in section 419A(f)(6).

The first, third and fourth characteristics under the proposed regulations indicating that a plan is not a 10 or more employer plan described in section 419A(f)(6) (*i.e.*, the assets of the plan are allocated among the participating employers through a separate accounting of contributions and expenditures for individual employers or otherwise, the plan does not provide for fixed welfare benefits for a fixed coverage period for a fixed price or the plan charges the participating employers an unreasonably high amount for the covered risk) have been retained without change.

The second characteristic under the proposed regulations indicating that a

plan is not a 10 or more employer plan described in section 419A(f)(6) is that amounts charged under the plan differ among the employers in a manner that is not reflective of differences in risk or rating factors that are commonly taken into account in manual rates used by insurers (such as age, gender, dependents covered, geographic locale, or benefit terms). In response to comments, this second characteristic has been clarified so that the exception for reflection of differences in risk or rating factors commonly taken into account in manual rates is limited to differences in charges that are merely reflective of differences in current risk (such as current age, gender, dependents covered, geographic locale, or benefit terms). Accordingly, an arrangement that charges different amounts for life insurance based on issue age would exhibit this second characteristic, unless the differences in amount charged are merely reflective of differences in risk or rating factors at the current age (*e.g.*, reflecting select and ultimate mortality).

The fifth characteristic under the proposed regulation indicating that a plan is not a 10 or more employer plan described in section 419A(f)(6) is that benefits or other amounts payable can be provided upon triggering events other than the illness, personal injury, or death of an employee or family member, or the employee's involuntary termination of employment. A number of commentators expressed concern that this fifth characteristic effectively prohibits a termination of a welfare benefit arrangement or otherwise redefines what is a welfare benefit arrangement. This concern reflects a misreading of the regulations, as this fifth characteristic does not prohibit the payment of benefits upon termination of the arrangement or withdrawal of an employer from the arrangement³ or in any other way seek to redefine what is a permitted welfare benefit. Instead the characteristic reflects the inherent difficulty an insurer would have in determining an actuarially appropriate price for providing fixed benefits on the occasion of these non-standard benefit triggers and the associated likelihood that the amount of the benefits payable on such

an occasion is being determined based on the overall experience of the employee or employer. The fact that some commentators have suggested that an employer be able to "spin-off" the employer's "share" of a fund is further indication that many plans that purport to fit within the section 419A(f)(6) exception are engaging in prohibited experience rating.

Taxpayers are reminded that a plan that exhibits one of these characteristics may still establish that the plan satisfies the requirements of section 419A(f)(6). For example, in the case of a plan that provides for a benefit to be provided on the occasion of an employer's withdrawal from the plan, the plan would have to demonstrate that the amount provided to an employee is not based on the benefits experience or the overall experience of the employee or the employer. In addition, in response to comments, the final regulations clarify that a plan does not exhibit this fifth characteristic merely because, upon cessation of participation in the plan, an employee is provided with the right to convert coverage under a group life insurance contract to coverage under an individual life insurance contract without demonstrating evidence of insurability, but only if there is no additional economic value associated with the conversion right.

The examples in the proposed regulations illustrating the application of the rules regarding experience-rating arrangements to specific fact situations are included in the final regulations, with minor changes, and two additional examples have been included. The facts described in some of the examples illustrate arrangements that do not maintain experience-rating arrangements with respect to individual employers. Other examples, however, describe arrangements that exhibit the characteristics of a fund that Congress intended to be subject to the deduction limitations of sections 419 and 419A. Each example illustrates only the application of the definition of experience-rating arrangements under section 419A(f)(6) and these regulations, and no inference should be drawn from the scope of the examples about whether these plans are otherwise described in section

³ A withdrawal of an employer merely terminates the arrangement for that employer, but it continues for the other employers.

419A(f)(6) or about any other provision of the Code.⁴

Pursuant to the authority set forth in section 419A(i), the regulations provide a special rule to assist participating employers and the Commissioner in verifying that the arrangement satisfies the section 419A(f)(6) requirements. Under that rule, an arrangement satisfies the requirements of section 419A(f)(6) and the regulations only if the plan is maintained pursuant to a written document that (1) requires the plan administrator to maintain records sufficient for the Commissioner or any participating employer to readily verify the plan's compliance with section 419A(f)(6) and (2) provides the Commissioner and each participating employer with the right to inspect and copy all such records.

Effective Date

Except as explained below, these regulations — which generally clarify existing law — are effective for contributions paid or incurred in taxable years of an employer beginning on or after July 11, 2002. For contributions made before this effective date, the IRS will continue applying existing law, including the analysis set forth in Notice 95-34 and relevant case law. Thus, taxpayers should not infer that a contribution that would be nondeductible under the regulations would be deductible if made before that date. In this regard, taxpayers are reminded that the IRS has already identified transactions that are the same as or substantially similar to the transactions described in Notice 95-34 as *listed transactions* for purposes of §1.6011-4T(b)(2) of the Temporary Income Tax Regulations and §301.6111-2T(b)(2) of the Temporary Procedure and Administration Regulations.

The requirement that written plan documents contain specified provisions relating to compliance information and the record maintenance requirement for plan administrators are effective for taxable years of a welfare benefit fund beginning after July 17, 2003. Existing record retention requirements and record production requirements under section 6001 continue to apply to employers and promoters.

Special Analyses

It has been determined that these regulations are not a significant regulatory action for purposes of Executive Order 12866. Accordingly, a regulatory assessment is not required. It has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. Chapter 5) does not apply to these regulations.

It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. The collections of information in the regulation are in §1.419A(f)(6)-1(a)(2) and (e) and consist of the requirements that a plan administrator maintain certain information and that it provide that information upon request to the Commissioner and to employers participating in the plan. This certification is based on the fact that requests for such information are likely to be made, on average, less than once per year per employer and that the costs of maintaining and providing this information are small. In addition, relatively few small entities are plan administrators. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required.

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

Drafting Information

The principal author of these regulations is Betty J. Clary, Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

§1.419A(f)(6)-1 is also issued under 26 U.S.C. 419A(i). * * *

Par. 2. Section 1.419A(f)(6)-1 is added to read as follows:

§1.419A(f)(6)-1 Exception for 10 or more employer plan

(a) *Requirements*—(1) *In general*. Sections 419 and 419A do not apply in the case of a welfare benefit fund that is part of a 10 or more employer plan described in section 419A(f)(6). A plan is a 10 or more employer plan described in section 419A(f)(6) only if it is a single plan—

(i) To which more than one employer contributes;

(ii) To which no employer normally contributes more than 10 percent of the total contributions contributed under the plan by all employers;

(iii) That does not maintain an experience-rating arrangement with respect to any individual employer; and

(iv) That satisfies the requirements of paragraph (a)(2) of this section.

(2) *Compliance information*. A plan satisfies the requirements of this paragraph (a)(2) if the plan is maintained pursuant to a written document that requires the plan administrator to maintain records sufficient for the Commissioner or any participating employer to readily verify that the plan satisfies the requirements of section 419A(f)(6) and this section and that provides the Commissioner and each participating employer (or a person acting on the participating employer's behalf) with the right, upon written request to the plan administrator, to inspect and copy all such records. See §1.414(g)-1 for the definition of plan administrator.

(3) *Application of rules*—(i) *In general*. The requirements described in paragraph (a)(1) and (2) of this section must be satisfied both in form and in operation.

(ii) *Arrangement is considered in its entirety*. The determination of whether a plan is a 10 or more employer plan described

⁴ For example, in *Neonatology Associates, P.A., v. Commissioner*, 299 F.3d 221 (3d Cir. 2002), affirming 115 T.C. 43 (2000), the Court held that the contributions were in a large part constructive dividends to the employee/owners (and thus did not reach the government's alternative contention that the plan was maintaining experience-rating arrangements with respect to individual employers). In *Booth v. Commissioner*, 108 T.C. 524 (1997), the Tax Court held that the arrangement was an aggregation of separate plans (and thus was not a single plan) and that there were experience-rating arrangements with respect to the individual employers.

in section 419A(f)(6) is based on the totality of the arrangement and all related facts and circumstances, including any related insurance contracts. Accordingly, all agreements and understandings (including promotional materials and policy illustrations) and the terms of any insurance contract will be taken into account in determining whether the requirements are satisfied in form and in operation.

(b) *Experience-rating arrangements*—(1) *General rule*. A plan maintains an experience-rating arrangement with respect to an individual employer and thus does not satisfy the requirement of paragraph (a)(1)(iii) of this section if, with respect to that employer, there is any period for which the relationship of contributions under the plan to the benefits or other amounts payable under the plan (the *cost of coverage*) is or can be expected to be based, in whole or in part, on the benefits experience or overall experience (or a proxy for either type of experience) of that employer or one or more employees of that employer. For purposes of this paragraph (b)(1), an employer's contributions include all contributions made by or on behalf of the employer or the employer's employees. See paragraph (d) of this section for the definitions of *benefits experience*, *overall experience*, and *benefits or other amounts payable*. The rules of this paragraph (b) apply under all circumstances, including employer withdrawals and plan terminations.

(2) *Adjustment of contributions*. An example of a plan that maintains an experience-rating arrangement with respect to an individual employer is a plan that entitles an employer to (or for which the employer can expect) a reduction in future contributions if that employer's overall experience is positive. Similarly, a plan maintains an experience-rating arrangement with respect to an individual employer where an employer can expect its future contributions to be increased if the employer's overall experience is negative. A plan also maintains an experience-rating arrangement with respect to an individual employer where an employer is entitled to receive (or can expect to receive) a rebate of all or a portion of its contributions if that employer's overall experience is positive or, conversely, where an employer is liable to make additional contributions if its overall experience is negative.

(3) *Adjustment of benefits*. An example of a plan that maintains an experience-rating arrangement with respect to an individual employer is a plan under which benefits for an employer's employees are (or can be expected to be) increased if that employer's overall experience is positive or, conversely, under which benefits are (or can be expected to be) decreased if that employer's overall experience is negative. A plan also maintains an experience-rating arrangement with respect to an individual employer if benefits for an employer's employees are limited by reference, directly or indirectly, to the overall experience of the employer (rather than having all the plan assets available to provide the benefits).

(4) *Special rules*—(i) *Treatment of insurance contracts*—(A) *In general*. For purposes of this section, insurance contracts under the arrangement will be treated as assets of the fund. Accordingly, the value of the insurance contracts (including non-guaranteed elements) is included in the value of the fund, and amounts paid between the fund and the insurance company are disregarded, except to the extent they generate gains or losses as described in paragraph (b)(4)(i)(C) of this section.

(B) *Payments to and from an insurance company*. Payments from a participating employer or its employees to an insurance company pursuant to insurance contracts under the arrangement will be treated as contributions made to the fund, and amounts paid under the arrangement from an insurance company will be treated as payments from the fund.

(C) *Gains and losses from insurance contracts*. As of any date, if the sum of the benefits paid by the insurer and the value of the insurance contract (including non-guaranteed elements) is greater than the cumulative premiums paid to the insurer, the excess is treated as a gain to the fund. As of any date, if the cumulative premiums paid to the insurer are greater than the sum of the benefits paid by the insurer and the value of the insurance contract (including non-guaranteed elements), the excess is treated as a loss to the fund.

(ii) *Treatment of flexible contribution arrangements*. Solely for purposes of determining the cost of coverage under a plan, if contributions for any period can vary with respect to a benefit package,

the Commissioner may treat the employer as contributing the minimum amount that would maintain the coverage for that period.

(iii) *Experience rating by group of employers or group of employees*. A plan will not be treated as maintaining an experience-rating arrangement with respect to an individual employer merely because the cost of coverage under the plan with respect to the employer is based, in whole or in part, on the benefits experience or the overall experience (or a proxy for either type of experience) of a rating group, provided that no employer normally contributes more than 10 percent of all contributions with respect to that rating group. For this purpose, a *rating group* means a group of participating employers that includes the employer or a group of employees covered under the plan that includes one or more employees of the employer.

(iv) *Family members, etc*. For purposes of this section, contributions with respect to an employee include contributions with respect to any other person (e.g., a family member) who may be covered by reason of the employee's coverage under the plan and amounts provided with respect to an employee include amounts provided with respect to such a person.

(v) *Leased employees*. In the case of an employer that is the recipient of services performed by a leased employee described in section 414(n)(2) who participates in the plan, the leased employee is treated as an employee of the recipient and contributions made by the leasing organization attributable to service performed with the recipient are treated as made by the recipient.

(c) *Characteristics indicating a plan is not a 10 or more employer plan*—(1) *In general*. The presence of any of the characteristics described in paragraphs (c)(2) through (c)(6) of this section generally indicates that the plan is not a 10 or more employer plan described in section 419A(f)(6). Accordingly, unless established to the satisfaction of the Commissioner that the plan satisfies the requirements of section 419A(f)(6) and this section, a plan having any of the following characteristics is not a 10 or more employer plan described in section 419A(f)(6). A plan's lack of all the following characteristics does not create any inference that the plan is a 10 or

more employer plan described in section 419A(f)(6).

(2) *Allocation of plan assets.* Assets of the plan or fund are allocated to a specific employer or employers through separate accounting of contributions and expenditures for individual employers, or otherwise.

(3) *Differential pricing.* The amount charged under the plan is not the same for all the participating employers, and those differences are not merely reflective of differences in current risk or rating factors that are commonly taken into account in manual rates used by insurers (such as current age, gender, geographic locale, number of covered dependents, and benefit terms) for the particular benefit or benefits being provided.

(4) *No fixed welfare benefit package.* The plan does not provide for fixed welfare benefits for a fixed coverage period for a fixed cost, within the meaning of paragraph (d)(5) of this section.

(5) *Unreasonably high cost.* The plan provides for fixed welfare benefits for a fixed coverage period for a fixed cost, but that cost is unreasonably high for the covered risk for the plan as a whole.

(6) *Nonstandard benefit triggers.* Benefits or other amounts payable can be paid, distributed, transferred, or otherwise provided from a fund that is part of the plan by reason of any event other than the illness, personal injury, or death of an employee or family member, or the employee's involuntary separation from employment. Thus, for example, a plan exhibits this characteristic if the plan provides for the payment of benefits or the distribution of an insurance contract to an employer's employees on the occasion of the employer's withdrawal from the plan. A plan will not be treated as having the characteristic described in this paragraph merely because, upon cessation of participation in the plan, an employee is provided with the right to convert coverage under a group life insurance contract to coverage under an individual life insurance contract without demonstrating evidence of insurability, but only if there is no additional economic value associated with the conversion right.

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

(1) *Benefits or other amounts payable.* The term *benefits or other amounts*

payable includes all amounts that are payable or distributable (or that will be otherwise provided) directly or indirectly to employers, to employees or their beneficiaries, or to another fund as a result of a spinoff or transfer, and without regard to whether payable or distributable as welfare benefits, cash, dividends, rebates of contributions, property, promises to pay, or otherwise.

(2) *Benefits experience.* The *benefits experience* of an employer (or of an employee or a group of employers or employees) means the benefits and other amounts incurred, paid, or distributed (or otherwise provided) directly or indirectly, including to another fund as a result of a spinoff or transfer, with respect to the employer (or employee or group of employers or employees), and without regard to whether provided as welfare benefits, cash, dividends, credits, rebates of contributions, property, promises to pay, or otherwise.

(3) *Overall experience*—(i) *Employer's overall experience.* The term *overall experience* means, with respect to an employer (or group of employers), the balance that would have accumulated in a welfare benefit fund if that employer (or those employers) were the only employer (or employers) providing welfare benefits under the plan. Thus, the overall experience is credited with the sum of the contributions under the plan with respect to that employer (or group of employers), less the benefits and other amounts paid or distributed (or otherwise provided) with respect to that employer (or group of employers) or the employees of that employer (or group of employers), and adjusted for gain or loss from insurance contracts (as described in paragraph (b)(4)(i) of this section), investment return, and expenses. Overall experience as of any date may be either a positive or a negative number.

(ii) *Employee's overall experience.* The term *overall experience* means, with respect to an employee (or group of employees, whether or not employed by the same employer), the balance that would have accumulated in a welfare benefit fund if the employee (or group of employees) were the only employee (or employees) being provided welfare benefits under the plan. Thus, the overall experience is credited with the sum of the contributions under the plan with respect to that employee (or group of employees), less the benefits and

other amounts paid or distributed (or otherwise provided) with respect to that employee (or group of employees), and adjusted for gain or loss from insurance contracts (as described in paragraph (b)(4)(i) of this section), investment return, and expenses. Overall experience as of any date may be either a positive or a negative number.

(4) *Employer.* The term *employer* means the employer whose employees are participating in the plan and those employers required to be aggregated with the employer under section 414(b), (c), or (m).

(5) *Fixed welfare benefit package*—(i) *In general.* A plan provides for fixed welfare benefits for a fixed coverage period for a fixed cost, if it—

(A) Defines one or more welfare benefits, each of which has a fixed amount that does not depend on the amount or type of assets held by the fund;

(B) Specifies fixed contributions to provide for those welfare benefits; and

(C) Specifies a coverage period during which the plan agrees to provide specified welfare benefits, subject to the payment of the specified contributions by the employer.

(ii) *Treatment of actuarial gains or losses.* A plan will not be treated as failing to provide for fixed welfare benefits for a fixed coverage period for a fixed cost merely because the plan does not pay the promised benefits (or requires all participating employers to make proportionate additional contributions based on the fund's shortfall) when there are insufficient assets under the plan to pay the promised benefits. Similarly, a plan will not be treated as failing to provide for fixed welfare benefits for a fixed coverage period for a fixed cost merely because the plan provides a period of extended coverage after the end of the coverage period with respect to employees of all participating employers at no cost to the employers (or provides a proportionate refund of contributions to all participating employers) because of the plan-wide favorable actuarial experience during the coverage period.

(e) *Maintenance of records.* The plan administrator of a plan that is intended

to be a 10 or more employer plan described in section 419A(f)(6) shall maintain permanent records and other documentary evidence sufficient to substantiate that the plan satisfies the requirements of section 419A(f)(6) and this section. (See §1.414(g)-1 for the definition of plan administrator.)

(f) *Examples.* The provisions of paragraph (c) of this section and the provisions of section 419A(f)(6) and this section relating to experience-rating arrangements may be illustrated by the following examples. Unless stated otherwise, it should be assumed that any life insurance contract described in an example is non-participating and has no value other than the value of the policy's current life insurance protection plus its cash value, and that no employer normally contributes more than 10 percent of the total contributions contributed under the plan by all employers. Paragraph (ii) of each example applies the characteristics listed in paragraph (c) of this section to the facts described in that example. Paragraphs (iii) and (iv) of each example analyze the facts described in the example to determine whether the plan maintains experience-rating arrangements with respect to individual employers. Paragraphs (iii) and (iv) of each example illustrate only the meaning of *experience-rating arrangements*. No inference should be drawn from these examples about whether these plans are otherwise described in section 419A(f)(6) or about the applicability or nonapplicability of any other Internal Revenue Code provision that may limit or deny the deduction of contributions to the arrangements. Further, no inference should be drawn from the examples concerning the tax treatment of employees as a result of the employer contributions or the provision of the benefits. The examples are as follows:

Example 1. (i) An arrangement provides welfare benefits to employees of participating employers. Each year a participating employer is required to contribute an amount equal to the claims and other expenses expected with respect to that employer for the year (based on current age, gender, geographic locale, number of participating employees, benefit terms, and other risk or rating factors commonly taken into account in manual rates used by insurers for the benefits being provided), multiplied by the ratio of actual claims with respect to that employer for the previous year over the expected claims with respect to that employer for the previous year.

(ii) This arrangement exhibits at least one of the characteristics listed in paragraph (c) of this section

generally indicating that an arrangement is not a 10 or more employer plan described in section 419A(f)(6). Differential pricing exists under this arrangement because the amount charged under the plan is not the same for all the participating employers, and those differences are not merely reflective of differences in current risk or rating factors that are commonly taken into account in manual rates used by insurers for the particular benefit or benefits being provided.

(iii) This arrangement does not satisfy the requirements of section 419A(f)(6) and this section because, at a minimum, the requirement of paragraph (a)(1)(iii) of this section is not satisfied. Under the arrangement, an employer's cost of coverage for each year is based, in part, on that employer's benefits experience (*i.e.*, the benefits and other amounts provided in the past with respect to one or more employees of that employer). Accordingly, pursuant to paragraph (b)(1) of this section, the arrangement maintains experience-rating arrangements with respect to individual employers.

Example 2. (i) The facts are the same as in *Example 1*, except that the amount charged to an employer each year is equal to claims and other expenses expected with respect to that employer for the year (determined the same as in *Example 1*), multiplied by the ratio of actual claims for the previous year (determined on a plan-wide basis) over the expected claims for the previous year (determined on a plan-wide basis).

(ii) Based on the limited facts described above, this arrangement exhibits none of the characteristics listed in paragraph (c) of this section generally indicating that an arrangement is not a 10 or more employer plan described in section 419A(f)(6). Unlike the arrangement discussed in *Example 1*, there is no differential pricing under the arrangement because the only differences in the amounts charged to the employers are solely reflective of differences in current risk or rating factors that are commonly taken into account in manual rates used by insurers for the particular benefit or benefits being provided.

(iii) Nothing in the facts described in this *Example 2* indicates that the arrangement maintains experience-rating arrangements prohibited under section 419A(f)(6) and this section. An employer's cost of coverage under the arrangement is based, in part, on the benefits experience of that employer (as well as of all the other participating employers). However, pursuant to paragraph (b)(4)(iii) of this section, the arrangement will not be treated as maintaining experience-rating arrangements with respect to the individual employers merely because the employers' cost of coverage is based on the benefits experience of a group of employees eligible under the plan, provided no employer normally contributes more than 10 percent of all contributions with respect to the rating group that includes the employees of an individual employer. Under the arrangement described in this *Example 2*, the rating group includes all the participating employers (or all of their employees), and no employer normally contributes more than 10 percent of the contributions made under the arrangement by all the employers. Accordingly, absent other facts, the arrangement will not be treated as maintaining experience-rating arrangements with respect to individual employers.

Example 3. (i) Arrangement A provides welfare benefits to employees of participating employers.

Each year an employer is required to contribute an amount equal to the claims and other expenses expected with respect to that employer for the year (based on current risk or rating factors commonly taken into account in manual rates used by insurers for the benefits being provided), adjusted based on the employer's notional account. An employer's notional account is determined as follows. The account is credited with the sum of the employer's contributions previously paid under the plan less the benefit claims for that employer's employees. The notional account is further increased by a fixed five percent investment return (regardless of the actual investment return earned on the funds). If an employer's notional account is positive, the employer's contributions are reduced by a specified percentage of the notional account. If an employer's notional account is negative, the employer's contributions are increased by a specified percentage of the notional account.

(ii) Arrangement A exhibits at least two of the characteristics listed in paragraph (c) of this section generally indicating that an arrangement is not a 10 or more employer plan described in section 419A(f)(6). First, assets under the plan are allocated to specific employers. Second, differential pricing exists because the amount charged under the plan is not the same for all the participating employers, and those differences are not merely reflective of differences in current risk or rating factors that are commonly taken into account in manual rates used by insurers for the particular benefit or benefits being provided.

(iii) Arrangement A does not satisfy the requirements of section 419A(f)(6) and this section because, at a minimum, the requirement of paragraph (a)(1)(iii) of this section is not satisfied. Under the arrangement, a participating employer's cost of coverage for each year is based on a proxy for that employer's overall experience. An employer's *overall experience*, as that term is defined in paragraph (d)(3) of this section, includes the balance that would have accumulated in the fund if that employer's employees were the only employees being provided benefits under the plan. Under that definition, the overall experience is credited with the sum of the contributions paid under the plan by or on behalf of that employer less the benefits or other amounts provided to with respect to that employer's employees, and adjusted for gain or loss from insurance contracts, expenses, and investment return. Under the formula used by the arrangement in this example to determine employer contributions, expenses are disregarded and a fixed investment return of five percent is used instead of actual investment return. The disregard of expenses and substitution of the fixed investment return for the actual investment return merely results in an employer's notional account that is a proxy for the overall experience of that employer. Accordingly, the arrangement maintains experience-rating arrangements with respect to individual employers.

Example 4. (i) Under Arrangement B, death benefits are provided for eligible employees of each participating employer. Individual level premium whole life insurance policies are purchased to provide the death benefits. Each policy has a face amount equal to the death benefit payable with respect to the individual employee. Each year, a participating employer is charged an amount equal to the level

premiums payable with respect to the employees of that employer. One participating employer, F, has an employee, P, whose coverage under the arrangement commenced at the beginning of 2000, when P was age 50. P is covered under the arrangement for \$1 million of death benefits, and a life insurance policy with a face amount of \$1 million has been purchased on P's life. The level annual premium on the policy is \$23,000. At the beginning of 2005, when P is age 55, the \$23,000 premium amount has been paid for five years and the policy, which continues to have a face amount of \$1 million, has a cash value of \$92,000. Another employer, G, has an employee, R, who is also 55 years old at the beginning of 2005 and is covered under Arrangement B for \$1 million, for which a level premium life insurance policy with a face amount of \$1 million has been purchased. However, R did not become covered under Arrangement B until the beginning of 2005. Because R's coverage began at age 55, the level annual premium charged for the policy on R's life is \$30,000, or \$7,000 more than the premiums payable on the policy in effect on P's life. Employer F is charged \$23,000 and employer G is charged \$30,000 for the death benefit for employees P and R, respectively. Assume that employees P and R are the only covered employees of their respective employers and that they are identical with respect to current risk and rating factors that are commonly taken into account in manual rates used by insurers for death benefits.

(ii) Arrangement B exhibits at least three of the characteristics listed in paragraph (c) of this section generally indicating that an arrangement is not a 10 or more employer plan described in section 419A(f)(6). First, assets of the plan are effectively allocated to specific employers. Second, there is differential pricing under the arrangement. That is, the amount charged under the plan during the year for a specific amount of death benefit coverage is not the same for all the employers (employer F is charged \$23,000 each year for \$1 million of death benefit coverage while employer G is charged \$30,000 each year for the same coverage), and the difference is not merely reflective of differences in current risk or rating factors that are commonly taken into account in manual rates used by insurers for the death benefit being provided. (The differences in amounts charged are attributable to differences in issue age and not to differences in current risk or rating factors, as employees P and R are the same age). Third, during the early years of the arrangement, the amounts charged are unreasonably high for the covered risk for the plan as a whole.

(iii) Arrangement B does not satisfy the requirements of section 419A(f)(6) and this section because, at a minimum, the requirement of paragraph (a)(1)(iii) of this section is not satisfied. Arrangement B maintains experience-rating arrangements with respect to individual employers because the cost of coverage for each year for any employer participating in the arrangement is based on a proxy for the overall experience of that employer. Under Arrangement B, employer F's cost of coverage for 2005 is \$23,000 for \$1 million of coverage. The \$92,000 cash value at the beginning of 2005 in the policy insuring P's life is a proxy for employer F's overall experience. (The \$92,000 is essentially the balance that would have accumulated in the fund

if employer F were the only employer providing welfare benefits under Arrangement B.) Further, the \$23,000 charged to F for the \$1 million of coverage in 2005 is based on the \$92,000 since, in the absence of the \$92,000, employer F would have been charged \$30,000 for P's \$1 million death benefit coverage. (Note that the conclusion that the \$92,000 balance is the basis for the lower premium charged to employer F is consistent with the fact that a \$92,000 balance, if converted to a life annuity using the same actuarial assumptions as were used to calculate the cash value amount, would be sufficient to provide for annual annuity payments of \$7,000 for the life of P — an amount equal to the \$7,000 difference from the premium charged in 2005 to employer G for the \$1 million of coverage on employee R's life.) Thus, F's cost of coverage for 2005 is based on a proxy for F's overall experience. Accordingly, Arrangement B maintains an experience-rating arrangement with respect to employer F.

(iv) Arrangement B also maintains an experience-rating arrangement with respect to employer G because it can be expected that each year G will be charged \$30,000 for the \$1 million of coverage on R's life. Each year, G's cost of coverage will reflect G's prior contributions and allocable earnings, so that G's cost of coverage will be based on a proxy for G's overall experience. Accordingly, Arrangement B maintains an experience-rating arrangement with respect to employer G. Similarly, Arrangement B maintains an experience-rating arrangement with respect to each other participating employer. Accordingly, Arrangement B maintains experience-rating arrangements with respect to individual employers. This would also be the result if Arrangement B maintained an experience-rating arrangement with respect to only one individual employer.

Example 5. (i) The facts are the same as in *Example 4* except that the death benefits are provided under 10-year level term life insurance policies. One participating employer, H, has an employee, M, whose coverage under the arrangement commenced at the beginning of 2000, when M was age 35. M is covered under the arrangement for \$1 million of death benefits, and a 10-year level term life insurance policy with a face amount of \$1 million has been purchased on M's life. The level annual premium on the policy for the first 10 years is \$700. At the beginning of 2007, when M is age 42, the \$700 premium amount has been paid for seven years. Another employer, J, has an employee, N, who is also 42 years old at the beginning of 2007 and is covered under the arrangement for \$1 million, for which a 10-year level term life insurance policy with a face amount of \$1 million has been purchased. However, N did not become covered under the arrangement until the beginning of 2007. Because N's coverage began at age 42, the 10-year level term premium charged for the policy on N's life is \$1,100, or \$400 more than the premiums then payable on the policy in effect on M's life. Neither the policy on employee M nor the policy on employee N has any cash value at any point during its term. Assume that employees M and N are the only covered employees of their respective employers and that they are identical with respect to any current risk and rating factors that are commonly taken into account in manual rates used by insurers for the death benefit being provided.

(ii) Based on the facts described in this *Example 5*, this arrangement exhibits at least two of the characteristics listed in paragraph (c) of this section generally indicating that an arrangement is not a 10 or more employer plan described in section 419A(f)(6). First, for the same reasons as described in paragraph (ii) of *Example 4*, there is differential pricing under the arrangement. Second, assets of the plan are effectively allocated to specific employers. This is the case even though the insurance policies used by employers H and J have no accessible cash value.

(iii) The facts described in this *Example 5* indicate that the arrangement does not satisfy the requirements of section 419A(f)(6) and this section because, at a minimum, the requirement of paragraph (a)(1)(iii) of this section is not satisfied. This arrangement maintains experience-rating arrangements with respect to individual employers because the cost of coverage for each year for any employer participating in the arrangement is based on a proxy for the overall experience of that employer. Under this arrangement employer H's cost of coverage in 2007 is \$700 for \$1 million of coverage. Although the policy insuring M's life has no cash value accessible to employer H, the accumulation of the excesses of the amounts paid by employer H on behalf of employee M over each year's underlying mortality and expense charges for providing life insurance coverage to employee M provide economic value to employer H (*i.e.*, the ability to purchase future coverage on M's life at a premium that is less than the underlying mortality and expense charges as those underlying charges increase with M's increasing age). Thus, H's cost of coverage for 2007 is based on a proxy for H's overall experience. Accordingly, this arrangement maintains an experience-rating arrangement with respect to employer H.

(iv) This arrangement also maintains an experience-rating arrangement with respect to employer J because it can be expected that for each of the next nine years J will be charged \$1,100 for the \$1 million of coverage on N's life. Each year, J's cost of coverage will reflect J's prior contributions, so that J's cost of coverage will be based on a proxy for J's overall experience. Accordingly, this arrangement maintains an experience-rating arrangement with respect to employer J. Similarly, this arrangement maintains an experience-rating arrangement with respect to each other participating employer. Accordingly, this arrangement maintains experience-rating arrangements with respect to individual employers. This would also be the result if this arrangement maintained an experience-rating arrangement with respect to only one individual employer.

Example 6. (i) Under Arrangement C, death benefits are provided for eligible employees of each participating employer. Flexible premium universal life insurance policies are purchased to provide the death benefits. Each policy has a face amount equal to the death benefit payable with respect to the individual employee. Each participating employer can make any contributions to the arrangement provided that the amount paid for each employee is at least the amount needed to prevent the lapse of the policy. The amount needed to prevent the lapse of the universal life insurance policy is the excess, if any, of the mortality and expense charges for the year over the policy balance. All contributions made by an employer are paid as

premiums to the universal life insurance policies purchased on the lives of the covered employees of that employer. Participating employers S and V each have a 50-year-old employee covered under Arrangement C for death benefits of \$1 million, which is the face amount of the respective universal life insurance policies on the lives of the employees. In the first year of coverage employer S makes a contribution of \$23,000 (the amount of a level premium) while employer V contributes only \$6,000, which is the amount of the mortality and expense charges for the first year. At the beginning of year two, the balance in employer S's policy (including earnings) is \$18,000, but the balance in V's policy is zero. Although S is not required to contribute anything in the second year of coverage, S contributes an additional \$15,000 in the second year. Employer V contributes \$7,000 in the second year.

(ii) Arrangement C exhibits at least two of the characteristics listed in paragraph (c) of this section generally indicating that an arrangement is not a 10 or more employer plan described in section 419A(f)(6). First, assets of the plan are effectively allocated to specific employers. Second, the arrangement does not provide for fixed welfare benefits for a fixed coverage period for a fixed cost.

(iii) Arrangement C does not satisfy the requirements of section 419A(f)(6) and this section because, at a minimum, the requirement of paragraph (a)(1)(iii) of this section is not satisfied. Arrangement C maintains experience-rating arrangements with respect to individual employers because the cost of coverage of an employer participating in the arrangement is based on a proxy for the overall experience of that employer. Pursuant to paragraph (b)(4)(ii) of this section (concerning treatment of flexible contribution arrangements), solely for purposes of determining an employer's cost of coverage, the Commissioner may treat an employer as contributing the minimum amount needed to maintain the coverage. Applying this treatment, H's cost of coverage for the first year of coverage under Arrangement C is \$6,000 for \$1 million of death benefit coverage, but for the second year it is zero for the same amount of coverage because that is the minimum amount needed to keep the insurance policy from lapsing. Employer H's overall experience at the beginning of the second year of coverage is \$18,000, because that is the balance that would have accumulated in the fund if H were the only employer providing benefits under Arrangement C. (The special rule of paragraph (b)(4)(ii) of this section only applies to determine cost of coverage; it does not apply in determining overall experience.) The \$18,000 balance in the policy insuring the life of employer H's employee is a proxy for H's overall experience. Employer H can choose not to make any contributions in the second year of coverage due to the \$18,000 policy balance. Thus, H's cost of coverage for the second year is based on a proxy for H's overall experience. Accordingly, Arrangement C maintains an experience-rating arrangement with respect to employer H.

(iv) Arrangement C also maintains an experience-rating arrangement with respect to employer J because in each year J can contribute more than the amount needed to prevent a lapse of the policy on the

life of its employee and can expect that its cost of coverage for subsequent years will reflect its prior contributions and allocable earnings. Accordingly, Arrangement C maintains an experience-rating arrangement with respect to employer J.

Example 7. (i) Arrangement D provides death benefits for eligible employees of each participating employer. Each employer can choose to provide a death benefit of either one, two, or three times the annual compensation of the covered employees. Under Arrangement D, the death benefit is payable only if the employee dies while employed by the employer. If an employee terminates employment with the employer or if the employer withdraws from the arrangement, the death benefit is no longer payable, no refund or other credit is payable to the employer or to the employees, and no policy or other property is transferrable to the employer or the employees. Furthermore, the employees are not provided with any right under Arrangement D to coverage under any other arrangement, nor with any right to purchase or to convert to an individual insurance policy, other than any conversion rights the employees may have in accordance with state law (and which provide no additional economic benefit). Arrangement D determines the amount required to be contributed by each employer for each month of coverage by aggregating the amount required to be contributed for each covered employee of the employer. The amount required to be contributed for each covered employee is determined by multiplying the amount of the death benefit coverage (in thousands) for the employee by five-year age bracket rates in a table specified by the plan, which is used uniformly for all covered employees of all participating employers. The rates in the specified table do not exceed the rates set forth in Table I of §1.79-3(d)(2), and differences in the rates in the table are merely reflective of differences in mortality risk for the various age brackets. The rates in the table are not based in whole or in part on the experience of the employers participating in Arrangement D. Arrangement D uses the amount contributed by each employer to purchase one-year term insurance coverage on the lives of the covered employees with a face amount equal to the death benefit provided by the plan. No employer is entitled to any rebates or refunds provided under the insurance contract.

(ii) Arrangement D does not exhibit any of the characteristics listed in paragraph (c) of this section generally indicating that an arrangement is not a 10 or more employer plan described in section 419A(f)(6). Under Arrangement D, assets are not allocated to a specific employer or employers. Differences in the amounts charged to the employers are solely reflective of differences in risk or rating factors that are commonly taken into account in manual rates used by insurers for the particular benefit or benefits being provided. The arrangement provides for fixed welfare benefits for a fixed coverage period for a fixed cost, within the meaning of paragraph (d)(5) of this section. The cost charged under the arrangement is not unreasonably high for the covered risk of the plan as a whole. Finally, benefits and other amounts payable can be paid, distributed, transferred, or otherwise made available only by reason of the death of the employee, so that there is no nonstandard benefit trigger under the arrangement.

(iii) Nothing in the facts of this *Example 7* indicates that Arrangement D fails to satisfy the requirements of section 419A(f)(6) or this section by reason of maintaining experience-rating arrangements with respect to individual employers. Based solely on the facts described above, Arrangement D does not maintain an experience rating-arrangement with respect to any individual employer because for each participating employer there is no period for which the employer's cost of coverage under the arrangement is based, in whole or in part, on either the benefits experience or the overall experience (or a proxy for either type of experience) of that employer or its employees.

Example 8. (i) The facts are the same as in *Example 7*, except that under the arrangement, any refund or rebate provided under that year's insurance contract is allocated among all the employers participating in the arrangement in proportion to their contributions, and is used to reduce the employers' contributions for the next year.

(ii) This arrangement exhibits at least one of the characteristics listed in paragraph (c) of this section generally indicating that an arrangement is not a 10 or more employer plan described in section 419A(f)(6). The arrangement includes nonstandard benefit triggers because amounts are made available to an employer by reason of the insurer providing a refund or rebate to the plan, an event that is other than the illness, personal injury, or death of an employee or family member, or an employee's involuntary separation from employment.

(iii) Based on the limited and specific facts described in this *Example 8*, an employer participating in this arrangement should be able to establish to the satisfaction of the Commissioner that the plan does not maintain experience-rating arrangements with respect to individual employers. A participating employer's cost of coverage is the relationship of its contributions to the death benefit coverage or other amounts payable with respect to that employer, including the employer's portion of the insurance company rebate and refund amounts. The rebate and refund amounts are allocated to an employer based on that employer's contribution for the prior year. However, even though an employer's overall experience includes its past contributions, contributions alone are not a proxy for an employer's overall experience under the particular facts described in this *Example 8*. As a result, a participating employer's cost of coverage under the arrangement for each year (or any other period) is not based on that employer's benefits experience or its overall experience (or a proxy for either type of experience), except as follows: If the total of the insurance company refund or rebate amounts is a proxy for the overall experience of all participating employers, a participating employer's cost of coverage will be based in part on that employer's overall experience (or a proxy therefor) by reason of that employer's overall experience being a portion of the overall experience of all participating employers. Under the special rule of paragraph (b)(2)(iii) of this section, however, that fact alone will not cause the arrangement to be treated as maintaining an experience-rating arrangement with respect to an individual employer because no employer normally contributes more than 10 percent of the total contributions under

the plan by all employers (the rating group). Accordingly, the arrangement will not be treated as maintaining experience-rating arrangements with respect to individual employers.

Example 9. (i) Arrangement E provides medical benefits for covered employees of 90 participating employers. The level of medical benefits is determined by a schedule set forth in the trust document and does not vary by employer. Other than any rights an employee may have to COBRA continuation coverage, the medical benefits cease when an employee terminates employment with the employer. If an employer withdraws from the arrangement, there is no refund of any contributions and there is no transfer of anything of value to employees of the withdrawing employer, to the withdrawing employer, or to another plan or arrangement maintained by the withdrawing employer. Arrangement E determines the amount required to be contributed by each employer for each year of coverage, and the aggregate amounts charged are not unreasonably high for the covered risk for the plan as a whole. To determine the amount to be contributed for each employer, Arrangement E classifies an employer based on the employer's location. These geographic areas are not changed once established under the arrangement. The amount charged for the coverage under the arrangement to the employers in a geographic area is determined from a rate-setting manual based on the benefit package and geographic area, and differences in the rates in the manual are merely reflective of current differences in those risk or rating factors. The rates in the rate-setting manual are not based in whole or in part on the experience of the employers participating in Arrangement E.

(ii) Arrangement E does not exhibit any of the characteristics listed in paragraph (c) of this section generally indicating that an arrangement is not a 10 or more employer plan described in section 419A(f)(6). Although the amounts charged under the arrangement to an employer in one geographic area can be expected to differ from those charged to an employer in another geographic area, the differences are merely reflective of differences in current risk or rating factors that are commonly taken into account in manual rates used by insurers for medical benefits.

(iii) Nothing in the facts of this *Example 9* indicates that Arrangement E fails to satisfy the requirements of section 419A(f)(6) or this section by reason of maintaining experience-rating arrangements with respect to individual employers. Based solely on the facts described above, Arrangement E does not maintain an experience rating-arrangement with respect to any individual employer because for each participating employer there is no period for which the employer's cost of coverage under the arrangement is based, in whole or in part, on either the benefits experience or the overall experience (or a proxy for either type of experience) of that employer or its employees.

Example 10. (i) The facts are the same as in *Example 9*, except that the amount charged for the coverage under the arrangement to the employers in a geographic area is initially determined from a rate-setting manual based on the benefit package and then adjusted to reflect the claims experience of the employers in that classification as a whole. The arrangement does not have any geographic area classification for

which one of the employers in the classification normally contributes more than 10 percent of the contributions made by all the employers in that classification.

(ii) This arrangement exhibits at least one of the characteristics listed in paragraph (c) of this section generally indicating that an arrangement is not a 10 or more employer plan described in section 419A(f)(6). There is differential pricing under the arrangement because the amounts charged to an employer in one geographic area can be expected to differ from those charged to an employer in another geographic area, and the differences are not merely reflective of current risk or rating factors that are commonly taken into account in manual rates used by insurers for medical benefits.

(iii) Based on the facts described in this *Example 10*, an employer participating in this arrangement should be able to establish to the satisfaction of the Commissioner that the plan does not maintain experience-rating arrangements with respect to individual employers even though there is differential pricing. Although an employer's cost of coverage for each year is based, in part, on its benefits experience (as well as the benefits experience of the other employers in its geographic area), that does not result in experience-rating arrangements with respect to any individual employer because the employers in each geographic area are a rating group and no employer normally contributes more than 10 percent of the contributions made by all the employers in its rating group. (See paragraph (b)(4)(iii) of this section.)

Example 11. (i) The facts of Arrangement F are the same as those described in *Example 10*, except that K, an employer in one of Arrangement F's geographic areas, normally contributes more than 10 percent of the contributions made by the employers in that geographic area.

(ii) For the same reasons as described in *Example 10*, Arrangement F results in differential pricing.

(iii) Arrangement F does not satisfy the requirements of section 419A(f)(6) and this section because, at a minimum, the requirement of paragraph (a)(1)(iii) of this section is not satisfied. An employer's cost of coverage for each year is based, in part, on its benefits experience (as well as the benefits experience of the other employers in its geographic area) and the special rule for experience-rating by a rating group does not apply to Arrangement F because employer K normally contributes more than 10 percent of the contributions made by the employers in its rating group. Accordingly, Arrangement F maintains experience-rating arrangements with respect to individual employers.

Example 12. (i) The facts of Arrangement G are the same as those described in *Example 10*, except for the way that the arrangement classifies the employers. Under Arrangement G, the experience of each employer for the prior year is reviewed and then the employer is assigned to one of three classifications (low cost, intermediate cost, or high cost) based on the ratio of actual claims with respect to that employer to expected claims with respect to that employer. No employer in any classification normally contributes more than 10 percent of the contributions of all employers in that classification.

(ii) For the same reasons as described in *Example 10*, Arrangement G results in differential pricing.

(iii) Arrangement G does not satisfy the requirements of section 419A(f)(6) and this section because, at a minimum, the requirement of paragraph (a)(1)(iii) of this section is not satisfied. The special rule in paragraph (b)(4)(iii) of this section for rating groups can prevent a plan from being treated as maintaining experience-rating arrangements with respect to individual employers if the mere use of a rating group is the only reason a plan would be so treated. Under Arrangement G, however, an employer's cost of coverage for each year is based on the employer's benefits experience in two ways: the employer's benefits experience is part of the benefits experience of a rating group that is otherwise permitted under the special rule of paragraph (b)(4)(iii) of this section, and the employer's benefits experience is considered annually in redetermining the rating group to which the employer is assigned. Accordingly, Arrangement G maintains experience-rating arrangements with respect to individual employers.

Example 13. (i) Arrangement H provides a death benefit equal to a multiple of one, two, or three times compensation as elected by the participating employer for all of its covered employees. Universal life insurance contracts are purchased on the lives of the covered employees. The face amount of each contract is the amount of the death benefit payable upon the death of the covered employee. Under the arrangement, each employer is charged annually an amount equal to 200 percent of the mortality and expense charges under the contracts for that year covering the lives of the covered employees of that employer. Arrangement H pays the amount charged each employer to the insurance company. Thus, the insurance company receives an amount equal to 200 percent of the mortality and expense charges under the policies. The excess amounts charged and paid to the insurance company increase the policy value of the universal life insurance contracts. When an employer ceases to participate in Arrangement H, the insurance policies are distributed to each of the covered employees of the withdrawing employer.

(ii) Arrangement H exhibits at least three of the characteristics listed in paragraph (c) of this section generally indicating that an arrangement is not a 10 or more employer plan described in section 419A(f)(6). First, assets are effectively allocated to specific employers. Second, because the amount of the withdrawal benefit (*i.e.*, the value of the life insurance policies to be distributed) is unknown, the arrangement does not provide for fixed welfare benefits for a fixed coverage period for a fixed cost. Finally, Arrangement H includes nonstandard benefit triggers because amounts can be distributed under the arrangement for a reason other than the illness, personal injury, or death of an employee or family member, or an employee's involuntary separation from employment.

(iii) Arrangement H does not satisfy the requirements of section 419A(f)(6) and this section because, at a minimum, the requirement of paragraph (a)(1)(iii) of this section is not satisfied. Pursuant to paragraph (b)(1) of this section, the prohibition against maintaining experience-rating arrangements applies under all circumstances, including employer withdrawals. Arrangement H maintains experience-rating arrangements with respect to individual employers because the cost of coverage for a participating employer is based on a proxy for the overall

experience of that employer. Under Arrangement H, the contributions of a participating employer are fixed. The benefits or other amounts payable with respect to an employer include the value of the life insurance policies that are distributable to the employees of that employer upon the withdrawal of that employer from the plan. Thus, the cost of coverage for any period of an employer's participation in Arrangement H is the relationship between the fixed contributions for that period and the variable benefits payable under the arrangement. The value of those variable benefits depends on the value of the policies that would be distributed if the employer were to withdraw at the end of the period. (Each year the insurance policies to be distributed to the employees in the event of the employer's withdrawal will increase in value due to the premium amounts paid on the policy in excess of current mortality and expense charges.) For reasons similar to those discussed above in *Example 6*, the aggregate value of the life insurance policies on the lives of an employer's employees is a proxy for that employer's overall experience. Thus, a participating employer's cost of coverage for any period is based on a proxy for the overall experience of that employer. Accordingly, Arrangement H maintains experience-rating arrangements with respect to individual employers.

(iv) The result would be the same if, rather than distributing the policies, Arrangement H distributed cash amounts equal to the cash values of the policies. The result would also be the same if the distribution of policies or cash values is triggered by employees terminating their employment rather than by employees ceasing to participate in the arrangement.

Example 14. (i)(1) The facts of Arrangement J are the same as those described in *Example 13* for Arrangement H, except that—

(A) Arrangement J purchases a special term insurance policy on the life of each covered employee with a face amount equal to the death benefit payable upon the death of the covered employee; and

(B) there is no benefit distributable upon an employer's withdrawal.

(2) The special term policy includes a rider that extends the term protection for a period of time beyond the term provided on the policy's face. The length of the extended term is not guaranteed, but is based on the excess of premiums over mortality and expense charges during the period of original term protection, increased by any investment return credited to the policies.

(ii) Arrangement J exhibits two of the characteristics listed in paragraph (c) of this section generally indicating that an arrangement is not a 10 or more employer plan described in section 419A(f)(6). First, assets of the plan are effectively allocated to specific employers. Second, the plan does not provide for fixed welfare benefits for a fixed coverage period for a fixed cost because the coverage period is not fixed.

(iii) Arrangement J does not satisfy the requirements of section 419A(f)(6) and this section because, at a minimum, the requirement of paragraph (a)(1)(iii) of this section is not satisfied. Arrangement J maintains experience-rating arrangements with respect to individual employers because the cost

of coverage for a participating employer is based on a proxy for the overall experience of that employer. Under Arrangement J, the contributions of a participating employer are fixed. The benefits or other amounts payable with respect to an employer are the one-, two-, or three-times-compensation death benefit for each employee of the employer for the current year, plus the extended term protection coverage for future years. Thus, for any period extending to or beyond the end of the original term of one or more of the policies on the lives of an employer's employees, the employer's cost of coverage is the relationship between the fixed contributions for that period and the variable benefits payable under the arrangement. The value of those variable benefits depends on the aggregate value of the policies insuring the employer's employees (*i.e.*, the total of the premiums paid on the policies by Arrangement J to the insurance company, reduced by the mortality and expense charges that were needed to provide the original term protection, and increased by any investment return credited to the policies). The aggregate value of the policies insuring an employer's employees is, at any time, a proxy for the employer's overall experience. Thus, a participating employer's cost of coverage for any period described above is based on a proxy for the overall experience of that employer. Accordingly, Arrangement J maintains experience-rating arrangements with respect to individual employers.

Example 15. (i) Arrangement K provides a death benefit to employees of participating employers equal to a specified multiple of compensation. Under the arrangement, a flexible-premium universal life insurance policy is purchased on the life of each covered employee in the amount of that employee's death benefit. Each policy has a face amount equal to the employee's death benefit under the arrangement. Each participating employer is charged annually with the aggregate amount (if any) needed to maintain the policies covering the lives of its employees. However, each employer is permitted to make additional contributions to the arrangement and, upon doing so, the additional contributions are paid to the insurance company and allocated to one or more contracts covering the lives of the employer's employees. In the event that any policy covering the life of an employee would lapse in the absence of new contributions from that employee's employer, and if at the same time there are policies covering the lives of other employees of the employer that have cash values in excess of the amounts needed to prevent their lapse, the employer has the option of reducing its otherwise-required contribution by amounts withdrawn from those other policies.

(ii) Arrangement K exhibits at least two of the characteristics listed in paragraph (c) of this section generally indicating that an arrangement is not a 10 or more employer plan described in section 419A(f)(6). First, assets of the plan are allocated to specific employers. Second, because the plan allows an employer to choose to contribute an amount that is different than that contributed by another employer for the same benefit, the amount charged under the plan is not the same for all participating employers (and the differences in the amounts are not merely reflective

of differences in current risk or rating factors that are commonly taken into account in manual rates used by insurers for the particular benefit or benefits being provided), resulting in differential pricing.

(iii) Arrangement K does not satisfy the requirements of section 419A(f)(6) and this section because, at a minimum, the requirement of paragraph (a)(1)(iii) of this section is not satisfied. Arrangement K maintains experience-rating arrangements with respect to individual employers because the cost of coverage for any employer participating in the arrangement is based on a proxy for the overall experience of that employer. Under Arrangement K the benefits with respect to an employer for any year are a fixed amount. For purposes of determining the employer's cost of coverage for that year, the Commissioner may treat the employer's contribution under the special rule of paragraph (b)(4)(ii) of this section (concerning treatment of flexible contribution arrangements) as being the minimum contribution amount needed to maintain the universal life policies with respect to that employer for the death benefit coverage for that year. Because the employer has the option to prevent the lapse of one policy by having amounts withdrawn from other policies, that minimum contribution amount will be based in part on the aggregate value of the policies on the lives of that employer's employees. That aggregate value is a proxy for the employer's overall experience. Accordingly, Arrangement K maintains experience-rating arrangements with respect to individual employers.

(g) *Effective date*—(1) *In general.* Except as set forth in paragraph (g)(2) of this section, this section applies to contributions paid or incurred in taxable years of an employer beginning on or after July 11, 2002.

(2) *Compliance information and recordkeeping.* Paragraphs (a)(1)(iv), (a)(2), and (e) of this section apply for taxable years of a welfare benefit fund beginning after July 17, 2003.

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.

Par. 4. In §602.101, paragraph (b) is amended by adding an entry in numerical order to the table to read as follows:

§602.101 OMB control numbers.

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(b) * * * *

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1.419A(f)(6)-1..... 1545-1795

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Robert E. Wenzel,
*Deputy Commissioner for
Services and Enforcement.*

Approved July 9, 2003.

Pamela F. Olson,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on July 16, 2003,
8:45 a.m., and published in the issue of the Federal Register
for July 17, 2003, 68 F.R. 42254)

Section 1503.—Computation and Payment of Tax

26 CFR 1503-2: Dual consolidated loss.

T.D. 9084

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

Dual Consolidated Loss Recapture Events

AGENCY: Internal Revenue Service
(IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations under section 1503(d) regarding the events that require the recapture of dual consolidated losses. These regulations are issued to facilitate compliance by taxpayers with the dual consolidated loss provisions. The regulations generally provide that certain events will not trigger recapture of a dual consolidated loss or payment of the associated interest charge. The regulations provide for the filing of certain agreements in such cases. This document also makes clarifying and conforming changes to the current regulations.

DATES: *Effective Dates:* These regulations are effective January 1, 2002.

FOR FURTHER INFORMATION CONTACT: Kenneth D. Allison or Kathryn T. Holman, (202) 622-3860 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545-1583. Responses to this collection of information are required to obtain the benefit of avoiding entering into a closing agreement with the IRS.

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

The estimated annual burden per recordkeeper varies from 1 to 3 hours, depending on individual circumstances, with an estimated average of 2 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, W:CAR:MP:T:T:SP, 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 a collection of information must be retained as long as their contents might 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

Final regulations implementing section 1503(d) were adopted by T.D. 8434, 1992-2, C.B. 240 [57 FR 41079], on September 9, 1992, and published in the **Federal Register**. On August 1, 2002, proposed regulations (REG-106879-00, 2002-2 C.B. 402 [67 FR 49892]), amending the final regulations, to reduce administrative burdens in certain cases, were published in the Federal Register. Three written comments were received. No public hearing was requested or held. After consideration of the comments, these final regulations are adopted by this Treasury decision. The changes and clarifications made in the final regulations in response to the comments received are discussed below.

Explanation of Provisions and Summary of Comments

Section 1503(d) generally provides that a "dual consolidated loss" of a domestic corporation cannot offset the taxable income of any other member of the corporation's consolidated group. The statute, however, authorizes the issuance of regulations permitting the use of a dual consolidated loss to offset the income of a domestic affiliate if the loss does not offset the income of a foreign corporation under foreign law.

Section 1.1503-2(g)(2)(i) currently permits a taxpayer to elect to use a dual consolidated loss of a dual resident corporation or separate unit to offset the income of a domestic affiliate by filing an agreement ((g)(2)(i) agreement) under which the taxpayer certifies that the dual consolidated loss has not been, and will not be, used to offset the income of another person under the laws of a foreign country. Section 1.1503-2(g)(2)(iii) provides that, in the year of a "triggering event," the taxpayer must recapture and report as gross income the amount of a dual consolidated

loss that is subject to the (g)(2)(i) agreement and must pay the interest charge required by paragraph (g)(2)(vii). Section 1.1503-2(g)(2)(iv)(B), however, provides that specified acquisitions are not considered to be triggering events if certain conditions are satisfied. In particular, the parties to the acquisition must enter into a closing agreement with the IRS under section 7121, and the acquiring corporation or consolidated group must file a new (g)(2)(i) agreement with respect to the loss.

The proposed regulations provided that a triggering event generally does not occur in two types of acquisitions, without any requirement to enter into a closing agreement or file a new (g)(2)(i) agreement: (1) when an unaffiliated dual resident corporation or unaffiliated domestic owner that filed a (g)(2)(i) agreement becomes a member of a consolidated group; and (2) when a dual resident corporation, or domestic owner, that is a member of a consolidated group that filed a (g)(2)(i) agreement (the acquired group) becomes a member of another consolidated group (the acquiring group) in an acquisition, so long as each member of the acquired group that is an includible corporation under section 1504(b) is included immediately after the acquisition in a consolidated U.S. income tax return filed by the acquiring group. Instead, in such cases, the proposed regulations required the filing of an information statement, whereby taxpayers would provide the IRS with most of the information that otherwise would have been provided in a new (g)(2)(i) agreement.

The proposed regulations were intended to relieve the burden of entering into a closing agreement in circumstances where the several liability imposed by §1.1502-6, in combination with the original (g)(2)(i) agreement, would provide for liability by the acquiring group sufficiently comparable to that provided by a closing agreement. A commentator, who raised questions regarding comparable liability under §1.1502-6 in such cases, in particular with respect to the interest charge, recommended that the regulations should retain the existing requirement for the acquiring corporation or consolidated group to enter into a new (g)(2)(i) agreement with respect to the dual consolidated

loss. Although the IRS and Treasury believe that §1.1502-6 provides an independent assurance of several liability, the recommendation to retain the existing requirement for a new (g)(2)(i) agreement has been adopted in these final regulations. The IRS and Treasury have concluded that the intended reduction in administrative burden can be accomplished through the elimination of the requirement to enter into a closing agreement in the cases specified in the proposed regulations. Moreover, with the retention of the requirement to file a new (g)(2)(i) agreement, the requirement in the proposed regulations to file a separate information statement containing essentially the same information has been eliminated. Additional changes have been made to clarify the nature of the new (g)(2)(i) agreement.

The commentators also suggested that any affiliated dual resident corporation or affiliated domestic owner should be permitted to join the acquiring group without causing a triggering event, regardless of whether all members of the consolidated group that filed the original (g)(2)(i) agreement also join the acquiring group, provided that the acquiring group files a new (g)(2)(i) agreement. This suggestion has not been adopted in these final regulations. The final regulations contain a modified description of the types of transactions for which a closing agreement no longer is required, to make clear that all members of an acquired group (or their successors-in-interest) must be members of the acquiring group immediately after the acquisition (*i.e.*, that no member of the acquired group, or its successor-in-interest, is excluded from the acquiring group due to any applicable restriction such as section 1504(a)(3) or section 1504(c)). However, the IRS and Treasury are continuing to consider this suggestion as well as other alternatives for further reducing the administrative and compliance burdens under the section 1503(d) regulations, and invite additional comments in this regard.

In order to accomplish the intended reduction in administrative burdens promptly, the final regulations are applicable with respect to transactions otherwise constituting triggering events occurring on or after January 1, 2002.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that these regulations do not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations will primarily affect affiliated groups of corporations that also have a foreign affiliate, which tend to be larger businesses. Moreover, the number of taxpayers affected and the average burden are minimal. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the proposed regulations preceding these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal authors of these regulations are Kenneth D. Allison and Kathryn T. Holman of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Section 1.1503-2 also issued under 26 U.S.C. 1502 * * *

Par. 2. In §1.1503-2 paragraphs (g)(2) and (h)(1) are amended as follows:

1. Paragraphs (g)(2)(iv)(B)(I), introductory text, and (g)(2)(iv)(B)(I)(i) are revised.

2. Paragraph (g)(2)(iv)(B)(1)(ii) is removed.

3. Paragraphs (g)(2)(iv)(B)(1)(iii) and (iv) are redesignated as paragraphs (g)(2)(iv)(B)(1)(ii) and (iii), respectively.

4. Paragraph (g)(2)(iv)(B)(2) and (g)(2)(iv)(B)(2)(iii) are revised and redesignated as paragraph (g)(2)(iv)(B)(3) and (g)(2)(iv)(B)(3)(iii) respectively.

5. Newly designated paragraph (g)(2)(4)(B)(3)(iii) is revised.

6. New paragraph (g)(2)(iv)(B)(2) is added.

7. Paragraph (g)(2)(iv)(D) is added.

8. Paragraph (h)(1) is amended by adding a sentence at the end of the paragraph.

The revisions and additions read as follows:

§1.1503-2 Dual consolidated loss.

* * * * *

- (g) * * *
(2) * * *
(iv) * * *

(B) * * *(1) If all the requirements of paragraph (g)(2)(iv)(B)(3) of this section are met, the following events shall not constitute triggering events requiring the recapture of the dual consolidated loss under paragraph (g)(2)(vii) of this section:

(i) An affiliated dual resident corporation or affiliated domestic owner becomes an unaffiliated domestic corporation or a member of a new consolidated group (other than in a transaction described in paragraph (g)(2)(iv)(B)(2)(ii) of this section);

* * * * *

(2) If the requirements of paragraph (g)(2)(iv)(B)(3)(iii) of this section are met, the following events shall not constitute triggering events requiring the recapture of the dual consolidated loss under paragraph (g)(2)(vii) of this section—

(i) An unaffiliated dual resident corporation or unaffiliated domestic owner becomes a member of a consolidated group;

(ii) A consolidated group that filed an agreement under this paragraph (g)(2) ceases to exist as a result of a transaction described in §1.1502-13(j)(5)(i) (other than a transaction in which any member of the terminating group, or the successor-in-interest of such member, is not a member of the surviving group immediately after the terminating group ceases to exist).

(3) If the following requirements (as applicable) are satisfied, the events listed in paragraphs (g)(2)(iv)(B)(1) and (2) of this section shall not constitute triggering events requiring recapture under paragraph (g)(2)(vii) of this section.

* * * * *

(iii) The unaffiliated domestic corporation or new consolidated group must file, with its timely filed income tax return for the taxable year in which the event described in paragraph (g)(2)(iv)(B)(1) or (2) of this section occurs, an agreement described in paragraph (g)(2)(i) of this section (new (g)(2)(i) agreement), whereby it assumes the same obligations with respect to the dual consolidated loss as the corporation or consolidated group that filed the original (g)(2)(i) agreement with respect to that loss. The new (g)(2)(i) agreement must be signed under penalties of perjury by the person who signs the return and must include a reference to this paragraph (g)(2)(iv)(B)(3)(iii).

* * * * *

(D) Example. The following example illustrates the application of paragraph (g)(2)(iv)(B)(2)(ii) of this section:

Example. (i) Facts. C is the common parent of a consolidated group (the C Group) that includes DRC, a domestic corporation. DRC is a dual resident corporation and incurs a dual consolidated loss in its taxable year ending December 31, Year 1. The C Group elects to be bound by the provisions of this paragraph

(g)(2) with respect to the Year 1 dual consolidated loss. No member of the C Group incurs a dual consolidated loss in Year 2. On December 31, Year 2, stock of C is acquired by D in a transaction described in § 1.1502-13(j)(5)(i). As a result of the acquisition, all the C Group members, including DRC, become members of a consolidated group of which D is the common parent (the D Group).

(ii) Acquisition not a triggering event. Under paragraph (g)(2)(iv)(B)(2)(ii) of this section, the acquisition by D of the C Group is not an event requiring the recapture of the Year 1 dual consolidated loss of DRC, or the payment of an interest charge, as described in paragraph (g)(2)(vii) of this section, provided that the D Group files the new (g)(2)(i) agreement described in paragraph (g)(2)(iv)(B)(3)(iii) of this section.

(iii) Subsequent event. A triggering event occurs on December 31, Year 3, that requires recapture by the D Group of the dual consolidated loss that DRC incurred in Year 1, as well as the payment of an interest charge, as provided in paragraph (g)(2)(vii) of this section. Each member of the D Group, including DRC and the other former members of the C Group, is severally liable for the additional tax (and the interest charge) due upon the recapture of the dual consolidated loss of DRC.

* * * * *

- (h) * * *

(1) * * * Paragraph (g)(2)(iv)(B)(2) of this section shall apply with respect to transactions otherwise constituting triggering events occurring on or after January 1, 2002.

* * * * *

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.

Par. 4. In §602.101, paragraph (b) is amended by adding an entry for 1.1503-2 to read as follows:

§602.601 OMB Control numbers.

* * * * *

- (b) * * *

Table with 2 columns: CFR part or section where identified and described, Current OMB control No. Row 1: 1.1503-2, 1545-1583

Robert E. Wenzel,
*Deputy Commissioner for
Services and Enforcement.*

Approved July 17, 2003.

Pamela F. Olson,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on July 29, 2003, 8:45 a.m., and published in the issue of the Federal Register for July 30, 2003, 68 F.R. 44616)

Section 2503.—Taxable Gifts

26 CFR 25.2503-1: General definitions of "taxable gifts" and of "total amount of gifts."

Certain previously published revenue rulings are obsolete with respect to the taxation of split-dollar life insurance arrangements entered into or materially modified after September 17, 2003. See Rev. Rul. 2003-105, page 696.

Section 2511.—Transfers in General

26 CFR 25.2511-1: Transfers in general.

Certain previously published revenue rulings are obsolete with respect to the taxation of split-dollar life insurance arrangements entered into or materially modified after September 17, 2003. See Rev. Rul. 2003-105, page 696.

Section 2512.—Valuation of Gifts

26 CFR 25.2512-6: Valuation of certain life insurance and annuity contracts; valuation of shares in an open-end investment company.

Certain previously published revenue rulings are obsolete with respect to the taxation of split-dollar

life insurance arrangements entered into or materially modified after September 17, 2003. See Rev. Rul. 2003-105, page 696.

Section 6042.—Returns Regarding Payments of Dividends and Corporate Earnings and Profits

The Service expects to revise Rev. Proc. 2003-28 to allow brokers to furnish composite substitute payee statements for Forms 1099-DIV, "Dividends and Distributions," and Forms 1099-MISC, Miscellaneous Income. See Notice 2003-67, page 752.

Section 6721.—Failure to File Correct Information Returns

The Service will exercise its authority under section 6724 to waive penalties under section 6721 for information returns for 2003 if a broker makes a good faith effort to satisfy its information reporting obligations consistent with the statutory changes effected by the Jobs and Growth Tax Relief Reconciliation Act of 2003. See Notice 2003-67, page 752.

Section 6722.—Failure to Furnish Correct Payee Statements

The Service will exercise its authority under section 6724 to waive penalties under section 6722 for information returns for 2003 if a broker makes a good faith effort to satisfy its information reporting obligations consistent with the statutory changes effected by the Jobs and Growth Tax Relief Reconciliation Act of 2003. See Notice 2003-67, page 752.

Section 6724.—Waiver; Definitions and Special Rules

The Service will exercise its authority under section 6724 to waive penalties under sections 6721 and 6722 for information returns for 2003 if a broker makes a good faith effort to satisfy its information reporting obligations consistent with the statutory changes effected by the Jobs and Growth Tax Relief Reconciliation Act of 2003. See Notice 2003-67, page 752.

Section 7805.—Rules and Regulations

26 CFR 301.7805-1: Rules and regulations.

Certain previously published revenue rulings are obsolete with respect to the taxation of split-dollar life insurance arrangements entered into or materially modified after September 17, 2003. See Rev. Rul. 2003-105, page 696.

Section 7872.—Treatment of Loans With Below-Market Interest Rates

26 CFR 1.7872-15: Split-dollar loans.

Certain previously published revenue rulings are obsolete with respect to the taxation of split-dollar life insurance arrangements entered into or materially modified after September 17, 2003. See Rev. Rul. 2003-105, page 696.

Part II. Treaties and Tax Legislation

Subpart A.—Tax Conventions and Other Related Items

Austria Agreement on Deferred Payments

Announcement 2003–58

Following is a copy of the News Release issued by the Director International (U.S. Competent Authority) on August 27, 2003 (IR–2003–104).

U.S. & Austria Reach Agreement on Taxing Deferred Payments to U.S. Citizens Residing in Austria

WASHINGTON — The U.S. and Austrian Competent Authorities have entered into a competent authority agreement. This agreement provides that the U.S.-Austria Income Tax Treaty signed on October 25, 1956, does not prohibit Austria from taxing deferred payments for services earned by U.S. citizens while working and residing in the United States, when such compensation was paid after these employees became residents of Austria. The agreement also confirms, however, that Austria shall deduct from its tax the amount of U.S. taxes imposed on the deferred payments for services, as required by the treaty. The 1956 income tax treaty is applicable for assessment periods up to and including 1998.

Inquiries concerning this agreement may be directed to Mr. Lynn Bartlett of the IRS at (202) 435–5021.

Swiss Agreement on Treaty Benefits

Announcement 2003–59

The following is a copy of the agreement concluded between the U.S. and Swiss competent authorities on August 20, 2003 and released on August 22, 2003 (IR–2003–103) regarding the Limitation of Benefits Article of the income tax treaty and accompanying Revised Memorandum of Understanding between the United States and the Swiss Confederation.

COMPETENT AUTHORITY AGREEMENT

The Competent Authorities of the United States and the Swiss Confederation enter into the following Agreement (“Agreement”) concerning the ownership requirements under paragraph 3 of Article 22 (Limitation on Benefits) and paragraph 7 (In reference to paragraph 6 of Article 22 (Limitation on Benefits)) of the Revised Memorandum of Understanding (“MOU”) of the Convention Between the United States of America and the Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income, signed on October 2, 1996 (“Treaty”). The Agreement is entered into under paragraph 3 of Article 25 (Mutual Agreement Procedure).

It is understood that for purposes of this Agreement, “Article” refers to an Article of the Treaty.

Ownership requirements under Article 22(3) and paragraph 7 of the MOU

Article 22(3) allows a Swiss company to receive limited derivative benefits with respect to dividends, royalties, and interest if it meets an ownership, base reduction, and derivative benefits test. Article 22, subparagraphs 3(a)(i) and (ii), sets forth a combined ownership test. One of the ways in which a company can meet the test under subparagraph 3(a)(ii) is if greater than 70 percent of the aggregate vote and value of its shares are ultimately owned by persons that are residents of a party to the North American Free Trade Agreement (“NAFTA”), and that are also described in Article 22(3)(b).

Under Article 22(6), a person who is not entitled to benefits under Article 22, paragraphs 1 through 5, may nevertheless be granted benefits if the competent authority of the State in which the income arises so determines, after consultation with the competent authority of the other Contracting State. Under paragraph 7 of the MOU, a company that meets an ownership test and a base-erosion test will be granted treaty benefits under Article 22(6). A company can meet the ownership test if the ultimate beneficial owners of 95 percent or

more of the aggregate vote and value of all its shares are seven or fewer persons that are residents of a party to the European Union, the European Economic Area or a party to the North American Free Trade Agreement (NAFTA), and that are also described in Article 22(3)(b).

Under Article 22(3)(b), ultimate beneficial ownership by a resident of a country that is a party to NAFTA will be taken into account for purposes of Article 22(3)(a)(ii) and paragraph 7 of the MOU only if the ultimate beneficial owner meets three conditions, one of which is that the owner be a resident of a country with which the other Contracting State has a comprehensive income tax convention. While the United States is a party to NAFTA, the United States does not have a comprehensive income tax convention with itself. Thus, there has been doubt as to whether U.S. residents may be taken into account.

In order to address this concern and provide certainty to taxpayers, the Competent Authorities of United States and the Swiss Confederation have agreed that a U.S. resident will qualify as a resident of a party to NAFTA for purposes of Article 22(3)(b) if the person is a resident of the United States and is also described in Article 22(1), sub-paragraphs (a) or (b), or clause (i) of sub-paragraph (e). Accordingly, an individual who is a resident of the United States (as determined under Article 4); the United States or a political subdivision of the United States; an instrumentality of the United States or political subdivision thereof; and a company incorporated in the United States whose principal class of shares is primarily and regularly traded on a recognized stock exchange within the meaning of paragraph 22(1)(e)(i) will be treated as a resident of a country that is a party to NAFTA for purposes of Article 22(3)(b), and therefore taken into account for purposes of Article 22(3)(a)(ii) and paragraph 7 of the MOU.

The principal author of this announcement is Nina Chowdhry of the Office of Associate Chief Counsel (International). For further information regarding this announcement, contact Nina Chowdhry at (202) 622–3880 (not a toll-free call).

Part III. Administrative, Procedural, and Miscellaneous

Built-in Gains and Losses Under Section 382(h)

Notice 2003-65

I. Purpose

The Internal Revenue Service (IRS) is studying the circumstances under which items of income, gain, deduction, and loss that a loss corporation recognizes after an ownership change should be treated as recognized built-in gain (RBIG) and recognized built-in loss (RBIL) under section 382(h) of the Internal Revenue Code. This notice provides guidance regarding the identification of built-in items and requests comments on this subject. As described below under the heading Reliance on Notice, taxpayers may rely upon this guidance until the IRS and Treasury Department issue temporary or final regulations under section 382(h). This notice discusses two alternative approaches for the identification of built-in items for purposes of section 382(h): the 1374 approach and the 338 approach.

II. Background

Section 382 provides that, after an ownership change, the amount of a loss corporation's taxable income for any post-change year that may be offset by pre-change losses shall not exceed the section 382 limitation for that year. The section 382 limitation generally equals the fair market value of the old loss corporation multiplied by the long-term tax-exempt rate. A loss corporation is any corporation that has a net operating loss, a net operating loss carryforward, or a net unrealized built-in loss for the taxable year in which the ownership change occurs. An ownership change is a greater than 50-percentage-point increase in ownership by 5-percent shareholders during the testing period, which is generally three years. Congress intended the section 382 limitation to apply when shareholders that did not bear the economic burden of the losses acquire a controlling interest in the loss corporation. *See* H.R. Rep. No. 99-426, 1986-3 C.B. (Vol. 2) 256; S. Rep. No. 99-313, 1986-3 C.B. (Vol. 3) 232.

Section 382(h) provides rules for the treatment of built-in gain or loss recognized with respect to assets owned by the loss corporation at the time of its ownership change. Section 382(h), as described below, reflects that, as a general matter, losses that offset built-in gain should not be subject to the section 382 limitation merely because the gain is recognized after an ownership change because if the gain had been recognized before the ownership change, it would have been offset without limitation by the loss corporation's net operating losses. Similarly, built-in loss should not escape the section 382 limitation merely because it is recognized after an ownership change because if the loss had been recognized before the ownership change, it would have been subject to the section 382 limitation.

The question of whether RBIG increases the section 382 limitation or whether RBIL is subject to the section 382 limitation begins with a determination of whether the loss corporation has a net unrealized built-in gain (NUBIG) or a net unrealized built-in loss (NUBIL). Pursuant to section 382(h)(3), a loss corporation's NUBIG equals the excess, if any, of the aggregate fair market value of its assets immediately before an ownership change over the assets' aggregate adjusted basis at that time, adjusted by the amount of certain items of income or deduction described in section 382(h)(6)(C) (described below). In addition, a loss corporation's NUBIL equals the excess, if any, of the aggregate adjusted basis of its assets immediately before an ownership change over the assets' aggregate fair market value at that time, adjusted by the amount of certain items of income or deduction described in section 382(h)(6)(C). Under section 382(h)(3)(B), if a loss corporation's NUBIG or NUBIL does not exceed a threshold amount (the lesser of \$10,000,000 or 15% of the fair market value of its assets immediately before the ownership change), the loss corporation's NUBIG or NUBIL is zero. Thus, a loss corporation cannot have both a NUBIG and a NUBIL, but it can have neither.

If a loss corporation has a NUBIG, pursuant to section 382(h)(1)(A), any RBIG for any taxable year within the 5-year recognition period following the

ownership change increases the section 382 limitation for that year. Similarly, if a loss corporation has a NUBIL, pursuant to section 382(h)(1)(B), any RBIL for any taxable year within the 5-year recognition period following the ownership change is treated as a pre-change loss subject to the section 382 limitation. Thus, only a loss corporation with a NUBIG can increase the section 382 limitation by RBIG, and only a loss corporation with a NUBIL can have RBIL that is treated as a pre-change loss.

In the case of dispositions of assets during the recognition period, section 382(h)(2) places the burden on the loss corporation to establish that any gain recognized is RBIG, and, conversely, that any loss recognized is not RBIL. Section 382(h)(2)(A) defines RBIG as any gain recognized during the 5-year recognition period on the disposition of any asset to the extent the new loss corporation establishes that (i) it held the asset on the change date and (ii) such gain does not exceed the asset's built-in gain on the change date. Furthermore, section 382(h)(2)(B) defines RBIL as any loss recognized during the 5-year recognition period on the disposition of any asset except to the extent the new loss corporation establishes that (i) it did not hold the asset on the change date or (ii) such loss exceeds the asset's built-in loss on the change date.

Section 382(h)(6) and the second sentence of section 382(h)(2)(B) provide rules treating certain items of income or deduction as RBIG or RBIL. Specifically, section 382(h)(6)(A) provides that any item of income "properly taken into account during the recognition period" is treated as RBIG if the item is "attributable to periods before the change date." Section 382(h)(6)(B) provides that any item of deduction "allowable as a deduction during the recognition period" is treated as RBIL if the item is "attributable to periods before the change date." In addition, the second sentence of section 382(h)(2)(B) provides that allowable depreciation, amortization, or depletion deductions are treated as RBIL except to the extent the loss corporation establishes that the amount of the deduction is not attributable to the asset's built-in loss on the change date. Finally, section 382(h)(6)(C) provides that NUBIG

or NUBIL shall be properly adjusted for items of income and deduction that would be treated as RBIG or RBIL under section 382(h)(6) if they were properly taken into account or allowable as a deduction during the recognition period.

The IRS has issued two notices concerning guidance under section 382(h). In Notice 87-79, 1987-1 C.B. 388, the IRS announced that it anticipated that regulations under section 382 would permit income from a discharge of indebtedness that is integrally related to a transaction resulting in an ownership change to be allocated to the pre-change period. In Notice 90-27, 1990-1 C.B. 336, the IRS announced that it would promulgate regulations providing that, if a taxpayer that sells a built-in gain asset either prior to or during the recognition period reports the gain using the installment method under section 453, the provisions of section 382(h) will continue to apply to RBIG from the installment sale after the recognition period (including any gain recognized from the disposition of the installment obligation).

III. The 1374 Approach

The 1374 approach generally incorporates the rules of section 1374(d) and §§1.1374-3, 1.1374-4, and 1.1374-7 of the Income Tax Regulations in calculating NUBIG and NUBIL and identifying RBIG and RBIL. The following sections describe the application of those rules in the context of section 382(h) and describe those areas in which the 1374 approach departs from those rules.

A. Calculation of NUBIG and NUBIL

Under the 1374 approach, NUBIG or NUBIL is the net amount of gain or loss that would be recognized in a hypothetical sale of the assets of the loss corporation immediately before the ownership change. Specifically, NUBIG or NUBIL is calculated by determining the amount that would be the amount realized if immediately before the ownership change the loss corporation had sold all of its assets, including goodwill, at fair market value to a third party that assumed all of its liabilities, decreased by the sum of any deductible liabilities of the loss corporation that would be included in the amount realized on the hypothetical sale and the loss

corporation's aggregate adjusted basis in all of its assets, increased or decreased by the corporation's section 481 adjustments that would be taken into account on a hypothetical sale, and increased by any RBIL that would not be allowed as a deduction under section 382, 383, or 384 on the hypothetical sale. See §1.1374-3(a) (regarding the calculation of NUBIG). The amount by which this result exceeds \$0 is the loss corporation's NUBIG; the amount by which \$0 exceeds this result is the loss corporation's NUBIL.

For all of the examples in this notice, unless otherwise noted, LossCo is a loss corporation (as defined in section 382(k)) that is a calendar year basis taxpayer that uses the accrual method of accounting and that has an ownership change on the last day of a taxable year.

Example 1. Immediately before an ownership change, LossCo has one asset with a fair market value of \$100 and an adjusted basis of \$10, and a deductible liability of \$30. Disregarding the threshold requirement of section 382(h)(3)(B), LossCo has a NUBIG of \$60 (\$100, the amount LossCo would realize if it sold all its assets to a third party that assumed all of its liabilities, decreased by \$40, the sum of the deductible liability (\$30) and the aggregate basis in the assets (\$10)).

Example 2. The facts are the same as in Example 1 except that the asset has an adjusted basis of \$90 instead of \$10. Disregarding the threshold requirement of section 382(h)(3)(B), LossCo has a NUBIL of \$20 (the amount by which \$0 exceeds -\$20 (\$100, the amount LossCo would realize if it sold all its assets to a third party that assumed all of its liabilities, decreased by \$120, the sum of the deductible liability (\$30) and the aggregate basis in the assets (\$90)).

B. Calculation of RBIG and RBIL

1. Gain and Loss from Sales or Exchanges of Assets

Under the 1374 approach, the amount of gain or loss recognized during the recognition period on the sale or exchange of an asset is RBIG or RBIL, respectively, subject to the limitations described in section 382(h)(2)(A) or (B). The sum of the RBIG or RBIL (including deductions that are treated as RBIL as described below) attributable to an asset cannot exceed the unrealized built-in gain or loss in that asset on the change date.

With respect to gain from sales reported under the section 453 installment method, the 1374 approach follows the section 1374 regulations and Notice 90-27, which

treat built-in gain recognized from installment sales that occur before or during the recognition period as RBIG, even if recognized after the recognition period. See §1.1374-4(h); see also Notice 90-27, 1990-1 C.B. 336.

In addition, as set forth in Notice 90-27, if a corporation transfers a built-in gain asset to an affiliated corporation, the gain is deferred under the consolidated return regulations, and, before the close of the recognition period, the affiliated corporation sells the built-in gain asset in a sale reportable under the installment method, such deferred gain is RBIG when such gain is taken into account by the selling or distributing member, and will cause an increase in the section 382 limitation for the taxable year of payment, even if the gain is taken into account after the recognition period. See Notice 90-27, 1990-1 C.B. 336, 338.

2. Items of Income and Deduction

a. In General

In cases other than sales and exchanges, the 1374 approach generally relies on the accrual method of accounting to identify income or deduction items as RBIG or RBIL, respectively. Under this approach, items of income or deduction properly included in income or allowed as a deduction during the recognition period are considered "attributable to periods before the change date" under sections 382(h)(6)(A) and (B) and, thus, are treated as RBIG or RBIL, respectively, if an accrual method taxpayer would have included the item in income or been allowed a deduction for the item before the change date. However, for purposes of determining whether an item is RBIL, section 461(h)(2)(C) and §1.461-4(g) (concerning certain liabilities for which payment is economic performance) do not apply. See §§1.1374-4(b)(1) and (2).

Example 3. Immediately before an ownership change, LossCo, which uses the cash method of accounting, has a \$50 account receivable with a fair market value of \$40 and a basis of \$0. In Year 2 of the recognition period, LossCo sells the account receivable for \$40 before collecting any part of it. LossCo has \$40 of RBIG in Year 2.

Example 4. The facts are the same as in Example 3, except that instead of selling the account receivable, LossCo collects \$50 on the account receivable in Year 2 of the recognition period. LossCo has \$50

of RBIG in Year 2, because that is the amount that accrued immediately before the ownership change. See §1.1374-4(b)(3), Example 1.

Example 5. The facts are the same as in *Example 3*, except that LossCo collects \$25 on the account receivable in Year 2 of the recognition period and then sells the remainder of the account receivable for \$20 in Year 3 of the recognition period. LossCo has \$25 of RBIG in Year 2, and \$15 of RBIG in Year 3 (\$40 of built-in gain on the change date decreased by \$25 of income previously treated as RBIG in Year 2).

(i) *Income Generated by Built-in Gain Assets*

In general, the 1374 approach does not treat income from a built-in gain asset during the recognition period as RBIG because such income did not accrue before the change date.

Example 6. LossCo has a NUBIG of \$300,000 that is attributable to several non-amortizable assets with an aggregate fair market value of \$650,000 and an aggregate adjusted basis of \$500,000, and a patent with a fair market value of \$170,000 and an adjusted basis of \$20,000. The patent is an “amortizable section 197 intangible” as defined in section 197(c). In Year 1 of the recognition period, LossCo has gross income of \$75,000, \$20,000 of which is attributable to royalties collected in connection with the license of the patent. No part of the \$20,000 attributable to the royalties is RBIG in Year 1 because the income would not have been properly taken into account before the change date by an accrual method taxpayer. Accordingly, LossCo’s section 382 limitation for Year 1 is not increased by any part of that amount.

(ii) *Depreciation, Amortization and Depletion Deductions with Respect to Built-in Loss Assets*

The 1374 approach departs from the tax accrual rule and the regulations under section 1374 in its treatment of amounts allowable as depreciation, amortization, or depletion (collectively, “amortization”) deductions during the recognition period. In accordance with the second sentence of section 382(h)(2)(B), except to the extent the loss corporation establishes that the amount is not attributable to the excess of an asset’s adjusted basis over its fair market value on the change date, these amounts are treated as RBIL, regardless of whether they accrued for tax purposes before the change date. A loss corporation may use any reasonable method to establish that the amortization deduction amount is not attributable to an asset’s built-in loss on the change date. One acceptable method is to compare the amount of the amortization deduction actually allowed to the amount of such deduction

that would have been allowed had the loss corporation purchased the asset for its fair market value on the change date. The amount by which the amount of the actual amortization deduction does not exceed the amount of the hypothetical amortization deduction is not RBIL.

Example 7. LossCo has a NUBIL of \$300,000 that is attributable to several non-amortizable assets with an aggregate fair market value of \$500,000 and an aggregate adjusted basis of \$650,000, and a patent with a fair market value of \$125,000 and an adjusted basis of \$275,000. The patent is an “amortizable section 197 intangible” as defined in section 197(c). As of the change date, the patent has a remaining useful life for tax purposes of 5 years. On its tax return for Year 1, LossCo claims a \$55,000 amortization deduction for the patent. If LossCo had purchased the patent for its fair market value on the change date, it would have been allowed an amortization deduction in the amount of \$8,333 on that return. Accordingly, LossCo is able to establish that \$8,333 of the amortization deduction for that taxable year is not attributable to the patent’s built-in loss on the change date. Therefore, \$46,667 of the actual amount of the amortization deduction in Year 1 is RBIL. On the first day of Year 2, LossCo sells the patent for \$70,000 and recognizes \$150,000 of loss. Of LossCo’s \$150,000 loss from the sale, \$103,333 is RBIL under section 382(h)(2)(B) (\$150,000 built-in loss on the change date decreased by the \$46,667 deduction attributable to the patent previously treated as RBIL).

b. *Discharge of Indebtedness Income and Bad Debt Deductions*

The 1374 approach generally treats as RBIG or RBIL any income or deduction item properly taken into account during the first 12 months of the recognition period as discharge of indebtedness income (“COD income”) that is included in gross income pursuant to section 61(a)(12) or as a bad debt deduction under section 166 if the item arises from a debt owed by or to the loss corporation at the beginning of the recognition period. See §1.1374-4(f). Any reduction of tax basis under sections 108(b)(5) and 1017(a) that occurs as a result of COD income realized within the first 12 months of the recognition period is treated as having occurred immediately before the ownership change for purposes of determining whether a recognized gain or loss is an RBIG or an RBIL under section 382(h)(2). However, the reduction of tax basis does not affect the loss corporation’s NUBIG or NUBIL under section 382(h)(3).

Example 8. LossCo has a NUBIG of \$300,000. On the change date, LossCo has an asset with a fair market value of \$200,000 and a basis of \$150,000. The asset is subject to a debt with an adjusted issue

price of \$98,000. During Year 1 of the recognition period, LossCo satisfies the debt by paying the lender \$95,000. On its tax return for Year 1, LossCo includes in gross income \$3,000 of COD income. That amount is RBIG in Year 1. In Year 2, LossCo sells the asset for \$200,000. The \$50,000 of gain recognized on the sale of the asset is RBIG in Year 2.

Example 9. The facts are the same as in *Example 8*, except that \$3,000 of the debt is discharged in a Title 11 case. LossCo excludes the \$3,000 of COD income under section 108(a) and reduces the tax basis of the asset from \$150,000 to \$147,000 under sections 108(b)(5) and 1017(a). The \$3,000 of COD income that is excluded from income is not treated as RBIG. However, because the basis reduction is treated as having occurred immediately before the recognition period for purposes of section 382(h)(2), the \$53,000 of gain recognized on the sale of the asset is RBIG.

As suggested above, the treatment of COD income under the 1374 approach differs from the treatment of that item as described in Notice 87-79, which treats COD income that is “integrally related to an ownership change” but is recognized after the ownership change as RBIG. Taxpayers that otherwise follow the 1374 approach may apply the rules described in Notice 87-79, rather than the rules included in the 1374 approach, to COD income for ownership changes that occur before September 12, 2003, but may not rely on the rules described in Notice 87-79 for ownership changes that occur on or after September 12, 2003.

IV. The 338 Approach

The 338 approach identifies items of RBIG and RBIL generally by comparing the loss corporation’s actual items of income, gain, deduction, and loss with those that would have resulted if a section 338 election had been made with respect to a hypothetical purchase of all of the outstanding stock of the loss corporation on the change date (the “hypothetical purchase”). As a result, unlike under the 1374 approach, under the 338 approach, built-in gain assets may be treated as generating RBIG even if they are not disposed of at a gain during the recognition period, and deductions for liabilities, in particular contingent liabilities, that exist on the change date may be treated as RBIL.

A. *Calculation of NUBIG and NUBIL*

Under the 338 approach, NUBIG or NUBIL is calculated in the same manner as it is under the 1374 approach. Accordingly, unlike the case in which a section

338 election is actually made, contingent consideration (including a contingent liability) is taken into account in the initial calculation of NUBIG or NUBIL, and no further adjustments are made to reflect subsequent changes in deemed consideration.

Example 10. Immediately before an ownership change, LossCo has one asset with a fair market value of \$100 and a basis of \$10 and a deductible contingent liability estimated at \$40. Disregarding the threshold requirement of section 382(h)(3)(B), LossCo has a NUBIG of \$50 (\$100, the amount LossCo would realize if it sold all of its assets to a third party that assumed all of its liabilities, decreased by \$50, the sum of deductible liabilities (\$40) and the aggregate basis of LossCo's assets (\$10)). During Year 1 of the recognition period, a final legal determination fixes the contingent liability at \$10. NUBIG is not readjusted to reflect the resolution of the amount of the contingent liability.

B. Calculation of RBIG and RBIL

The 338 approach identifies RBIG or RBIL by comparing the loss corporation's actual items of income, gain, deduction, and loss with the items of income, gain, deduction, and loss that would result if a section 338 election had been made for the hypothetical purchase. For purposes of identifying those items that would have resulted had a section 338 election been made with respect to the hypothetical purchase, after the hypothetical purchase, the loss corporation is treated as using those accounting methods that the loss corporation actually uses. The following sections describe the application of the 338 approach to certain items of the loss corporation.

1. Gain and Loss from Sales or Exchanges of Assets

The 338 approach identifies RBIG or RBIL from sales and exchanges of assets by comparing the loss corporation's actual item of gain or loss with the gain or loss that would result if a section 338 election had been made for the hypothetical purchase. With respect to gain from sales reported under the section 453 installment method, the 338 approach follows Notice 90-27, which, as described above, treats built-in gain recognized from installment sales that occur before or during the recognition period as RBIG, even if recognized after the recognition period. In addition, the 338 approach follows Notice 90-27 in cases in which a corporation transfers a

built-in gain asset to an affiliated corporation, the gain is deferred under the consolidated return regulations, and, before the close of the recognition period, the affiliated corporation sells the built-in gain asset in a sale reportable under the installment method. In such cases, the deferred gain is RBIG when it is taken into account by the selling or distributing member, even if the gain is taken into account after the recognition period. See Notice 90-27, 1990-1 C.B. 336.

2. Wasting or Consumption of Built-in Gain Assets

As described above, for loss corporations with a NUBIG, the 338 approach treats certain built-in gain assets of the loss corporation as generating RBIG even if such assets are not disposed of during the recognition period. The 338 approach assumes that, for any taxable year, an asset that had a built-in gain on the change date generates income equal to the cost recovery deduction that would have been allowed for such asset under the applicable Code section if an election under section 338 had been made with respect to the hypothetical purchase. Therefore, with respect to an asset that had a built-in gain on the change date, the 338 approach treats as RBIG an amount equal to the excess of the cost recovery deduction that would have been allowable with respect to such asset had an election under section 338 been made for the hypothetical purchase over the loss corporation's actual allowable cost recovery deduction. The cost recovery deduction that would have been allowed to the loss corporation had an election under section 338 been made with respect to the hypothetical purchase will be based on the asset's fair market value on the change date and a cost recovery period that begins on the change date. The excess amount is RBIG, regardless of the loss corporation's gross income in any particular taxable year during the recognition period.

Example 11. LossCo has a NUBIG of \$300,000 that is attributable to various non-amortizable assets with an aggregate fair market value of \$710,000 and an aggregate adjusted basis of \$500,000, and a patent with a fair market value of \$120,000 and an adjusted basis of \$30,000. The patent is an "amortizable section 197 intangible" as defined in section 197(c) for which 10 years of tax depreciation remain. In Year 1 of the recognition period, LossCo has gross income of \$75,000. In Year 1, \$5,000 is RBIG attributable to

the patent (the excess of the \$8,000 amortization deduction that would have been allowed had a section 338 election been made with respect to a hypothetical purchase of all of the stock of LossCo (\$120,000 fair market value divided by 15, the amortization period) over \$3,000 (the actual allowable amortization deduction)). This \$5,000 of RBIG increases LossCo's section 382 limitation for Year 1.

On the first day of Year 2, LossCo sells the patent to an unrelated third party for \$117,000 and recognizes \$90,000 of gain. If a section 338 election had been made with respect to a hypothetical purchase of all of the stock of LossCo, LossCo would have recognized \$5,000 of gain on the sale of the patent, because LossCo would have had an adjusted basis of \$112,000 in the patent at the time of its sale. Therefore, LossCo has \$85,000 of RBIG from the sale of the patent (the excess of LossCo's actual \$90,000 of gain over the \$5,000 of gain LossCo would have recognized had an election under section 338 been made with respect to a hypothetical purchase of all of the stock of LossCo). Thus, LossCo's section 382 limitation for Year 2 is increased by \$85,000.

Example 12. The facts are the same as in *Example 11*, except that, as of the change date, only 2 years of tax depreciation remain for the patent. For Year 1 of the recognition period, LossCo has gross income of \$75,000. No amount is RBIG attributable to the patent (\$8,000, the amortization deduction that would have been allowed had a section 338 election been made with respect to the hypothetical purchase of all of the stock of LossCo, does not exceed the \$15,000 actual allowable amortization deduction). In Year 3, \$8,000 is RBIG attributable to the patent (the excess of the \$8,000 amortization deduction that would have been allowed had a section 338 election been made with respect to the hypothetical purchase of all of the stock of LossCo over \$0, the actual allowable amortization deduction (because the patent's basis is exhausted)). Thus, LossCo's section 382 limitation for Year 3 is increased by \$8,000.

3. Depreciation, Depletion, and Amortization Deductions with Respect to Built-in Loss Assets

For loss corporations with a NUBIL, the 338 approach treats as RBIL certain deductions of the loss corporation. In particular, with respect to an asset that has a built-in loss on the change date, the 338 approach treats as RBIL the excess of the loss corporation's actual allowable cost recovery deduction over the cost recovery deduction that would have been allowable to the loss corporation with respect to such asset had an election under section 338 been made with respect to the hypothetical purchase.

Example 13. LossCo has a NUBIL of \$410,000 that is attributable to various non-amortizable assets with an aggregate fair market value of \$500,000 and an aggregate adjusted basis of \$850,000, and a patent with a fair market value of \$90,000 and an adjusted basis of \$150,000. LossCo acquired the patent in a

transaction in which LossCo acquired no other intangibles. The patent is an “amortizable section 197 intangible” as defined in section 197(c) for which 10 years of tax depreciation remain. The patent generates a \$15,000 amortization deduction each year. During each year of the recognition period, \$9,000 of the deduction is RBIL attributable to the patent (the excess of the \$15,000 actual allowable amortization deduction over the \$6,000 amortization deduction that would have been allowed had a section 338 election been made with respect to the hypothetical purchase of all of the stock of LossCo (\$90,000 fair market value divided by 15, the amortization period)).

On the first day of Year 2 of the recognition period, LossCo sells the patent to a third party for \$80,000 and recognizes a \$55,000 loss. If a section 338 election had been made with respect to a hypothetical purchase of all of the stock of LossCo on the change date, LossCo would have recognized a \$4,000 loss on the patent, because, in that case, LossCo would have had an adjusted basis of \$84,000 in the patent at the time of its sale. Therefore, LossCo has \$51,000 of RBIL from the sale of the patent (the excess of LossCo’s actual \$55,000 loss over the \$4,000 loss LossCo would have recognized had an election under section 338 been made with respect to a hypothetical purchase of all of the stock of LossCo).

C. Contingent Liabilities

The 338 approach treats a deduction for the payment of a liability that is contingent on the change date as RBIL to the extent of the estimated liability on the change date.

Example 14. LossCo has a contingent liability estimated at \$25 on the change date. During Year 2 of the recognition period, LossCo pays \$30 to settle the liability and claims a deduction for that amount. Of that amount, \$25 is RBIL.

D. Discharge of Indebtedness Income

Under the 338 approach, COD income that is included in gross income under section 61(a)(12) and that is attributable to any pre-change debt of the loss corporation is RBIG in an amount not exceeding the excess, if any, of the adjusted issue price of the discharged debt over the fair market value of the debt on the change date. The 338 approach treats a reduction of tax basis under sections 108(b)(5) and 1017(a) that occurs during the recognition period as having occurred immediately before the ownership change for purposes of section 382(h)(2) to the extent of the excess, if any, of the adjusted issue price of the debt over the fair market value of the debt on the change date. However, the reduction of tax basis does not affect the loss corporation’s NUBIG or NUBIL under section 382(h)(3). As with the 1374 approach,

taxpayers that otherwise follow the 338 approach may apply the rules described in Notice 87–79, rather than the rules included in the 338 approach to COD income for ownership changes that occur before September 12, 2003, but may not rely on the rules of Notice 87–79 for ownership changes that occur on or after September 12, 2003.

Example 15. LossCo has a NUBIG of \$300,000 that is, in part, attributable to an asset with a fair market value of \$200,000 and a basis of \$150,000. The asset is subject to a debt with an adjusted issue price of \$98,000, and a fair market value of \$95,000. During Year 2 of the recognition period, \$95,000 of the debt is satisfied and \$3,000 of the debt is discharged in a Title 11 case. LossCo excludes the \$3,000 COD income under section 108(a) and reduces the tax basis of the asset under sections 108(b)(5) and 1017(a) to \$147,000. The tax basis of the asset does not otherwise change during the recognition period. In Year 3, LossCo sells the asset for \$200,000 and recognizes \$53,000 of gain. The \$3,000 of COD income that is excluded from income is not RBIG. If a section 338 election had been made with respect to a hypothetical purchase of all of the stock of LossCo, LossCo would have recognized \$0 of gain on the sale of the asset, because, in that case, LossCo would have had an adjusted basis of \$200,000 in the asset at the time of its sale. Therefore, LossCo has \$53,000 of RBIG from the sale of the asset (the excess of LossCo’s actual \$53,000 of gain over the \$0 of gain LossCo would have recognized had an election under section 338 been made with respect to a hypothetical purchase of all of the stock of LossCo). Thus, LossCo’s section 382 limitation for Year 3 is increased by \$53,000.

E. Other Items

The 338 approach incorporates the special rules in §1.1374–4(i) concerning partnership items and §1.1374–4(d) concerning section 481 adjustments, to the extent those items are not already taken into account in the basic methodology of the 338 approach of comparing actual items of the loss corporation to those that would have resulted had a section 338 election been made with respect to the hypothetical purchase.

V. Reliance on Notice

Taxpayers may rely on the approaches set forth in this notice for purposes of applying section 382(h) to an ownership change that occurred prior to the issuance of this notice or on or after the issuance of this notice and prior to the effective date of temporary or final regulations under section 382(h). The IRS will not assert an alternative interpretation of section 382(h)

against a taxpayer that consistently applies either the 1374 approach or the 338 approach described in this notice. Taxpayers may use either the 1374 approach or the 338 approach, but not elements of both, for each ownership change with respect to a loss corporation or a loss subgroup as defined in §1.1502–91(d). Although the approaches described in this notice serve as safe harbors, they are not the exclusive methods by which a taxpayer may identify built-in items for purposes of section 382(h). Other methods taxpayers use to identify built-in items for purposes of section 382(h) will be examined on a case-by-case basis.

VI. Effect on Other Documents

Notice 87–79, 1987–1 C.B. 388, is modified.

VII. Request for Comments

The IRS intends to publish, in the near future, proposed regulations providing a single set of rules for identifying built-in items for purposes of section 382(h). The IRS requests comments regarding whether one of the two approaches described in this notice should be adopted and to what extent, if any, the approaches should be combined or modified to produce a set of rules that is both reflective of statutory intent and administrable. The IRS also invites comments regarding other issues under section 382(h) that should be addressed in regulations. Finally, the IRS requests comments regarding the extent to which regulations promulgated under section 384 identifying built-in items should differ from regulations promulgated under section 382(h) identifying built-in items. Comments should refer to Notice 2003–65, and should be submitted to:

Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044
Attn: CC:PA:LPD:PR
Room 5203

or electronically via the Service internet site at: *Notice.Comments@irs.counsel.treas.gov* (the Service comments e-mail address). All comments will be

available for public inspection and copying.

DRAFTING INFORMATION

The principal author of this notice is Marie Byrne of the Office of Associate Chief Counsel (Corporate). For further information regarding this notice, contact Ms. Byrne at (202) 622-7750 (not a toll-free number).

The Jobs and Growth Tax Relief Reconciliation Act of 2003—Information Reporting for Payments in Lieu of Dividends

Notice 2003-67

SECTION 1. PURPOSE

This notice provides guidance to brokers and individuals regarding provisions in the Jobs and Growth Tax Relief Reconciliation Act of 2003 (the JGTRRA), Pub. L. No. 108-27, 117 Stat. 752, that affect information reporting for payments in lieu of dividends (sometimes called “substitute payments”). This notice announces that:

1. The Internal Revenue Service will exercise its authority under section 6724(a) of the Internal Revenue Code to waive penalties under sections 6721 and 6722 for information returns with respect to calendar year 2003 payments if a broker makes a good faith effort to satisfy its information reporting obligations in a way that is consistent with the statutory changes effected by the JGTRRA.

2. The Service has revised the instructions to the 2003 Form 1099-MISC, “*Miscellaneous Income*,” to require brokers to report payments in lieu of dividends to individuals in Box 8 of Form 1099-MISC.

3. The Service expects to revise Rev. Proc. 2003-28, 2003-16 I.R.B. 759, to allow brokers to furnish composite substitute payee statements for Forms 1099-DIV, “*Dividends and Distributions*,” and Forms 1099-MISC, reporting payments in lieu of dividends, as well as other information returns.

4. If a payment in lieu of dividends is reported as dividend income on a 2003

Form 1099-DIV, the taxpayer receiving the form may treat the payment for tax purposes as a dividend, and not as a payment in lieu of dividends, unless the taxpayer knows, or has reason to know, of the actual character of the payment.

5. The Service expects to amend section 1.6045-2 of the Income Tax Regulations to reflect the statutory changes effected by the JGTRRA regarding payments in lieu of dividends. The Service expects to amend the regulations to provide new rules for brokers to use to determine which shares are loanable and to permit brokers to use a new hierarchical method to allocate transferred shares to new pools of loanable shares. The amendments are expected to be applicable to dividends received on or after January 1, 2003.

SECTION 2. BACKGROUND

Effective for taxable years beginning after December 31, 2002, and beginning before January 1, 2009, section 302 of the JGTRRA reduces the tax rate for “qualified dividends” paid to an individual shareholder to the same tax rate as capital gains. The reduced tax rate does not apply to a dividend on stock that is held (within the meaning of section 246(c)) by the taxpayer for 60 days or less of the 120-day period that begins 60 days before the ex-dividend date. The favorable tax rate is also denied to the extent that the taxpayer is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

The legislative history states, however, that “Payments in lieu of dividends are not eligible for the lower rates.” H.R. REP. NO. 108-94, 108th Cong., 1st Sess. 31 n.36 (2003). (The distinction between payments made with respect to a financial instrument by its issuer and payments made by a third party who had borrowed the instrument was already relevant even before the JGTRRA for exempt interest dividends, capital gain dividends, distributions treated as a return of capital, foreign tax credit dividends, and dividends eligible for the dividends received deduction, but was generally not relevant for dividends or in lieu of dividend payments received by an individual. *See* section 1.6045-2(a), (f)). In addition, the Conference Report states:

In the case of brokers and dealers who engage in securities lending transactions, short sales, or other similar transactions on behalf of their customers in the normal course of their trade or business, the conferees intend that the IRS will exercise its authority under section 6724(a) to waive penalties where dealers and brokers attempt in good faith to comply with the information reporting requirements under sections 6042 and 6045, but are unable to reasonably comply because of the period necessary to conform their information reporting systems to the retroactive rate reductions on qualified dividends provided by the conference agreement. In addition, the conferees expect that individual taxpayers who receive payments in lieu of dividends from these transactions may treat the payments as dividend income to the extent that the payments are reported to them as dividend income on their Forms 1099-DIV received for calendar year 2003, unless they know or have reason to know that the payments are in fact payments in lieu of dividends rather than actual dividends. The conferees expect that the Treasury Department will issue guidance as rapidly as possible on information reporting with respect to payments in lieu of dividends made to individuals.

H.R. CONF. REP. NO. 108-126, 108th Cong., 1st Sess. 42-43 (2003).

SECTION 3. WAIVER OF PENALTIES UNDER SECTION 6724(a)

Section 6721 imposes a penalty if a payor fails to file correct information returns with the Service, including returns required under section 6042 (relating to payment of dividends) and section 6045 (relating to returns of brokers). Section 6722 imposes a penalty if a payor fails to furnish correct information statements to payees, including statements required under sections 6042 and 6045. Section 6724(a) authorizes the Service to waive the section 6721 and 6722 penalties if the failure to comply is due to reasonable cause and not to willful neglect.

If they have not already done so, brokers as defined in section 6045 who engage in securities lending transactions, short sales, or other similar transactions

on behalf of their customers in the normal course of the brokers' trade or business should immediately undertake action to conform their information reporting systems to the JGTRRA. The Service expects brokers to complete those efforts as soon as reasonably possible for the calendar year 2003 and, to the extent reasonably possible, to comply with their reporting responsibilities in a manner consistent with the JGTRRA for payments in lieu of dividends for the calendar year 2003.

The Service will exercise its authority under section 6724(a) to waive penalties if a broker shows that it made a good faith attempt to comply with the information reporting requirements under sections 6042 and 6045 in a manner consistent with the JGTRRA for dividend payments made during calendar year 2003 but could not reasonably do so because the broker had inadequate time within which to conform the broker's information reporting systems to the JGTRRA. The Service will consider all relevant facts and circumstances in determining whether a broker acted in good faith in attempting to comply with the information reporting requirements for dividend payments made during calendar year 2003. For dividend payments made during calendar year 2004, however, except in extraordinary circumstances, the Service will consider brokers to have had adequate time to conform their information reporting systems to the new law for payments in lieu of dividends.

SECTION 4. INSTRUCTIONS TO FORM 1099-MISC AND REV. PROC. 2003-28

The Service has revised the Instructions to Form 1099-MISC for calendar year 2003 for payments in lieu of dividends. The revised instructions direct brokers to report payments in lieu of dividends in Box 8 of Form 1099-MISC whether the recipient is a corporation, an individual, or some other type of taxpayer. In addition, the Service expects to revise Rev. Proc. 2003-28 to allow brokers to furnish composite substitute payee statements for Forms 1099-DIV and Forms 1099-MISC, reporting payments in lieu of dividends, as well as other information returns.

SECTION 5. PAYMENTS REPORTED ON FORMS 1099-DIV FOR 2003

Some taxpayers may receive Forms 1099-DIV for calendar year 2003 that erroneously characterize payments in lieu of dividends as dividend income because the brokers issuing the forms have not yet modified their information reporting systems to comply with the JGTRRA. A taxpayer who receives payments in lieu of dividends may treat the payments as dividend income to the extent that the payments are reported to the taxpayer as dividend income on Form 1099-DIV for calendar year 2003, unless the taxpayer knows, or has reason to know, that the payments are in fact payments in lieu of dividends rather than actual dividends.

SECTION 6. AMENDMENT OF REGULATION SECTION 1.6045-2

In general, section 1.6045-2 of the existing regulations, which was issued prior to enactment of the JGTRRA, excludes from the broker reporting requirements of section 6045 payments in lieu of dividends received by a broker on behalf of an individual. That is, these regulations generally require broker reporting only for payments in lieu of dividends received on behalf of corporations. The Service expects to amend section 1.6045-2 to reflect the differential tax treatment under JGTRRA for dividends and payments in lieu of dividends, effective for dividends received on or after January 1, 2003.

Under the existing regulations, brokers must allocate transferred shares (that is, shares giving rise to payments in lieu of dividends) among: (1) shares of stock that the broker has borrowed under a securities lending agreement with the customer (borrowed shares); and (2) shares of stock that are held by the broker on behalf of customers who have authorized the broker to loan their shares to third parties (loanable shares). Loanable shares also include shares of the same class and issue held for the broker's own account. Under the existing regulations, transferred shares may be allocated first to borrowed shares; then, to the extent that the number of transferred shares exceeds the number of borrowed shares (or if the broker does not allocate the transferred shares to the borrowed shares

first), the broker must allocate the transferred shares between pools of loanable shares.

.01 *Loanable Shares Defined*

The amendments to section 1.6045-2 are expected to clarify the present rule that loanable shares do not include shares that the broker by law is prevented from lending. Thus, loanable shares do not include shares that the broker has not been given permission to borrow or lend, shares that the owner may not transfer (such as restricted stock), and shares that, although held in a margin account, may not be borrowed because of Securities and Exchange Commission restrictions on the value of the shares that may be borrowed from the account.

The Service also expects to amend the existing regulations to provide new rules regarding shares that are to be treated as loanable shares. When amended, the regulations are expected to permit brokers to exclude from loanable shares one or more of the following categories of shares:

1. All shares held for the broker's own account.
2. All shares that would not be loanable but for the fact that they are held in a margin account pursuant to account documentation authorizing the lending of shares.
3. Shares that the owner has requested the broker not to lend (even if the owner had executed a written authorization to lend), provided that, consistent with an established practice reflected in the broker's books and records, the broker complies with the request.
4. Shares which had been loaned, but, with respect to which the owner exercised a right under the lending agreement to call back the shares within a fixed period.
5. Any other category of shares described in guidance issued by the Service.

The regulations are expected to provide that, under the preceding paragraph, shares in any of these five categories may

be treated as not loanable only if all of the following requirements are satisfied:

- a. At the time the broker designates the share as not loanable, the share has not, in fact, been loaned under an outstanding loan agreement;
- b. The designation of a category of shares as not being loanable is reflected in a written policy of the broker that was placed in its books and records on or before the time of the stock loans to be affected by the policy; and
- c. The policy is consistently applied for both tax and nontax purposes to all shares described in the category.

The Service invites comments on these categories of shares and on the requirements that must be satisfied to treat the shares as not loanable.

.02 Allocation and Selection of Transferred Shares

Pending issuance of amendments to section 1.6045-2, the rules of that section continue to apply for recordkeeping for payments in lieu of dividends and for identifying which customers had their shares transferred. A broker may continue to allocate transferred shares to borrowed shares. In addition, if a broker uses the method of allocation and selection of loanable shares specified in paragraph (f)(2)(ii) of section 1.6045-2, the amendments are expected to allow the broker, starting in 2003, to make the selection of the transferred shares within the individual pool described in section 1.6045-2(f)(2)(ii)(C) using the methods of selection of transferred shares used within the nonindividual pool as prescribed in section 1.6045-2(f)(2)(ii)(B).

The Service expects to amend the existing regulations to permit brokers to use a new hierarchical method to allocate transferred shares. Under this new hierarchical method, a broker must allocate transferred shares first to shares that are borrowed under a securities lending agreement. Brokers must then allocate the remaining transferred shares to one or more pools of shares held by tax-indifferent customers to the extent of loanable shares in

those pools. For this purpose, a tax-indifferent customer is a customer (for example, a tax-exempt entity) for whom the broker has reasonably determined that the tax treatment of qualifying dividends and payments in lieu of dividends are the same. These pools may also include shares held by customers for whom the tax treatment of dividends is more desirable than the tax treatment of payments in lieu of dividends, but who have specifically authorized that the shares be included in a tax-indifferent-customer pool. After the broker has exhausted all the loanable shares in the tax-indifferent-customer pools, the broker must allocate the transferred shares to a single residual pool of all other loanable shares. If only a portion of the loanable shares held in any pool are transferred, the broker must allocate the transferred shares among customers in the pool using the random lottery method provided in section 1.6045-2(f)(2)(ii)(B) of the existing regulations. A broker may use some other allocation method only with the consent of the Service. See Rev. Proc. 2003-1, 2003-1 I.R.B. 1, for the procedures to request a letter ruling. The Service invites comments on this hierarchical method as well as other methods of allocating transferred shares (giving rise to payments in lieu of dividends) among customers holding loanable shares. The amendments are expected to allow brokers to use the allocation method described in this Section 6 for dividends received after January 1, 2003. The provisions applicable to foreign persons receiving substitute dividends payments continue to apply (e.g., character rules under section 1.871-7(b)(2)).

SECTION 7. EFFECTIVE DATE

This Notice is effective September 16, 2003.

SECTION 8. COMMENTS

The Service invites interested persons to comment on the issues raised in this notice. Interested persons should send comments to:

CC:PA:LPD:PR (NOT-139295-03)
Room 5203
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20224

Alternatively, comments may be hand delivered between the hours of 8:00 a.m. and 5:00 p.m. to:

CC:PA:LPD:PR (NOT-139295-03)
Courier's Desk
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20224

Comments may also be transmitted electronically via the following e-mail address: *Notice.Comments@irs.coun.sel.treas.gov*. Please include "Notice 2003-67" in the subject line of any electronic communications.

SECTION 9. PAPERWORK REDUCTION ACT

The collection of information contained in this notice has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1858.

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 OMB control number.

The recordkeeping requirement in this notice is in Section 6. This information is required for brokers to use the rules for determining loanable shares and to use the rules for allocating transferred shares to loanable shares. The collection of information is voluntary to obtain a benefit. The likely respondents are businesses or other for profit institutions.

The estimated total annual recordkeeping burden is 60,000 hours.

The estimated annual burden per recordkeeper varies from 50 hours to 150 hours, depending on individual circumstances, with an estimated average of 100 hours.

The estimated number of recordkeepers is 600.

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

**SECTION 10. CONTACT
INFORMATION**

The principal author of this notice is
Michael Hara of the Office of Associate

Chief Counsel (Procedure and Administra-
tion), Administrative Provisions and Judi-
cial Practice Division. Mr. Hara may be

contacted at (202) 622-4910 (not a toll-
free number).

Part IV. Items of General Interest

Notice of Proposed Rulemaking

Suspension of Running of Period of Limitations During a Proceeding to Enforce or Quash a Designated or Related Summons

REG-208199-91

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations regarding the use of designated summonses and related summonses and the effect on the period of limitations on assessment when a case is brought with respect to a designated or related summons. These proposed regulations reflect changes to section 6503 of the Internal Revenue Code of 1986 made by the Omnibus Budget Reconciliation Act of 1990 and the Small Business Job Protection Act of 1996. This regulation affects corporate taxpayers that are examined under the coordinated issue case (CIC) program and are served with designated or related summonses. This regulation also affects third parties that are served with designated or related summonses for information pertaining to the corporate examination.

DATES: Written or electronic comments and requests for a public hearing must be received by November 29, 2003.

ADDRESSES: Send submissions to: CC:PA:RU (REG-208199-91), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 4 p.m. to: CC:PA:RU (REG-208199-91), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Taxpayers may also submit electronic comments directly to the IRS Internet site at www.irs.gov/regs.

FOR FURTHER INFORMATION CONTACT: Elizabeth Rawlins, (202) 622-3630 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed regulations amending the Procedure and Administration Regulations (26 CFR part 301) under section 6503 of the Internal Revenue Code of 1986. Section 11311 of the Omnibus Budget Reconciliation Act of 1990 (Public Law 101-508, 104 Stat. 1388) (1990 Act) amended section 6503(k) to suspend the period of limitations on assessment when a case is brought with respect to a designated or related summons. Section 6503(k) was redesignated as section 6503(j) by section 1702(h)(17)(A) of the Small Business Job Protection Act of 1996 (Public Law 104-188, 110 Stat. 1874).

Explanation of Provisions

These proposed regulations generally provide that the period of limitations on assessment provided for in section 6501 is suspended with respect to any return of tax by a corporation that is the subject of a designated or related summons if a court proceeding to enforce or quash is instituted with respect to that summons.

Designated Summonses and Related Summonses

A designated summons is a summons issued to determine the amount of any internal revenue tax of a corporation for which a return was filed if certain additional requirements are satisfied. A designated summons may only be issued to a corporation (or any other person to whom such corporation has transferred records) if the corporation is being examined under the IRS' coordinated examination program "or any successor program." The existing successor program to the coordinated examination program is the coordinated issue case (CIC) program.

Section 6503(j)(2)(A)(i) requires that the issuance of the summons be preceded by a review by the regional counsel of the Office of Chief Counsel for the region in which the examination of the corporation is being conducted. Because the prior regional structure of the IRS no longer exists, these proposed regulations provide that the

review must be completed by the Division Commissioner and the Division Counsel of the Office of Chief Counsel for the organizations that have jurisdiction over the corporation whose liability is the subject of the summons. The summons also must be issued at least 60 days before the day on which the statute of limitations on assessment under section 6501 would otherwise expire. Finally, the summons must clearly state that it is a designated summons for purposes of section 6503(j).

A related summons is any other summons that is issued with respect to the same tax return of the corporation as a designated summons and is issued during the 30-day period that begins on the date the designated summons is issued.

Suspension of Period of Limitations on Assessment

Section 6503(j)(1) suspends the period of limitations on assessment under section 6501 for the applicable tax period when a court proceeding is brought with respect to a designated or related summons. For purposes of these proposed regulations, a court proceeding is a proceeding brought in a United States district court either to quash a designated or related summons under section 7609(b)(2) or to enforce a designated or related summons under section 7604. The court proceeding must be brought within the otherwise applicable period of limitations in order to suspend that period under section 6503(j).

The proposed regulations provide that the suspension begins on the day that a court proceeding is brought and continues until there is a final resolution as to the summoned party's response to the summons (discussed in the next section), plus an additional 120 days if the court requires any compliance with the summons at issue. If the court does not require any compliance, then the period of limitations on assessment resumes running on the day following the date of the final resolution and in no event shall expire before the 60th day following the date of final resolution.

Final Resolution of a Summoned Party's Response to a Summons

Under section 6503(j)(3)(B), the length of the suspension under section 6503(j)

depends on when “final resolution” of a summoned party’s response to the designated or related summons occurs. The term “final resolution” is not defined in the statute. The legislative history to the 1990 Act states that the term “final resolution” has the same meaning it has under section 7609(e)(2)(B), relating to third-party summonses. H.R. Conf. Rep. No. 101–964 (1990). Specifically, the conference report to the 1990 Act states that final resolution means that no court proceeding remains pending and that the summoned party has complied with the summons to the extent required by the court.

Accordingly, the proposed regulations provide that final resolution occurs when the summoned party complies with a summons to the extent required by the court and all court proceedings and times for appeals applicable to those proceedings have terminated. If the summoned party has complied with the summons to the extent required by a court but there still remains time to appeal that order, final resolution occurs when the time for appeal has expired. (Were final resolution deemed to occur before that point, the period of limitations on assessment might resume running even though a later order after appeal might require additional compliance.) If all appeal periods have expired but the summoned party has not complied with the summons to the extent required by the court order, the proposed regulations provide that final resolution does not occur until the summoned party has complied with the summons to the extent required by the court order.

Whether a party has complied with the terms of the summons as enforced by the court cannot be determined until the completeness of the materials produced and the testimony given have been evaluated. In cases where the court wholly denies enforcement or orders that the summons in its entirety be quashed, the date of compliance with the court’s order is treated as occurring on the date when all appeals are disposed of or when all appeal periods expire.

In cases where the court orders the summons enforced in whole or in part, the determination of whether the summoned party has complied with the order will be made by the Commissioner or his delegate (Commissioner). This determination

will be made as soon as practicable after the summoned party has given testimony or produced books, papers, records, or other data as required by the court order. Notification of a favorable determination, and the date of such determination, will be made in writing and sent to the summoned party (and the taxpayer if the taxpayer is not the summoned party) within five days after the date the determination is made. If the period to appeal the court’s order has already run, the date of the favorable determination shall be the date of final resolution for purposes of determining the length of the suspension under section 6503(j).

The proposed regulations provide that the Commissioner is not required to give notice that the court’s order has not been complied with prior to instituting a collateral proceeding challenging whether the testimony given or the production made by the summoned party fully satisfies the court order and requesting that sanctions be imposed against the summoned party for a failure to testify or produce. The proposed regulations further provide that if such a collateral proceeding is instituted, then the collateral proceeding shall be treated as a continuation of the original proceeding.

Statement of Compliance

A summoned party also may request a determination from the IRS that it has fully complied with a designated or related summons to the extent required by court order. Under this procedure, if the summoned party believes that it has complied, the summoned party may submit a written statement (statement of compliance) to the IRS that the summoned party has fully complied with the court order. The statement of compliance must be properly addressed and sent by registered or certified mail. The statement of compliance must contain the summoned party’s current contact information and information specifically identifying the applicable summons and court order.

To prevent the filing of premature or repetitious statements of compliance, the proposed regulations provide that a statement of compliance will be disregarded as a nullity if it is submitted before production or the giving of testimony (or the last act of production when there is a mutual

agreement that production will be accomplished in stages) or before the IRS has responded to a previously-submitted statement of compliance. A statement of compliance also will be treated as a nullity if it is submitted by the summoned party while a referral to the Department of Justice for a collateral proceeding with respect to the court order or an appeal of the court order is pending.

Unless the IRS, within 180 days of the receipt of a statement of compliance, or within the time agreed to by the IRS and the summoned party, mails to the summoned party by registered or certified mail notification that it has not fully satisfied the designated or related summons, the summons will be treated as having been fully complied with as of the 180th day following the date the IRS received the statement. The date on which the statement of compliance was mailed by registered or certified mail will be treated as the date on which the IRS received the statement.

Other Rules

These proposed regulations provide additional rules regarding the number of designated and related summonses that may be issued with respect to a return for any taxable period, the time within which a court proceeding must be brought to enforce or quash a designated or related summons, the computation of the suspension period in cases of multiple court proceedings, and the computation of the 60-day period for assessment when the last day falls on a weekend or holiday.

The proposed regulations also address the relationship of the suspension period provided for in section 6503(j) with other suspension provisions in the Code. The proposed regulations first provide that if a designated or related summons also could be subject to the suspension rules governing third-party summonses under section 7609(e), then the suspension rules in section 6503(j) govern. In addition, the section 6503(j) suspension period is independent of, and may run concurrently with, any other period of suspension, such as the suspension period for third-party summonses under section 7609(e) if a separate third-party summons also was issued in a case. Examples of these rules are contained in the proposed regulations.

Proposed Effective Date

These regulations are proposed to be applicable on the date final regulations are published in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It 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 Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and the Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying. A public hearing may be scheduled if requested in writing by a person who 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 regulations is Elizabeth Rawlins of the Office of the Associate Chief Counsel, Procedure and Administration (Collection, Bankruptcy and Summonses Division), IRS. However, other personnel from the IRS and the Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 301 is proposed to be amended as follows:

PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 continues to read in part as follows:

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

Par. 2. Section 301.6503(j)–1 is added to read as follows:

§301.6503(j)–1 Suspension of running of period of limitations; extension in case of designated and related summonses.

(a) *General rule.* The running of the applicable period of limitations on assessment provided for in section 6501 is suspended with respect to any return of tax by a corporation that is the subject of a designated or related summons if a court proceeding is instituted with respect to that summons.

(b) *Period of suspension.* The period of suspension is the time during which the running of the applicable period of limitations on assessment provided for in section 6501 is suspended under section 6503(j). If the court requires any compliance with a designated or related summons by ordering that any record, document, paper, object, or items be produced, or the testimony of any person be given, the period of suspension consists of the judicial enforcement period plus 120 days. If the court does not require any compliance with a designated or related summons, the period of suspension consists of the judicial enforcement period, and the period of limitations on assessment provided in section 6501 shall not expire before the 60th day after the judicial enforcement period.

(c) *Definitions*—(1) *Designated summons.* A designated summons is a summons issued to a corporation (or to any other person to whom the corporation has transferred records) with respect to any return of tax by such corporation for a taxable period for which such corporation is being examined under the coordinated industry case program or any other successor to the coordinated examination program—

(i) If the Division Commissioner and the Division Counsel of the Office of Chief

Counsel (or their successors) for the organizations that have jurisdiction over the corporation whose tax liability is the subject of the summons have reviewed the summons before it is issued;

(ii) If the IRS issues the summons at least 60 days before the day the period prescribed in section 6501 for the assessment of tax expires (determined with regard to extensions); and

(iii) If the summons states that it is a designated summons for purposes of section 6503(j).

(2) *Related summons.* A related summons is any summons issued that—

(i) Relates to the same return of the corporation under examination as the designated summons; and

(ii) Is issued to any person, including the person to whom the designated summons was issued, during the 30-day period that begins on the day the designated summons is issued.

(3) *Judicial enforcement period.* The judicial enforcement period is the period that begins on the day on which a court proceeding is instituted with respect to a designated or related summons and ends on the day on which there is a final resolution as to the summoned person's response to that summons.

(4) *Court proceeding*—(i) *In general.* For purposes of this section, a court proceeding is a proceeding filed in a United States district court either to quash a designated or related summons under section 7609(b)(2) or to enforce a designated or related summons under section 7604 and includes any collateral proceeding to that proceeding such as a civil contempt proceeding.

(ii) *Date when proceeding is no longer pending.* A proceeding to quash or to enforce a designated or related summons is no longer pending when all appeals are resolved, or after the expiration of the period in which an appeal may be taken or a request for further review may be made. If, however, following an enforcement order, a collateral proceeding is brought challenging whether the testimony given or production made by the summoned party fully satisfied the court order and whether sanctions should be imposed against the summoned party for a failure to so testify or produce, the proceeding to quash or to enforce the summons shall include the time from which the proceeding to quash

or to enforce the summons was brought until the decision in the collateral proceeding becomes final. The decision becomes final on the date when all appeals are disposed of or when the period in which an appeal may be taken or a request for further review may be made expires. Any collateral proceeding to the original proceeding shall be considered to be a continuation of the original proceeding.

(5) *Compliance*—(i) *In general*. Compliance is the giving of testimony or the performance of an act or acts of production, or both, in response to a court order concerning the designated or related summons and the determination that the terms of the court order have been satisfied.

(ii) *Date compliance occurs*. Compliance with a court order that wholly denies enforcement of a designated or related summons is deemed to occur on the date when all appeals are disposed of or when the period in which an appeal may be taken or a request for further review may be made expires. Compliance with a court order that grants enforcement, in whole or in part, of a designated or related summons, occurs on the date the Commissioner or his delegate (Commissioner) determines that the testimony given, or the books, papers, records, or other data produced, or both, by the summoned party fully satisfy the court order concerning the summons. The determination whether there has been compliance will be made as soon as practicable after the testimony is given or the materials are produced.

(6) *Final resolution*. Final resolution means that compliance with a court order concerning the designated or related summons has occurred and that court proceedings are no longer pending.

(d) *Special rules*—(1) *Number of summonses that may be issued*—(i) *Designated summonses*. Only one designated summons may be issued in connection with the examination of a specific taxable year or other period of a corporation. A designated summons may cover more than one year or other period of a corporation. The designated summons may seek information that was previously sought in a summons (other than a designated summons) that was issued in the course of the examination of that particular corporation.

(ii) *Related summonses*. There is no restriction on the number of related summonses that may be issued in connection

with the examination of a corporation. As provided in paragraph (c)(2) of this section, however, a related summons must be issued within the 30-day period that begins on the date on which the designated summons to which it relates is issued and must relate to the same return as the designated summons. A related summons may request the same information as the designated summons.

(2) *Time within which court proceedings must be brought*. In order for the period of limitations on assessment to be suspended under section 6503(j), a court proceeding to enforce or to quash a designated or related summons must be instituted within the period of limitations on assessment provided in section 6501 otherwise applicable to that tax return.

(3) *Computation of suspension period if multiple court proceedings are instituted*. If multiple court proceedings are instituted to enforce or to quash a designated or one or more related summonses concerning the same tax return, the period of limitations on assessment is suspended for the entire period beginning on the day the first court proceeding is brought and ending on the last day of the last-ending suspension period resulting from the court proceedings that were brought.

(4) *Effect on other suspension periods*—(i) *In general*. The periods of suspension on the running of the period of limitations under section 6501 provided for under sections 7609(e)(1) and (2) are not applicable with respect to any summons that is issued pursuant to section 6503(j). The suspension under section 6503(j) on the running of the period of limitations on assessment under section 6501 is independent of, and may run concurrent with, any other period of suspension of the period of limitations on assessment applicable to the tax return to which the designated or related summons relates.

(ii) *Examples*. The rules of paragraph (d)(4)(i) of this section are illustrated by the following examples:

Example 1. The period of limitations on assessment against Corporation P for its calendar 1997 return is scheduled to end on March 15, 2001. On January 3, 2001, a designated summons is issued to Corporation P concerning its 1997 return. On March 1, 2001 (14 days before the period of limitations on assessment would otherwise expire with respect to Corporation P's 1997 tax return), a court proceeding is brought to enforce the designated summons issued

to Corporation P. On June 5, 2001, the court orders Corporation P to comply with the designated summons. Corporation P does not appeal the court's order. On September 3, 2001, agents for Corporation P deliver material that they state are the records requested by the designated summons. On October 15, 2001, a final resolution to Corporation P's response to the designated summons occurs when the Commissioner determines that Corporation P has fully complied with the court's order. The suspension period applicable with respect to the designated summons issued to Corporation P consists of the judicial enforcement period (March 1, 2001, through October 15, 2001) and an additional 120-day period under section 6503(j)(1)(B), because the court required Corporation P to comply with the designated summons. Thus, the suspension period applicable with respect to the designated summons issued to Corporation P would begin on March 1, 2001, and end on February 12, 2002. Under the facts of this example, the period of limitations on assessment against Corporation P would be extended to February 26, 2002, to account for the additional 14 days that remained on the period of limitations on assessment under section 6501 when the suspension period under section 6503(j) began.

Example 2. Assume the same facts set forth in *Example 1*. On April 3, 2001, a summons concerning Corporation P's calendar 1997 return is issued and served on individual A, a third party. This summons is not a related summons because it was not issued during the 30-day period that began on the date the designated summons was issued. The third-party summons served on individual A is subject to the notice requirements of section 7609(a). If there is no final resolution of individual A's response to this summons by October 3, 2001, i.e., six months from the date of service of the summons, the period of limitations on assessment against Corporation P would be suspended under section 7609(e)(2) to the date on which there is a final resolution to that response for the purposes of section 7609(e)(2). If a final resolution to the summons served on individual A occurs after February 12, 2002, the end of the suspension period for the designated summons, the period of limitations on assessment against Corporation P expires 14 days after the date that the final resolution as provided for in section 7609(e)(2) occurs with respect to the summons served on individual A.

(5) *Computation of 60-day period when last day of assessment period falls on a weekend or holiday*. For purposes of paragraph (c)(1)(ii) of this section, in determining whether a designated summons has been issued at least 60 days before the date on which the period of limitations on assessment prescribed in section 6501 expires, the provisions of section 7503 apply when the last day of the assessment period falls on a Saturday, Sunday, or legal holiday.

(6) *Determination of compliance with designated and related summonses if a court proceeding has been instituted*—(i) *In general*. The Commissioner will determine, in an expeditious manner, whether

a summoned party has fully complied with any court order if the designated or related summons is the subject of a court proceeding to quash or to enforce. The determination will be made as soon as practicable after the later of—

(A) The giving of any testimony required to be given by a summoned party; or

(B) The act of production (or the last act of production in the case of production that is accomplished in parts or in stages pursuant to a mutual agreement between the summoned party and the Commissioner) by the summoned party.

(ii) *Procedure for a favorable determination.* If the Commissioner determines that the summoned party has fully complied with the court order, the Commissioner will mail notice of that determination within 5 business days after the date of the determination, which will be sent by certified or registered mail, to the summoned party and the taxpayer under examination (if the taxpayer is not the summoned party).

(iii) *Notification of favorable determination.* The written notification that the summoned party has fully complied with the court order will contain the following information—

(A) The name and address of the summoned party;

(B) The name, address, type of tax, and taxable period of the taxpayer corporation with respect to which testimony or records, or both, were sought by the summons; and

(C) The date on which the Commissioner made the determination that the summoned party fully complied with court order.

(iv) *Effective date of favorable determination.* The Commissioner's determination that the summoned party has fully complied with the court order will be effective on the date the determination is stated to have been made in the written notification sent to the summoned party.

(7) *Statement of compliance with a court order—(i) In general.* In the case of a court order to which paragraph (d)(6)(i) of this section applies, the summoned party may submit a statement in writing that the summoned party has fully complied with the court order to the office identified on the summons (marked for the attention of the Internal Revenue Service

employee who issued the summons to which the order relates).

(ii) *Form.* The statement of compliance shall be sent by registered or certified mail and shall include—

(A) The name, current address, current home and work telephone numbers of the person making the statement and any convenient times that person can be contacted;

(B) A specific identification of the court order with which compliance has been achieved and the summons to which the order relates; and

(C) The signature of the summoned party or the duly authorized representative.

(iii) *Response.* (A) As soon as practicable after receipt of such a statement of compliance, but in no event later than 180 days after such receipt, the Commissioner will mail a response to the summoned party (and a copy of the response to the taxpayer, if the summoned party is not the taxpayer) by registered or certified mail. The date on which the summoned person mails the statement of compliance shall be deemed to be the date on which the Commissioner receives it. The Commissioner's response will notify the summoned party—

(1) That a determination of compliance with the court order has been made and the date of that determination; or

(2) That a determination of noncompliance has been made and the date of that determination.

(B) The Commissioner is not required to give notice that the court order has not been complied with prior to instituting a collateral proceeding challenging whether the testimony given or the production made by the summoned party fully satisfies the court order and requesting that sanctions be imposed against the summoned party for a failure to comply with the order. The institution of a collateral proceeding shall constitute notice of a determination of noncompliance.

(C) The summoned party may, in writing, grant the Commissioner additional time within which to notify it regarding compliance or noncompliance with the summons.

(iv) *Failure to respond within 180 days.* If the Commissioner fails to respond to a properly submitted statement of compliance within the 180-day period, described

in paragraph (d)(7)(iii)(A) of this section, or such longer period as agreed to in writing by the summoned party, then the court order with respect to which the summoned party submitted a statement of compliance shall be deemed complied with as of the expiration of 180 days or such longer period.

(v) *Limitations.* The Commissioner may treat as a nullity and return to the summoned party without action, as described in paragraph (d)(7)(iii) of this section, a statement of compliance that is filed in the following circumstances—

(A) Before the summoned party has provided testimony, or books, papers, records, or other data, or both in response to the court order (or before the last act of production in the case of production that is accomplished in stages pursuant to a mutual agreement);

(B) Before the Commissioner has issued a determination pursuant to paragraph (d)(7)(iii) of this section with respect to a previously-tendered statement of compliance or before the expiration of 180 days from the date such statement of compliance was received by the Commissioner, whichever is earlier; or

(C) While a referral to the Department of Justice for a collateral proceeding with respect to the court order or an appeal of that order is pending.

(e) *Effective date.* This section is applicable on the date final regulations are published in the **Federal Register**.

Robert E. Wenzel,
Deputy Commissioner of
Internal Revenue.

(Filed by the Office of the Federal Register on July 30, 2003, 8:45 a.m., and published in the issue of the Federal Register for July 31, 2003, 68 F.R. 44905)

Notice of Proposed Rulemaking by Cross-Reference to Temporary Regulations

Reduction of Tax Attributes Due to Discharge of Indebtedness

REG-113112-03

AGENCY: Internal Revenue Service
(IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: In this issue of the Bulletin, the IRS is issuing temporary regulations (T.D. 9080) relating to the reduction of tax attributes under sections 108 and 1017 of the Internal Revenue Code. The temporary regulations affect taxpayers that exclude discharge of indebtedness income from gross income under section 108. The text of those regulations also serves as the text of these proposed regulations.

DATES: Written or electronic comments must be received by October 16, 2003.

ADDRESSES: Send submissions to: CC:PA:RU (REG-113112-03), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 4 p.m. to CC:PA:RU (REG-113112-03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC or sent electronically, via the IRS Internet site at: www.irs.gov/reg.

FOR FURTHER INFORMATION CONTACT: Theresa M. Kolish (202-622-7930) of the Office of the Associate Chief Counsel (Corporate) (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

Temporary regulations in this issue of the Bulletin amend the Income Tax Regulations (26 CFR part 1) relating to sections 108 and 1017. The temporary regulations will affect taxpayers that exclude discharge of indebtedness income from gross income under section 108. The text of those temporary regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the amendments.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has

also been determined that section 553(b) of the Administrative Procedures Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and 8 copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

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

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Section 1.108-7 also issued under 26 U.S.C. 108. * * *

Par. 2. Section 1.108-7 is added to read as follows:

§1.108-7 Reduction of attributes.

[The text of the proposed §1.108-7 is the same as the text for §1.108-7T published elsewhere in this issue of the Bulletin].

Par. 3. Section 1.1017-1 is amended by adding paragraph (b)(4) to read as follows:

§1.1017-1 Basis reductions following a discharge of indebtedness.

* * * * *

(b) * * *

(4) [The text of the proposed §1.1017-1(b)(4) is the same as the text for §1.1017-1T(b)(4) published elsewhere in this issue of the Bulletin].

* * * * *

Robert E. Wenzel,
*Deputy Commissioner for
Services and Enforcement.*

(Filed by the Office of the Federal Register on July 17, 2003, 8:45 a.m., and published in the issue of the Federal Register for July 18, 2003, 68 F.R. 42652)

List of Nonbank Trustees and Custodians

Announcement 2003-54

The following is a list of entities that have been approved by the Commissioner of the Internal Revenue Service, pursuant to § 1.408-2(e) of the Income Tax Regulations, to serve as a nonbank trustee or custodian. This list updates and supercedes the list published with Announcement 2002-12, 2002-1 C.B. 553.

Archer medical savings accounts (Archer MSAs) established under § 220 of the Internal Revenue Code, custodial accounts of a pension plan qualified under § 401, custodial accounts described in § 403(b)(7), trust or custodial accounts of individual retirement accounts (IRAs) established under §§ 408(a), 408A (Roth IRAs), or 530 (Coverdell Education Savings Accounts), and custodial accounts of eligible deferred compensation plans described in § 457(b) will not be tax exempt if the trustee or custodian of such accounts is not a bank (as defined in § 408(n)) (and in the case of Archer MSAs a bank within

the meaning of § 408(n) or an insurance company within the meaning of § 816) or an approved nonbank trustee or custodian.

An entity that is not a bank, as defined in § 408(n), must receive approval from the Service to serve as a nonbank trustee or nonbank custodian. A prospective nonbank trustee or custodian must file a written application with the Commissioner of Internal Revenue demonstrating that the requirements of § 1.408-2(e)(2) through § 1.408-2(e)(7) of the regulations will be met. If the application is approved, a written notice of approval will be issued to the applicant. The notice of approval will state the day on which it becomes effective, and (except as otherwise provided therein) will remain effective until revoked by the Service or withdrawn by the applicant. Entities that have received such approval from the Service may also sponsor certain retirement plans, custodial accounts under § 403(b)(7) of the Code and individual retirement arrangements established under § 408. (See Rev. Proc. 2000-20, 2000-1 C.B. 553, and Rev. Proc. 87-50, 1987-2 C.B. 647, as modified.)

A prospective nonbank trustee or custodian may not accept any fiduciary account before such notice of approval becomes effective. In addition, a nonbank trustee or custodian may not accept a fiduciary account until after the plan administrator or the person for whose benefit the account is to be established is furnished with a copy of the written notice of approval issued to the applicant.

The continued reliance on a notice of approval is dependent upon the continued

satisfaction of the nonbank trustee requirements set forth in the regulations. The notice of approval issued to an applicant will be revoked if the Commissioner determines that the applicant is unwilling or unable to administer fiduciary accounts in a manner consistent with the requirements of the regulations. Generally, the notice will not be revoked unless the Commissioner determines that the applicant has knowingly, willfully, or repeatedly failed to administer fiduciary accounts in a manner consistent with the requirements of the regulations, or has administered a fiduciary account in a grossly negligent manner.

The written notice of approval to serve as a nonbank trustee or nonbank custodian is not an endorsement of any investment made with respect to any retirement plan or arrangement handled by the approved nonbank trustee or custodian. The Internal Revenue Service does not review or approve investments.

If the trustee or custodian of an account described above is not a bank or an approved nonbank trustee or nonbank custodian, the amounts held in such account (including earned interest) will be deemed distributed and includible in gross income in the year(s) the account's trustee or custodian was not a bank or an approved nonbank trustee or nonbank custodian. Contributions made to such account are not deductible from gross income and will be disallowed if claimed on an income tax return.

This list of approved nonbank trustees and nonbank custodians includes their

names, addresses, and the date each application was approved.

If an approved nonbank trustee or custodian believes that the information about it is incorrect, incomplete, or that it has been incorrectly omitted from this list, it may, on or before December 5, 2003, which is 60 days from the date of the publication of this list in the Internal Revenue Bulletin, notify the Service in writing of any changes it proposes to the list. This notification should include a copy of the approval letter.

The notification should be addressed to:

Internal Revenue Service
SE:T:EP:RA:T1
Announcement 2003-54
1111 Constitution Ave., NW
Washington, DC 20224

Drafting Information

The principal author of this announcement is Calvin Thompson of the Employee Plans, Tax Exempt and Government Entities Division. Please contact Mr. Thompson at 1-202-283-9596 (not a toll-free number), if there are any questions regarding the publication of this list. Written inquiries concerning this announcement should be addressed to the Internal Revenue Service at the above address.

APPROVED Nonbank Trustees/Custodians as of December 31, 2002

Name	Address	Approval Date
1. A.B. Culbertson & Co.	1250 Continental Plaza Fort Worth, TX 76102	May 15, 1984
2. A.G. Becker & Co.	Chicago, IL	December 12, 1979
3. A.G. Edwards & Sons, Inc.	One North Jefferson St. Louis, MO 63103	November 26, 1980
4. ABN AMRO Securities LLC	55 East 52nd Street New York, NY 10022	September 7, 2000
5. Adler, Coleman Clearing Corp.	20 Broad St. New York, NY 10005	April 7, 1987
6. Advanced Clearing, Inc.	4211 South 102nd Street Omaha, NE 68127-1031	April 18, 1984
7. Advest, Inc.	280 Trumbull Street Hartford, CT 06103	January 24, 1989
8. Aisel & Co.	20 Broad Street New York, NY 10005	April 26, 1991
9. American Brokerage Services, Inc.	131 Lafayette Ave. Detroit, MI 48226	September 18, 1991
10. American Capital Marketing, Inc. (FKA American General Capital)	2777 Allen Parkway Houston, TX 77215	June 25, 1984
11. American Express Financial Corp.	IDS Tower 10 Minneapolis, MN 55440	August 12, 1977
12. American Heritage Life Ins. Co.	76 South Laura Street Jacksonville, FL 32202	December 11, 1984
13. American Transtech, Inc.	8000 Baymeadows Way Jacksonville, FL 32256	August 15, 1990
14. Analytic Investment Management, Inc.	2222 Martin Street, Suite 230 Irvine, CA 92715-1454	May 9, 1989
15. Aspen Partnership	1895 Claremont Road Hoffman Estates, IL 60195	October 25, 1990
16. B.C. Ziegler & Co.	215 North Main Street West Bend, WI 53095	September 27, 1985
17. Banc One Capital Corporation	P.O. Box 18277 90 North High Street Columbus, OH 43218	February 24, 1992
18. Bank Hapoulim B.M.	6501 Wilshire Blvd. Los Angeles, CA 90048	May 15, 1986
19. Bank Julius Baer & Co., LTD	330 Madison Avenue New York, NY 10017	December 15, 1988
20. Bank Leumi Le - Israel B.N. Western Hemisphere Regional Mgt.	242 Fifth Avenue New York, NY 10022	February 10, 1982
21. Bartlett & Co.	36 East Fourth Street Cincinnati, OH 45202	February 1, 1989
22. Bear, Stearns & Co., Inc.	5 Hanover Square New York, NY 10004	June 2, 1986

APPROVED Nonbank Trustees/Custodians as of December 31, 2002

Name	Address	Approval Date
23. Bear, Sterns, Securities Corp.	2 Broadway, 12th Floor New York, NY 10004	June 24, 1991
24. Berklee College of Music, Inc.	1140 Boylston Street Boston, MA 02110	May 9, 1989
25. Blunt Ellis & Loewi, Inc.	225 East Mason Street Milwaukee, WI 53202	January 25, 1982
26. BNY Clearing Services, LLC (FKA Kemper Clearing)	111 East Kilbourn Milwaukee, WI 53202	August 21, 1989
27. Boettcher & Company, Inc.	828 Seventeenth Street Denver, CO 80201	August 10, 1987
28. Brown & Company Securities Corporation	20 Winthrop Square Boston, MA 02110	February 27, 1985
29. Bruns, Nordeman, Rea & Co.	New York, NY	October 31, 1977
30. Burke, Christensen & Lewis Securities, Inc.	120 S. La Salle Street, Suite 940 Chicago, IL 60603	March 11, 1986
31. Burton J. Vincent, Chesley & Co.	105 West Adams St. Chicago, IL 60603	March 25, 1982
32. Butler Wick & Co., Inc.	City Center One Bldg. Youngstown, OH 44501	October 8, 1992
33. BUYandHold Securities Corporation	110 Wall Street New York, NY 10005	October 5, 2000
34. Carolina Securities Corp.	239 Fayetteville St. Raleigh, NC 27602	August 29, 1983
35. Chapin, Davis & Company, Inc.	3 Village Square, Cross Keys Baltimore, MD 21210	December 7, 1983
36. Charles Schwab & Co., Inc.	101 Montgomery Street San Francisco, CA 94104	January 8, 1982
37. Christian & Missionary Alliance	P.O. Box C Nyack, NY 10960	August 15, 1985
38. CIBC World Markets Corporation	200 Liberty Street New York, NY 10281	July 26, 1977
39. City Securities Corp.	135 North Pennsylvania Street Indianapolis, IN 46204	December 21, 1982
40. Commerce First Thrift	Midvale, UT 84047	May 25, 1978
41. Comprehensive Investment, Inc.	One Moody Plaza Galveston, TX 77550	June 16, 2000
42. Continental Trust Co.	17110 Dallas Parkway, Suite 200 Dallas, TX 75248	February 22, 1977
43. D. A. Davidson & Co.	Davidson Building #8 Third Street North Great Falls, MT 59403	June 11, 1982
44. D.J. St. Germain, Inc.	1500 Main Street Springfield, MA 01115	January 1, 1977

APPROVED Nonbank Trustees/Custodians as of December 31, 2002

Name	Address	Approval Date
45. Davenport & Co. of Virginia, Inc.	901 E. Cary Street Richmond, VA 23219	February 2, 1987
46. Davenport & Company LLC	901 East Cary Street Richmond, VA 23219	March 31, 1997
47. Deutsche Bank Securities Corp. d.b.a. C.J. Lawrence Deutsche	1290 Avenue of the Americas New York, NY 10104	March 14, 1980
48. Deutsche Bank Securities, Inc.	1 South Street Baltimore, MD 21203	April 11, 1994
49. Donaldson, Lufkin & Jenrette Securities Corp.	140 Broadway New York, NY 10005	December 4, 1985
50. Dougherty, Dawkins, Strand & Yost, Inc.	100 South Fifth Street, Suite 2300 Minneapolis, MN 55402	February 22, 1986
51. Dresdner Kleinwort Wasserstein Securities LLC	75 Wall Street New York, NY 10005	October 9, 2002
52. Dreyfus Investment Services, Corp.	Two Mellon Bank Center Pittsburgh, PA 15259	May 18, 1989
53. Duncan-Williams, Inc.	5860 Ridgeway Center Parkway Memphis, TN 38120	December 13, 1995
54. E*Trade Clearing LLC	10951 White Rock Road Rancho Cardova, CA 95670	September 3, 2002
55. E*Trade Securities LLC	4500 Bohannon Drive Menlo Park, CA 94025	August 30, 2002
56. E*Trade Securities, Inc.	480 California Avenue Palo Alto, CA 94306	February 1, 1996
57. Eads Generoe Trust	St. Louis, MO	February 3, 1977
58. Edward D. Jones & Co.	201 Progress Parkway Maryland Height, MO 63043	May 30, 1985
59. El Paso Electric Co.	P.O. Box 982 El Paso, TX 79960	June 15, 1983
60. Elan Investment Services, Inc.	777 E. Wisconsin Ave. Milwaukee, WI 53282	December 21, 1987
61. Emmett A. Larkin Co., Inc.	100 Bush Street San Francisco, CA 94104	April 17, 1986
62. Eppler, Guerin & Turner, Inc.	2001 Bryan Tower, Suite 2300 Dallas, TX 75201	September 6, 1984
63. EVEREN Securities, Inc.	77 West Wacker Drive Chicago, IL 60601-1694	November 19, 1998
64. Fahnestock & Co., Inc. (formerly Edward A. Viner & Co.)	110 Wall Street New York, NY 10005	April 15, 1982
65. Fechtor, Detwiler & Co., Inc.	155 Federal Street Boston, MA 02110	March 26, 1982
66. Ferris, Baker Watts, Inc. (formerly Ferris & Company)	1720 Eye Street, NW Washington, DC 20006	December 4, 1987

APPROVED Nonbank Trustees/Custodians as of December 31, 2002

Name	Address	Approval Date
67. Financial Data Services, Inc.	400 Atrium Drive Somerset, NJ 08873	November 14, 1990
68. First Albany Corp.	41 State Street Albany, NY 12207	September 26, 1979
69. First Clearing Corporation	10700 Wheat First Dr. Glen Allen, VA 23060	April 21, 1999
70. First Illinois Capital Corp.	424 7th Street Plaza 7 Rockford, IL 61110	May 27, 1982
71. First Investors Corp.	120 Wall Street New York, NY 10005	April 19, 1982
72. First Manhattan Co.	437 Madison Avenue New York, NY 10022	January 26, 1990
73. First of Michigan Corporation	100 Renaissance Center, 26th Floor Detroit, MI 48243	August 31, 1994
74. Fiserv Securities, Inc.	One Commerce Square 2005 Market Street Philadelphia, PA 19103	November 15, 1984
75. Fleet Clearing Corporation	67 Wall Street New York, NY 10005	December 3, 1986
76. Fleet Norstar Securities, Inc.	14 Wall Street New York, NY 10005	August 30, 1991
77. Folger, Nolan, Fleming & Douglass	725 15th Street, N.W. Washington, DC 20015	September 16, 1981
78. Freedom Capital Management Corporation	One Beacon Street Boston, MA 02108	August 29, 1991
79. Freeman Welwood & Co., Inc.	1501 Fourth Avenue, Suite 1700 Seattle, WA 98101	February 13, 1996
80. G.T. Global Investors Services, Inc.	50 California Street San Francisco, CA 94111	May 27, 1994
81. General Conference of the Mennonite Brethren Churches, Board of Trustees	315 South Lincoln Hillsboro, KS 67063	March 8, 1983
82. Goldman, Sachs & Co.	85 Broad Street New York, NY 10004	December 8, 1982
83. Greek Catholic Union of the U.S.A.	5400 Tuscarawas Rd. Beaver, PA 15009-9513	May 24, 2000
84. Gruntal & Co, Inc.	14 Wall Street New York, NY 10005	June 13, 1984
85. H&R Block Financial Advisors, Inc.	735 Griswold Street Detroit, MI 48226	December 8, 1983
86. H.G. Wellington & Co., Inc.	14 Wall Street New York, NY 10005	September 13, 1993
87. H.M. Payson & Co.	One Portland Square P.O. Box 31 Portland, ME 04112	August 20, 1987

APPROVED Nonbank Trustees/Custodians as of December 31, 2002

Name	Address	Approval Date
88. Halpert and Company, Inc.	284 Millburn Avenue Millburn, NJ 07041	April 17, 1996
89. Hamilton Investments, Inc. (formerly Illinois Company, Inc.)	30 North La Salle St. Chicago, IL 60602	August 6, 1982
90. Hampshire Funding, Inc.	One Granite Place P.O. Box 2005 Concord, NH 03301	May 26, 1988
91. Hanifen, Imhoff Clearing Corp.	1125 17th Street Denver, CO 80217	April 22, 1997
92. Hanifen, Imhoff, Inc.	1125 17th Street, Suite 1700 Denver, CO 80202	December 3, 1985
93. Harris Investor Services LLC	Harborside Financial Center 501 Plaza II Jersey City, NJ 07311	May 1, 2002
94. Hartford Life Insurance Co.	Hartford Plaza Hartford, CT 06106	March 3, 1982
95. Hazlett, Burt & Watson, Inc.	1300 Chapline Street Wheeling, WV 26003	April 11, 1995
96. Heartland Securities, Inc.	208 South LaSalle St. Chicago, IL 60604	March 6, 1984
97. Henry Scott, Inc.	Philadelphia, PA	March 23, 1982
98. Herzfeld & Stern, Inc.	30 Broad Street New York, NY 10004	December 12, 1984
99. Herzog, Heine, Geduld, Inc.	26 Broadway New York, NY 10004	February 11, 1982
100. Holt & Collins	188 Embarcadero, Suite 760 San Francisco, CA 94105	September 8, 1988
101. Home Life Financial Assurance Corporation	2400 West Bay Drive Largo, FL 33540	November 13, 1986
102. Howard, Weil, Labouisse, Friedrichs, Inc.	1100 Paydrus Street, Suite 900 New Orleans, LA 70163	December 28, 1987
103. Howe Barnes Investments, Inc.	135 S. LaSalle Street Chicago, IL 60603	July 6, 1994
104. Huntleigh Securities Corporation	222 South Central Ave. St. Louis, MO 63102	October 22, 1997
105. I.M. Simon & Co.	7730 Forsyth Blvd. Clayton, MO 63105	November 3, 1981
106. iClearing, LLC	100 Wood Avenue South Iselin, NJ 08830	February 7, 2001
107. Investment Advisers, Inc.	1100 Dain Tower Minneapolis, MN 55440	October 9, 1981
108. Isler, Colling & McAdams	Portland, OR	October 5, 1978

APPROVED Nonbank Trustees/Custodians as of December 31, 2002

Name	Address	Approval Date
109. J.C. Bradford & Co.	330 Commerce Street Nashville, TN 37201	February 28, 1982
110. J.J.B. Hilliard, W.L. Lyons, Inc.	Hilliard Lyons Center 501 South Fourth St. Louisville, KY 40202	February 11, 1992
111. Jacob Engle Foundation, Inc. (The)	P.O. Box 1136 Upland, CA 91786	March 25, 1983
112. Janney Montgomery Scott, Inc.	1801 Market Street Philadelphia, PA 19103	March 23, 1982
113. Jefferson Pilot Investor Services, Inc.	100 North Greene St. Greensboro, NC 27401	October 22, 1979
114. Jesup, Josephthal & Co., Inc.	One Whitehall Street New York, NY 10004	December 18, 1990
115. John Hancock Clearing Corporation	200 Liberty Street New York, NY 10281	March 21, 1991
116. John Hancock Mutual Life Insurance Company	John Hancock Place 200 Clarendon Boston, MA 02117	August 24, 1993
117. Juran & Moody, Inc.	Minnesota Mutual Life Center 400 N. Robert St. St. Paul, MN 55101	May 27, 1994
118. Kagin Numismatic Services, Ltd.	1000 Insurance Exchange Bldg. Des Moines, IA 50309	March 18, 1980
119. KH Funding Company	10801 Lockwood Drive, Suite 370 Silver Spring, MD 20901	February 13, 2002
120. Kirkpatrick, Pettis, Smith Polian, Inc.	1623 Farnam Street, Suite 700 Omaha, NE 68102	August 18, 1981
121. L.F. Rothchild, Unterberg, Towbin	55 Water Street New York, NY 10041	December 23, 1985
122. Legg Mason Wood Walker, Inc.	111 S. Calvert Street P.O. Box 1476 Baltimore, MD 21203	June 4, 1985
123. Lehman Brothers, Inc.	200 Vesey St. New York, NY 10285	December 20, 2000
124. Lester Sumrall Evangelistic Association, Inc.	530 East Ireland Road South Bend, IN 46614	September 2, 1988
125. Liberty Life Insurance Co.	P.O. Box 789 Greenville, SC 29602	September 3, 1982
126. Manley, Bennett, McDonald & Co.	St. Louis, MO	January 1, 1977
127. McDonald & Company Securities, Inc.	580 Walnut Street Cincinnati, OH 45202	December 15, 1983
128. MEGA Life and Health Insurance Company (The)	501 West Interstate 44 Service Road Oklahoma City, OK 73118	May 29, 1991
129. Menold, Crawford, Hippler & Co.	23930 Michigan Ave. Dearborn, MI 40126	December 9, 1988

APPROVED Nonbank Trustees/Custodians as of December 31, 2002

Name	Address	Approval Date
130. Merrill, Lynch, Pierce, Fenner & Smith, Inc.	One Liberty Plaza New York, NY 10006	August 3, 1987
131. Merrimack Valley Investment, Inc.	367 Kingsbury Ave. Haverhill, MA 01830	September 28, 1984
132. Mesirow Financial, Inc.	350 N. Clark Street Chicago, IL 60610	May 28, 1982
133. Metropolitan Life Insurance Co.	One Madison Avenue New York, NY 10010	January 28, 1987
134. Metropolitan Mortgage & Securities Corporation	W. 292 Sprague Ave. Spokane, WA 99204	November 10, 1976
135. Mid-Ohio Securities Corp.	Spitzer Park Plaza 511 Broad St. Elyria, OH 44035	January 28, 1983
136. Mid-States Enterprises, Inc.	Carroll, IA	December 30, 1976
137. Miller Johnson & Kuehn, Inc.	5500 Wayzata Blvd. Minneapolis, MN 55416	November 15, 2000
138. Milwaukee Company (The)	250 E. Wisconsin Ave. Milwaukee, WI 53202	September 15, 1986
139. MKI Securities Corp.	61 Broadway New York, NY 10006	April 17, 1985
140. Money Management Associates	4922 Fairmont Avenue Bethesda, MD 20814	May 26, 1987
141. Moore & Schley, Cameron & Co.	Two Broadway New York, NY 10004	November 15, 1977
142. Morgan Keegan & Company, Inc.	Morgan Keegan Tower Fifty Front Street Memphis, TN 38108	January 27, 1982
143. Morgan Stanley DW, Inc.	1585 Broadway New York, NY 10036	May 29, 1986
144. Mortgage Loan Services, Inc.	780 Lynnhaven Parkway, Suite 200 Virginia Beach, VA 23452	March 15, 1995
145. Moseley, Hallgarten, Estabrook & Weeden, Inc.	One New York Plaza New York, NY	December 10, 1985
146. Murphy Favre, Inc.	W. 601 Riverside, 9th Floor Spokane, WA 99201	August 2, 1976
147. Mutual Service Cooperative	Two Pine Tree Drive Arden Hills, MN 55112	June 6, 1996
148. Myriad Corporation	1400 50th Street West Des Moines, IA 50265	July 20, 1977
149. National Bank of Greece, S.A.	33 State Street Boston, MA 02109	February 4, 1988
150. National Covenant Properties	Chicago, IL	June 30, 1978
151. National Investor Services Corp.	44 Wall Street New York, NY 10005	March 18, 1996

APPROVED Nonbank Trustees/Custodians as of December 31, 2002

Name	Address	Approval Date
152. National Life Insurance Company	One National Life Drive Montpelier, VT 05604	January 1, 1998
153. National Securities Corporation	1001 Fourth Avenue, Suite 2200 Seattle, WA 98154	December 31, 1986
154. Nationwide Advisory Services, Inc. (Nationwide Financial Services, Inc)	One Nationwide Plaza Columbus, OH 43216	September 25, 1985
155. Nationwide Credit Union	One Nationwide Plaza Columbus, OH 43216	April 13, 1978
156. NBC Securities, Inc.	1927 First Ave., North Birmingham, AL 35203	July 16, 1996
157. Neuberger & Berman	522 Fifth Ave. New York, NY 10036	October 4, 1983
158. Newhard, Cook & Co.	300 North Broadway St. Louis, MO 63102	June 4, 1985
159. Oberweis Securities, Inc.	841 North Lake Street Aurora, IL 60506	February 11, 1985
160. PaineWebber, Incorporated	1285 Avenue of the Americas New York, NY 10019	May 12, 1989
161. Parker/Hunter, Inc.	600 Grant Street Pittsburgh, PA 15219	June 15, 1990
162. Partnership Services, Inc.	5520 LBJ Freeway, Suite 430 Dallas, TX 75240	March 31, 1993
163. Peninsular Securities Co.	Waters Building Grand Rapids, MI 49503	January 28, 1985
164. Perelman-Carley & Associates, Inc.	3000 Farnam Street Omaha, NE 68131	January 13, 1989
165. Perkins, Wolf, McDonnell & Company	53 West Jackson Blvd. Chicago, IL 60604	December 30, 1991
166. Pflueger & Baerwald, Inc.	220 Montgomery Street San Francisco, CA 94104	November 9, 1981
167. PFS Investments, Inc.	3120 Breckenridge Blvd. Duluth, GA 30199	September 28, 1995
168. Pioneer Financial Services, Inc.	4233 Roanoke Road Kansas City, MO 64111	January 25, 1985
169. Pioneer Investment Management	60 State Street Boston, MA 02109	February 21, 1986
170. Prescott, Ball & Turben, Inc.	1331 Euclid Ave. Cleveland, OH 44115	January 27, 1983
171. PrimeVest Financial Services, Inc.	400 First Street South St. Cloud, MN 56301-3600	December 8, 1993
172. Principal Life Insurance Company	711 High Street Des Moines, IA 50392-0001	July 27, 1988
173. Prudential Securities, Inc.	100 Gold Street New York, NY 10292	July 28, 1989

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Name	Address	Approval Date
174. R. Rowland & Co., Inc.	St. Louis, MO	March 29, 1984
175. R.G. Dickinson & Co.	200 Des Moines Building 405 6th Ave. Des Moines, IA 50309	July 20, 1983
176. R.J. Steichen & Company	Midwest Plaza, Suite 100 801 Nicolett Mall Minneapolis, MN 55402-2526	May 21, 1993
177. Raymond James & Associates, Inc.	880 Carrillon Parkway P.O. Box 12749 St. Petersburg, FL 33733-2749	April 26, 1982
178. Raymond James & Associates, Inc.	880 Carillon Parkway P.O. Box 12749 St. Petersburg, FL 33733-2749	March 8, 1982
179. RBC Dain Rauscher, Inc.	Dain Rauscher Plaza 60 South Sixth Street Minneapolis, MN 55402-4422	March 2, 1998
180. RBC Dain Rauscher, Inc.	Dain Rauscher Plaza 60 South Sixth Street Minneapolis, MN 55402-4422	January 22, 1982
181. Regan MacKenzie, Incorporated	999 Third Avenue, Suite 4300 Seattle, WA 98104	August 31, 1989
182. Regions Investment Company, Inc.	2011 Fourth Ave. North Birmingham, AL 35203	July 20, 2000
183. Reserve Management Company, Inc.	810 Seventh Avenue New York, NY 10019	October 18, 1989
184. Robert W. Baird & Co., Inc.	777 E. Wisconsin Ave. Milwaukee, WI 53202	July 31, 1986
185. Robinson-Humphrey Co., Inc (The)	2 Peachtree St., N.W. Atlanta, GA 30383	May 24, 1982
186. Romano Bros. & Co.	820 Davis Street Evanston, IL 60201	September 28, 1984
187. Rose & Company Investment, Inc.	141 W. Jackson Blvd. Chicago, IL 60604	April 14, 1982
188. Rotan Mosle, Inc.	1500 South Tower Pennzoil Place P.O. Box 3226 Houston, TX 77001	May 6, 1980
189. Rushmore Investment Brokers, Inc.	4922 Fairmont Avenue Bethesda, MD 20814	September 24, 1986
190. Salomon Smith Barney, Inc.	388 Greenwich St. New York, NY 10105	July 22, 1985
191. Sanford C. Bernstein & Co., Inc.	767 Fifth Avenue New York, NY 10153	November 13, 1986
192. Santa Ana City Employees Credit Union	800 W. Santa Ana Blvd. Santa Ana, CA 92701	March 25, 1982

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Name	Address	Approval Date
193. Saturna Capital Corporation	101 Prospect Street Bellingham, WA 98227-2838	March 28, 1991
194. SBC Trust Services, Inc.	2401 Cedar Springs Rd. Dallas, TX 75201-1407	April 10, 2001
195. SBCI Swiss Bank Corporation	Investment Banking, Inc. 222 Broadway, 4th Floor New York, NY 10038	February 11, 1992
196. SBM Financial Services, Inc.	8400 Normandale Lake Boulevard Suite 1150 Minneapolis, MN 55437	May 13, 1995
197. Scott & Stringfellow, Inc. (FKN Craige, Inc.)	823 E. Main Street Richmond, VA 23219	May 5, 1999
198. Scottsdale Securities, Inc.	12855 Flushing Meadow Drive St. Louis, MO 63131	October 9, 1996
199. Securities Management Research	Two Moody Plaza Galveston, TX 77550	June 22, 1978
200. Security Management Company (FKA Security Management)	700 SW Harrison St. Topeka, KS 66636-0001	August 14, 1996
201. SG Cowen Securities Corporation	1221 Avenue of the Americas New York, NY 10020	June 30, 1998
202. SMA Services, Inc.	35 Lakeshore Drive Birmingham, AL 35209	August 27, 1998
203. Smith, Moore & Co.	400 Locust Street St. Louis, MO 63102	January 18, 1983
204. Southwest Securities, Inc.	Renaissance Tower 1201 Elm Street Suite 4300 Dallas, TX 75270	December 9, 1992
205. Spear Rees & Co.	505 North Brand Blvd., Sixteenth Floor Glendale, CA 91203	January 13, 1988
206. Spear, Leeds & Kellog	120 Broadway New York, NY 10271	March 29, 1996
207. State Bond and Mortgage Company	8500 Normandale Lake Blvd., Minneapolis, MN 55437	December 21, 1990
208. State Employees Credit Union	801 Hillsborough Street P.O. Box 26807 Raleigh, NC 27611-6807	January 1, 1977
209. State Farm Investment Corporation	One State Farm Plaza Bloomington, IL 61410	September 22, 1999
210. Stephens, Inc.	111 Center Street Little Rock, AR 72201	December 4, 1987
211. Stern Brothers & Co	1100 Main Street, Suite 2200 Kansas City, MO 64199	December 15, 1987
212. Sterne, Agee & Leach, Inc.	1500 Am South-Sonat Tower Birmingham, AL 35203	September 11, 1981

APPROVED Nonbank Trustees/Custodians as of December 31, 2002

Name	Address	Approval Date
213. Stifel, Nicolaus & Co., Inc.	500 North Broadway St. Louis, MO 63102	September 9, 1981
214. Summit Discount Brokerage (FKA Lehigh Securities Corp.)	1457 MacArthur Road Lehigh Valley, PA 18002	April 4, 1990
215. Sunpoint Securities, Inc.	911 W. Loop 281 Longview, TX 75604	April 1, 1998
216. SunTrust Capital Markets, Inc.	3333 Peachtree Road, NE Atlanta, GA 30326	May 27, 1982
217. Sutro & Company, Inc.	201 California Street San Francisco, CA 94111-5096	December 8, 1988
218. Swiss American Securities, Inc.	100 Wall Street New York, NY 10005	December 2, 1980
219. Texas First Securities Corporation	1360 Post Oak Blvd., Suite 120 Houston, TX 77056	November 17, 1988
220. TIAA-CREF Individual & Institutional Services, Inc.	730 Third Avenue New York, NY 10017	September 9, 2002
221. Tucker Anthony, Incorporated	One Beacon Street Boston, MA 02108	October 23, 1980
222. U.S. Bancorp Piper Jaffray, Inc.	800 Micollet Mall, Suite 800 Minneapolis, MN 55402-7020	April 21, 1982
223. U.S. Clearing Corporation	120 Wall Street New York, NY 10005	May 3, 1983
224. Unified Financial Securities, Inc.	429 North Pennsylvania Street Indianapolis, IN 46204	October 28, 1976
225. United of Omaha Life Insurance	Mutual of Omaha Plaza Omaha, NE 68175	March 16, 1982
226. USAA Transfer Agency Company of Delaware	USAA Building San Antonio, TX 78288	October 2, 1990
227. W.H. Reaves & Co., Inc.	30 Montgomery Street Jersey City, NJ 07302	December 7, 1990
228. W.H. Turlington & Co.	509 East Center Street Lexington, NC 27292	November 3, 1980
229. Wachovia Securities, Inc.	201 North Tryon Street Charlotte, NC 28202	April 6, 1990
230. Waterhouse Securities, Inc.	44 Wall Street New York, NY 10005	February 23, 1988
231. Wayne Hummer & Co.	300 South Wacker Drive Chicago, IL 60606	January 25, 1983
232. Web Street Securities, Inc.	222 South Riverside Plaza, 11th Floor Chicago, IL 60601	April 27, 2000
233. Wedbush Morgan Securities	1000 Wilshire Boulevard Los Angeles, CA 90030	December 24, 1984
234. Weiss, Peck & Greer	One New York Plaza New York, NY 10004	June 16, 1982

APPROVED Nonbank Trustees/Custodians as of December 31, 2002

Name	Address	Approval Date
235. Wells Advisors, Inc.	3885 Holcomb Bridge Road Norcross, GA 30092	March 20, 1992
236. Wexford Clearing Services Corporation	1 New York Plaza, 11th Floor New York, NY 10292	June 30, 1998
237. Wheat, First Securities, Inc.	707 East Main Street P.O. Box 135 Richmond, VA 23211	March 23, 1983
238. William R. Hough & Co., Inc.	100 2nd Avenue South, Suite 800 St. Petersburg, FL 33701	April 18, 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 laws 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 a new ruling.

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

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

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

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

Abbreviations

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

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

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

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

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Key to Abbreviations:

Ann	Announcement
CD	Court Decision
DO	Delegation Order
EO	Executive Order
PL	Public Law
PTE	Prohibited Transaction Exemption
RP	Revenue Procedure
RR	Revenue Ruling
SPR	Statement of Procedural Rules
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TD	Treasury Decision
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