Internal Revenue
bulletin

Bulletin No. 2002–33
August 19, 2002

HIGHLIGHTS OF THIS ISSUE

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

INCOME TAX

Rev. Rul. 2002–51, page 327.
Low-income housing credit; satisfactory bond; "bond factor" amounts for the period July through September 2002. This ruling announces the monthly bond factor amounts to be used by taxpayers who dispose of qualified low-income buildings or interests therein during the period July through September 2002.

T.D. 9004, page 331.
Final regulations under section 860E of the Code detail safe harbor conditions under which the transfer of a REMIC noneconomic residual interest or FASIT ownership interest is presumed to be accomplished without an intention to impede the assessment or collection of tax. Rev. Proc. 2001–12 obsoleted.

T.D. 9008, page 335.
Final regulations under sections 702, 952, 954, and 956 of the Code provide guidance necessary to clarify the treatment by a controlled foreign corporation (CFC) of its distributive share of partnership income under subpart F of the Code.

T.D. 9009, page 328.
Final regulations under section 706 of the Code provide guidance on determining the taxable year of a partnership with certain foreign partners and tax-exempt partners.

REG–115781–01, page 380.
Proposed regulations under section 2055 of the Code conform the income, gift, and estate tax regulations to the Tax Court's decision in *Estate of Boeshore v. Commissioner*, 78 T.C. 523 (1982), *acq. in result*, 1987–2 C.B. 1, holding portions of section 20.2055(e)(2)(vi)(*e*) of the estate tax regulations invalid. Rev. Rul. 76–225 revoked. A public hearing is scheduled for October 16, 2002.

EMPLOYEE PLANS

REG–124256–02, page 383.
Proposed regulations under sections 408 and 408A of the Code provide a new method for determining the earnings allocable to IRA contributions that are returned or recharacterized before the applicable tax return due date.

Notice 2002–57, page 379.
Weighted average interest rate update. The weighted average interest rate for August 2002 and the resulting permissible range of interest rates used to calculate current liability for purposes of the full funding limitation of section 412(c)(7) of the Code are set forth.

ESTATE TAX

REG–115781–01, page 380.
Proposed regulations under section 2055 of the Code conform the income, gift, and estate tax regulations to the Tax Court's decision in *Estate of Boeshore v. Commissioner*, 78 T.C. 523 (1982), *acq. in result*, 1987–2 C.B. 1, holding portions of section 20.2055(e)(2)(vi)(*e*) of the estate tax regulations invalid. Rev. Rul. 76–225 revoked. A public hearing is scheduled for October 16, 2002.

GIFT TAX

REG–115781–01, page 380.
Proposed regulations under section 2055 of the Code conform the income, gift, and estate tax regulations to the Tax Court's decision in *Estate of Boeshore v. Commissioner*, 78 T.C. 523 (1982), *acq. in result*, 1987–2 C.B. 1, holding portions of section 20.2055(e)(2)(vi)(*e*) of the estate tax regulations invalid. Rev. Rul. 76–225 revoked. A public hearing is scheduled for October 16, 2002.

Finding Lists begin on page ii.

(Continued on the next page)

Department of the Treasury
Internal Revenue Service

ADMINISTRATIVE

T.D. 9007, page 349.
Final regulations under sections 7122, 6331, and 6103 of the Code provide procedures for the compromise of Internal Revenue tax and provide expanded compromise authority for the IRS. The regulations will permit compromise of liabilities when there is doubt as to the amount of the liability owed, when there is doubt whether the full amount of the tax can be collected, and when compromise would promote effective tax administration. The IRS may compromise to promote effective tax administration when it determines that collection of the full amount of the tax liability would create economic hardship or that compelling public policy or equity considerations identified by the taxpayer provide a sufficient basis for compromise.

T.D. 9010, page 341.
Final regulations under sections 6041 and 6045 of the Code concern information reporting requirements for certain payments made on behalf of another person, payments to joint payees, and payments of gross proceeds from sales involving investment advisors. Rev. Ruls. 54–571, 55–606, 59–328, 64–36, 65–129, 67–197, 73–232, 77–53, 85–50, and 93–70 obsoleted as of January 1, 2003. Rev. Ruls. 69–595 and 70–608 obsoleted in part as of January 1, 2003.

T.D. 9011, page 356.
Final regulations provide clarifying guidance with respect to and modify the regulations governing practice before the Internal Revenue Service (Circular 230).

Announcement 2002–73, page 387.
The Service announces that a supplement to Publication 590, *Individual Retirement Arrangements (IRAs)*, is now available.

Announcement 2002–74, page 387.
The Service announces that an updated edition, revised June 2002, of Publication 971, *Innocent Spouse Relief (And Separation of Liability and Equitable Relief)* is currently available.

The IRS Mission

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

Introduction

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

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

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

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

The Bulletin is divided into four parts as follows:

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

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

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

Part IV.—Items of General Interest.
This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

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

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This page is reserved for missing child Maricela Rumbo

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

Section 42.—Low-Income Housing Credit

Low-income housing credit; satisfactory bond; "bond factor" amounts for the period July through September 2002. This ruling announces the monthly bond factor amounts to be used by taxpayers who dispose of qualified low-income buildings or interests therein during the period July through September 2002.

Rev. Rul. 2002–51

In Rev. Rul. 90–60, 1990–2 C.B. 3, the Internal Revenue Service provided guidance to taxpayers concerning the general methodology used by the Treasury Department in computing the bond factor amounts used in calculating the amount of bond considered satisfactory by the Secretary under § 42(j)(6) of the Internal Revenue Code. It further announced that the Secretary would publish in the Internal Revenue Bulletin a table of "bond factor" amounts for dispositions occurring during each calendar month.

Rev. Proc. 99–11, 1999–1 C.B. 275, established a collateral program as an alternative to providing a surety bond for taxpayers to avoid or defer recapture of the low-income housing tax credits under § 42(j)(6). Under this program, taxpayers may establish a Treasury Direct Account and pledge certain United States Treasury securities to the Internal Revenue Service as security.

This revenue ruling provides in Table 1 the bond factor amounts for calculating the amount of bond considered satisfactory under § 42(j)(6) or the amount of United States Treasury securities to pledge in a Treasury Direct Account under Rev. Proc. 99–11 for dispositions of qualified low-income buildings or interests therein during the period July through September 2002.

Table 1
Rev. Rul. 2002–51
Monthly Bond Factor Amounts for Dispositions Expressed
As a Percentage of Total Credits

	Calendar Year Building Placed in Service or, if Section 42(f)(1) Election Was Made, the Succeeding Calendar Year										
Month of Disposition	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
Jul '02	17.76	32.73	45.44	56.24	65.46	64.90	65.42	65.94	66.58	67.29	68.17
Aug '02	17.76	32.73	45.44	56.24	65.46	64.74	65.26	65.78	66.42	67.13	68.01
Sep '02	17.76	32.73	45.44	56.24	65.46	64.58	65.10	65.62	66.26	66.98	67.86

Table 1 (cont'd)
Rev. Rul. 2002–51
Monthly Bond Factor Amounts for Dispositions Expressed
As a Percentage of Total Credits

	Calendar Year Building Placed in Service or, if Section 42(f)(1) Election Was Made, the Succeeding Calendar Year			
Month of Disposition	1999	2000	2001	2002
Jul '02	69.05	69.94	71.25	72.55
Aug '02	68.90	69.81	71.14	72.55
Sep '02	68.76	69.68	71.04	72.55

For a list of bond factor amounts applicable to dispositions occurring during other calendar years, see: Rev. Rul. 98–3, 1998–1 C.B. 248; Rev. Rul. 2001–2, 2001–2 C.B. 255; and Rev. Rul. 2001–53, 2001–46 I.R.B. 489. For dispositions occurring during the period January through March 2002, see Rev. Rul. 2002–8, 2002-9 I.R.B. 564. For dispositions occurring during the period April through June 2002, see Rev. Rul. 2002–24, 2002–19 I.R.B. 848.

DRAFTING INFORMATION

The principal author of this revenue ruling is Gregory N. Doran of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling, contact Mr. Doran at (202) 622–3040 (not a toll-free number).

Section 706.—Taxable Years of Partner and Partnership

26 CFR 1.706–1: Taxable years of partner and partnership.

T.D. 9009

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Taxable Years of Partner and Partnership; Foreign Partners

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final regulations on the taxable year of a partnership with foreign partners and tax-exempt partners. The final regulations provide that in certain circumstances the taxable year of a partnership will be determined without regard to the taxable year of certain foreign partners and certain tax-exempt partners.

DATES: *Effective date:* These regulations are effective on July 23, 2002.

Applicability date: For dates of applicability of these regulations, see §§ 1.706–1(b)(5)(iii), (b)(6)(v), and (b)(11)(ii).

FOR FURTHER INFORMATION CONTACT: Dan Carmody, (202) 622–3080 (not a toll-free number). For specific information regarding international issues, contact Ronald M. Gootzeit, (202) 622–3860 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Introduction

This document finalizes portions of § 1.706–1(b) of the Income Tax Regulations (26 CFR part 1) relating to the determination of the taxable year of a partnership with tax-exempt partners and foreign partners. This document also withdraws § 1.706–3T (26 CFR part 1).

Background

On May 24, 1988, Treasury and the Internal Revenue Service (IRS) issued temporary regulations (§ 1.706–3T, promulgated as part of T.D. 8205 (1998–1 C.B. 56 [53 FR 19688])) with a contemporaneous notice of proposed rulemaking (LR–53–88, 1988–1 C.B. 935 [53 FR 19715]) relating to the determination of the taxable year of a partnership with tax-exempt partners (the 1988 Proposed Regulations). On January 17, 2001, Treasury and the IRS published in the **Federal Register** a notice of proposed rulemaking (REG–104876–00, 2001–1 C.B. 998 [66 FR 3920]) to provide guidance relating to the determination of the taxable year of a partnership with foreign partners (the 2001 Proposed Regulations). In that notice of proposed rulemaking, Treasury and the IRS also indicated that the 1988 Proposed Regulations would be finalized. A public hearing was held on June 6, 2001. After consideration of the comments, the proposed regulations are adopted as revised by this Treasury decision.

Explanation of Revisions and Summary of Comments

I. *In General*

Section 706 provides rules relating to the taxable years of a partnership and its partners. Under section 706(a), in computing the taxable income of a partner for a taxable year, the partner must include the partner’s share of any income, gain, loss, deduction, or credit of the partnership for the partnership’s taxable year that ends within or with the partner’s taxable year.

Section 706(b)(1)(B) provides that, unless the partnership establishes a business purpose for a different taxable year, a partnership cannot have a taxable year other than: (i) the majority interest taxable year; (ii) if there is no majority interest taxable year, the taxable year of all the principal partners of the partnership; or (iii) if there is no taxable year described in (i) or (ii), the calendar year unless the Secretary by regulation prescribes another period. Section 1.706–1(b)(2) of the Income Tax Regulations provides that, if neither section 706(b)(1)(B)(i) nor (ii) apply, the partnership’s taxable year will be the taxable year that results in the least aggregate deferral of partnership income.

As part of a larger guidance project on accounting periods, the regulations under section 706 were restructured on May 17, 2002 (T.D. 8996, 2002–24 I.R.B. 1127 [67 FR 35009]). To conform with the restructuring, the regulations finalized by this document will be finalized as amendments to § 1.706–1 even though they were proposed under §§ 1.706–3 and 1.706–4. A small portion of the proposed regulation under § 1.706–3 dealing with the effect of partner elections under section 444 has been finalized as § 1.706–1(b)(11).

II. *Treatment of Tax-Exempt Partners*

The 1988 Proposed Regulations provide that, in determining the taxable year (the current year) of a partnership under section 706(b) and the regulations thereunder, a partner that is tax-exempt under section 501(a) is disregarded if such partner was not subject to tax, under chapter 1 of the Internal Revenue Code (Code), on any income attributable to its investment in the partnership during the partnership’s taxable year immediately preceding the current year. This Treasury decision finalizes the 1988 Proposed Regulations without substantive change and withdraws the temporary regulations.

III. *Treatment of Foreign Partners*

A. *General rule*

The 2001 Proposed Regulations generally provide that a foreign partner that is not subject to U.S. taxation on a net basis on income earned through the partnership is disregarded for purposes of section 706(b). For these purposes, a foreign partner will be considered subject to U.S. taxation on a net basis only if the partner is allocated gross income of the partnership that is effectively connected (or treated as effectively connected) with the conduct of a trade or business within the United States (effectively connected income or ECI). In the case of a foreign partner claiming benefits under a U.S. income tax treaty, such partner is disregarded unless it is allocated any gross income that is attributable to a permanent establishment in the United States.

The final regulations follow the same approach as the proposed regulations, but the general rule has been clarified to provide that a foreign partner is disregarded unless such partner is allocated any gross income that is ECI, and the taxation of the income is not otherwise precluded under any U.S. income tax treaty. Gross income for these purposes does not include income that is excluded under another Code provision (*e.g.*, the exclusion from gross income under section 883 for certain transportation income). Further, as the preamble to the proposed regulations (REG–104876–00, 2001–1 C.B. 998 [66 FR 3920, 3922]) states, the Commissioner may challenge an arrangement that, while conforming to these rules, is undertaken with a principal purpose of achieving a tax result that is inconsistent with the intent of section 706. § 1.701–2.

A commentator questioned the statutory authority for regulations that disregard the interest in a partnership held by certain foreign partners in determining a partnership's taxable year under section 706(b). Treasury and the IRS believe that they have the authority to adopt these final regulations in order to resolve ambiguity in the statutory provisions in a manner that is consistent with the objectives of section 706(b) to eliminate or reduce the amount of deferral available on income earned through a partnership.

B. *Application of the minority interest rule*

Treasury and the IRS recognize that requiring a partnership taxable year to be determined without regard to certain foreign partners may present difficulties for minority partners in some cases. For this reason, the proposed regulations include a "minority interest rule" which provides that the taxable years of foreign partners are not disregarded for purposes of section 706(b) if no single partner (other than a disregarded foreign partner) holds a 10-percent or greater interest in the capital or profits of the partnership, and if, in the aggregate, the partners that are not disregarded foreign partners do not hold a 20-percent or greater interest in the capital or profits of the partnership.

The 2001 Proposed Regulations provide that, for purposes of determining a partner's ownership in the partnership, the constructive ownership rules of section 318 apply (substituting "10 percent" for "50 percent" in section 318(a)(2)(C) and (3)(C)) and the attribution rules of section 267(c) also apply to the extent that those rules attribute ownership to persons to whom section 318 does not attribute ownership. These regulations replace this attribution rule with an attribution rule based on the principles of sections 267(b) and 707(b). Attribution under sections 267(b) and 707(b) is more commonly applied in the partnership context than is attribution under section 318, which is generally used to determine constructive ownership of stock.

Commentators expressed concern that the 10- and 20-percent thresholds were too low. They explained that U.S. minority partners would have difficulty reporting partnership income timely under these rules, because a U.S. minority partner typically lacks the practical or legal ability to cause a foreign partnership to close its books and conduct a mid-year accounting. Treasury and the IRS believe that partners can generally negotiate with the partnership to obtain the information needed to comply with their reporting obligations under these regulations. Recognizing, though, that partners in existing partnerships may not be in a position to renegotiate for partnership information, Treasury and the IRS have made these regulations applicable on a mandatory basis only to partnerships formed on or after September 23, 2002. Partnerships formed before September 23, 2002, however, may elect to change their taxable years to conform with these regulations. Such a change will be treated as a change to a required taxable year under § 4 of Rev. Proc. 2002–38, 2002–22 I.R.B. 1037, or any successor, and the partnership will then be subject to the requirements of § 1.706–1(b)(6). Moreover, if an existing partnership terminates under the rules of section 708(b)(1)(B), the resulting partnership will be subject to the requirements of these regulations. Treasury and the IRS request comments on additional ways in which the administrative burdens associated with these regulations may be reduced.

The preamble to the 2001 Proposed Regulations requests comments on whether tax-exempt partners should be excluded for purposes of the minority interest rule. As no comments were received, the final regulations consider tax-exempt partners in determining whether the minority interest rule applies.

IV. *Effective Date*

The regulations under § 1.706–1(b)(5) relating to the taxable year of a partnership with tax-exempt partners apply to taxable years beginning on or after July 23, 2002. For taxable years beginning before July 23, 2002, see § 1.706–3T as contained in 26 CFR part 1 revised April 1, 2002.

The regulations under § 1.706–1(b)(6) relating to the taxable year of a partnership with foreign partners are applicable for taxable years of partnerships (other than existing partnerships as defined in § 1.706–1(b)(6)(v)) beginning on or after July 23, 2002.

The regulations under § 1.706–1(b)(11) relating to the effect of partner elections under section 444 are applicable for taxable years of partnerships beginning on or after July 23, 2002. For taxable years beginning before July 23, 2002, see § 1.706–3T as contained in 26 CFR part 1 revised April 1, 2002.

V. *Transitional Relief for Existing Partnerships with Foreign Partners.*

The 2001 Proposed Regulations recognize that a potential hardship exists for partners of an existing partnership that changes its taxable year to comply with § 1.706–1(b)(6). If the change results in two partnership taxable years ending within a partner's single taxable year, that partner could experience a bunching of more than 12 months of partnership income in a single taxable year. In order to avoid potential hardships, the 2001 Proposed Regulations incorporate the transitional rules of § 1.702–3T to allow the gain recognition to be spread over a four-year period. A partnership that uses this transitional rule is required to take into account all items of income, gain, loss, deduction and credit ratably over the four-year period.

Unlike the 2001 Proposed Regulations, these regulations do not require that existing partnerships change their taxable years to conform to the regulations. Because the regulations do not require existing partnerships to change their taxable years, the need for transitional relief is less imperative. Nevertheless, to encourage existing partnerships to change their taxable years to conform to these regulations, Treasury and the IRS have retained the transitional rule for any partnership that elects to apply the regulations in its first taxable year beginning on or after July 23, 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) 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, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

Drafting Information

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

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. In § 1.706–1, paragraphs (b)(5) and (b)(6) are revised and paragraph (b)(11) is added to read as follows:

§ 1.706–1 Taxable years of partner and partnership.

* * * * *

(b) * * *

(5) *Taxable year of a partnership with tax-exempt partners*—(i) *Certain tax-exempt partners disregarded*. In determining the taxable year (the current year) of a partnership under section 706(b) and the regulations thereunder, a partner that is tax-exempt under section 501(a) shall be disregarded if such partner was not subject to tax, under chapter 1 of the Internal Revenue Code, on any income attributable to its investment in the partnership during the partnership's taxable year immediately preceding the current year. However, if a partner that is tax-exempt under section 501(a) was not a partner during the partnership's immediately preceding taxable year, such partner will be disregarded for the current year if the partnership reasonably believes that the partner will not be subject to tax, under chapter 1 of the Internal Revenue Code, on any income attributable to such partner's investment in the partnership during the current year.

(ii) *Example*. The provisions of paragraph (b)(5)(i) of this section may be illustrated by the following example:

Example. Assume that partnership A has historically used the calendar year as its taxable year. In addition, assume that A is owned by 5 partners, 4 calendar year individuals (each owning 10 percent of A's profits and capital) and a tax-exempt organization (owning 60 percent of A's profits and capital). The tax-exempt organization has never had unrelated business taxable income with respect to A and has historically used a June 30 fiscal year. Finally, assume that A desires to retain the calendar year for its taxable year beginning January 1, 2003. Under these facts and but for the special rule in paragraph (b)(5)(i) of this section, A would be required under section 706(b)(1)(B)(i) to change to a year ending June 30, for its taxable year beginning January 1, 2003. However, under the special rule provided in paragraph (b)(5)(i) of this section the partner that is tax-exempt is disregarded, and A must retain the calendar year, under section 706(b)(1)(B)(i), for its taxable year beginning January 1.

(iii) *Effective date*. The provisions of this paragraph (b)(5) are applicable for taxable years beginning on or after July 23, 2002. For taxable years beginning before July 23, 2002, see § 1.706–3T as contained in 26 CFR part 1 revised April 1, 2002.

(6) *Certain foreign partners disregarded*—(i) *Interests of disregarded foreign partners not taken into account*. In determining the taxable year (the current taxable year) of a partnership under section 706(b) and the regulations thereunder, any interest held by a disregarded foreign partner is not taken into account. A foreign partner is a disregarded foreign partner unless such partner is allocated any gross income of the partnership that was effectively connected (or treated as effectively connected) with the conduct of a trade or business within the United States during the partnership's taxable year immediately preceding the current taxable year (or, if such partner was not a partner during the partnership's immediately preceding taxable year, the partnership reasonably believes that the partner will be allocated any such income during the current taxable year) and taxation of that income is not otherwise precluded under any U.S. income tax treaty.

(ii) *Definition of foreign partner*. For purposes of this paragraph (b)(6), a foreign partner is any partner that is not a U.S. person (as defined in section 7701 (a)(30)), except that a partner that is a controlled foreign corporation (as defined in section 957(a)) or a foreign personal holding company (as defined in section 552) shall not be treated as a foreign partner.

(iii) *Minority interest rule*. If each partner that is not a disregarded foreign partner under paragraph (b)(6)(i) of this section (regarded partner) holds less than a 10-percent interest, and the regarded partners, in the aggregate, hold less than a 20-percent interest in the capital or profits of the partnership, then paragraph (b)(6)(i) of this section does not apply. In determining ownership in a partnership for purposes of this paragraph (b)(6)(iii), each regarded partner is treated as owning any interest in the partnership owned by a related partner. For this purpose, partners are treated as related if they are related within the meaning of sections 267(b) or 707(b) (using the language "10 percent" instead of "50 percent" each place it appears). However, for purposes of determining if partners hold less than a 20-percent interest in the aggregate, the same interests will not be considered as being owned by more than one regarded partner.

(iv) *Example*. The provisions of paragraph (b)(6) of this section may be illustrated by the following example:

Example. Partnership B is owned by two partners, F, a foreign corporation that owns a 95-percent interest in the capital and profits of partnership B, and D, a domestic corporation that owns the remaining 5-percent interest in the capital and profits of partnership B. Partnership B is not engaged in the conduct of a trade or business within the United States, and, accordingly, partnership B does not earn any income that is effectively connected with a U.S. trade or business. F uses a March 31 fiscal year, and causes partnership B to maintain its books and records on a March 31 fiscal year as well. D is a calendar year taxpayer. Under paragraph (b)(6)(i) of this section, F would be disregarded and partnership B's taxable year would be determined by reference to D. However, because D owns less than a 10-percent interest in the capital and profits of partnership B, the minority interest rule of paragraph (b)(6)(iii) of this section applies, and partnership B must adopt the March 31 fiscal year for Federal tax purposes.

(v) *Effective date*—(A) *Generally*. The provisions of this paragraph (b)(6) are applicable for the first taxable year of a partnership other than an existing partnership that begins on or after July 23, 2002. For this purpose, an existing partnership is a partnership that was formed prior to September 23, 2002.

(B) *Voluntary change in taxable year*. An existing partnership may change its taxable year to a year determined in accordance with this section. An existing partnership that makes such a change will cease to be exempted from the requirements of paragraph (b)(6) of this section.

(C) *Subsequent sale or exchange of interests*. If an existing partnership terminates under section 708(b)(1)(B), the resulting partnership is not an existing partnership for purposes of paragraph (b)(6)(v)(A) of this section.

(D) *Transition rule*. If, in the first taxable year beginning on or after July 23, 2002, an existing partnership voluntarily changes its taxable year to a year determined in accordance with this paragraph (b)(6), then the partners of that partnership may apply the provisions of § 1.702–3T to take into account all items of income, gain, loss, deduction, and credit attributable to the partnership year of change ratably over a four-year period.

* * * * *

(11) *Effect of partner elections under section 444*—(i) *Election taken into account*. For purposes of section 706(b)(1)(B), any section 444 election by a partner in a partnership shall be taken into account in determining the taxable year of the partnership. See § 1.7519–1T (d), *Example (4)*.

(ii) *Effective date*. The provisions of this paragraph (b)(11) are applicable for taxable years beginning on or after July 23, 2002. For taxable years beginning before July 23, 2002, see § 1.706–3T as contained in 26 CFR part 1 revised April 1, 2002.

* * * * *

§ 1.706–3T [Removed]

Par. 3. Section 1.706–3T is removed.

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

Approved July 16, 2002.

Pamela F. Olson,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on July 22, 2002, 8:45 a.m., and published in the issue of the Federal Register for July 23, 2002, 67 F.R. 48017)

Section 860E.—Treatment of Income in Excess of Daily Accruals on Residual Interests

26 CFR 1.860E–1: Treatment of taxable income of a residual interest holder in excess of daily accruals.

T.D. 9004

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

Real Estate Mortgage Investment Conduits

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to safe harbor transfers of noneconomic residual interests in real estate mortgage investment conduits (REMICs). The final regulations provide additional limitations on the circumstances under which transferors may claim safe harbor treatment.

DATES: *Effective date:* These regulations are effective July 19, 2002.

Applicability date: For dates of applicability of these regulations, see § 1.860 E–(1)(c)(10).

FOR FURTHER INFORMATION CONTACT: Courtney Shepardson at (202) 622–3940 (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 1545–1675.

The collection of information in this regulation is in § 1.860E–1(c)(5)(ii). This information is required to enable the IRS to verify that a taxpayer is complying with the conditions of this regulation. The collection of information is mandatory and is required. Otherwise, the taxpayer will not receive the benefit of safe harbor treatment as provided in the regulation. The likely respondents are businesses and 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:FP:S, Washington, DC 20224. Comments on the collection of information should be received by September 17, 2002. Comments are specifically requested concerning:

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

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

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

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

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

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

The estimated total annual reporting burden is 470 hours, based on an estimated number of respondents of 470 and an estimated average annual burden hours per respondent of one hour.

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 final regulations regarding the proposed amendments to 26 CFR part 1 under section 860E of the Internal Revenue Code (Code). The regulations provide the circumstances under which a transferor of a noneconomic REMIC residual interest meeting the investigation and representation requirements may avail itself of the safe harbor by satisfying either the formula test or the asset test.

Final regulations governing REMICs, issued in 1992, contain rules governing the transfer of noneconomic REMIC residual interests. In general, a transfer of a noneconomic residual interest is disregarded for all tax purposes if a significant purpose of the transfer is to enable the transferor to impede the assessment or collection of tax. A purpose to impede the assessment or collection of tax (a wrongful purpose) exists if the transferor, at the time of the transfer, either knew or should have known that the transferee would be unwilling or unable to pay taxes due on its share of the REMIC's taxable income.

Under a safe harbor, the transferor of a REMIC noneconomic residual interest is presumed not to have a wrongful purpose if two requirements are satisfied: (1) the transferor conducts a reasonable investigation of the transferee's financial condition (the investigation requirement); and (2) the transferor secures a representation from the transferee to the effect that the transferee understands the tax obligations associated with holding a residual interest and intends to pay those taxes (the representation requirement).

The IRS and Treasury have been concerned that some transferors of noneconomic residual interests claim they satisfy the safe harbor even in situations where the economics of the transfer clearly indicate the transferee is unwilling or unable to pay the tax associated with holding the interest. For this reason, on February 7, 2000, the IRS published in the **Federal Register** a notice of proposed rulemaking (REG–100276–97; REG–122450–98, 2000–1 C.B. 682 [65 FR 5807]) designed to clarify the safe harbor by adding the "formula test," an economic test. The proposed regulation provides that the safe harbor is unavailable unless the present value of the anticipated tax liabilities associated with holding the residual interest does not exceed the sum of: (1) the present value of any consideration given to the transferee to acquire the interest; (2) the present value of the expected future distributions on the interest; and (3) the present value of the anticipated tax savings associated with holding the interest as the REMIC generates losses.

The notice of proposed rulemaking also contained rules for FASITs. Section 1.860H–6(g) of the proposed regulations provides requirements for transfers of FASIT ownership interests and adopts a safe harbor by reference to the safe harbor provisions of the REMIC regulations.

In January 2001, the IRS published Rev. Proc. 2001–12, 2001–1 C.B. 335, to set forth an alternative safe harbor that taxpayers could use while the IRS and the Treasury considered comments on the proposed regulations. Under the alternative safe harbor, if a transferor meets the investigation requirement and the representation requirement but the transfer fails to meet the formula test, the transferor may invoke the safe harbor if the transferee meets a two-prong test (the asset test). A transferee generally meets the first prong of this test if, at the time of the transfer, and in each of the two years preceding the year of transfer, the transferee's gross assets exceed $100 million and its net assets exceed $10 million. A transferee generally meets the second prong of this test if it is a domestic, taxable corporation and agrees in writing not to transfer the interest to any person other than another domestic, taxable corporation that also satisfies the requirements of the asset test. A transferor cannot rely on the asset test if the transferor knows, or has reason to know, that the transferee will not comply with its written agreement to limit the restrictions on subsequent transfers of the residual interest.

Rev. Proc. 2001–12 provides that the asset test fails to be satisfied in the case of a transfer or assignment of a noneconomic residual interest to a foreign branch of an otherwise eligible transferee. If such a transfer or assignment were permitted, a corporate taxpayer might seek to claim that the provisions of an applicable income tax treaty would resource excess inclusion income as foreign source income, and that, as a consequence, any U.S. tax liability attributable to the excess inclusion income could be offset by foreign tax credits. Such a claim would impede the assessment or collection of U.S. tax on excess inclusion income, contrary to the congressional purpose of assuring that such income will be taxable in all events. See, *e.g.*, sections 860E(a)(1), (b), (e) and 860G(b) of the Code.

The Treasury and the IRS have learned that certain taxpayers transferring noneconomic residual interests to foreign branches have attempted to rely on the formula test to obtain safe harbor treatment in an effort to impede the assessment or collection of U.S. tax on excess inclusion income. Accordingly, the final regulations provide that if a noneconomic residual interest is transferred to a foreign permanent establishment or fixed base of a U.S. taxpayer, the transfer is not eligible for safe harbor treatment under either the asset test or the formula test. The final regulations also require a transferee to represent that it will not cause income from the noneconomic residual interest to be attributable to a foreign permanent establishment or fixed base.

Section 1.860E–1(c)(8) provides computational rules that a taxpayer may use to qualify for safe harbor status under the formula test. Section 1.860E–1(c)(8)(i) provides that the transferee is presumed to pay tax at a rate equal to the highest rate of tax specified in section 11(b). Some commentators were concerned that this presumed rate of taxation was too high because it does not take into consideration taxpayers subject to the alternative minimum tax rate. In light of the comments received, this provision has been amended in the final regulations to allow certain transferees that compute their taxable income using the alternative minimum tax rate to use the alternative minimum tax rate applicable to corporations.

Additionally, § 1.860E–1(c)(8)(iii) provides that the present values in the formula test are to be computed using a discount rate equal to the applicable Federal short-term rate prescribed by section 1274(d). This is a change from the proposed regulation and Rev. Proc. 2001–12. In those publications the provision stated that "present values are computed using a discount rate equal to the applicable Federal rate prescribed in section 1274(d) compounded semiannually" and that "[a] lower discount rate may be used if the transferee can demonstrate that it regularly borrows, in the course of its trade or business, substantial funds at such lower rate from an unrelated third party." The IRS and the Treasury Department have learned that, based on this provision, certain taxpayers have been attempting to use unrealistically low or zero interest rates to satisfy the formula test, frustrating the intent of the test. Furthermore, the Treasury Department and the IRS believe that a rule allowing for a rate other than a rate based on an objective index would add unnecessary complexity to the safe harbor. As a result, the rule in the proposed regulations that permits a transferee to use a lower discount rate, if the transferee can demonstrate that it regularly borrows substantial funds at such lower rate, is not included in the final regulations; and the Federal short-term rate has been substituted for the applicable Federal rate. To simplify taxpayers' computations, the final regulations allow use of any of the published short-term rates, provided that the present values are computed with a corresponding period of compounding. With the exception of the provisions relating to transfers to foreign branches, these changes generally have the proposed applicability date of February 4, 2000, but taxpayers may choose to apply the interest rate formula set forth in the proposed regulation and Rev. Proc. 2001–12 for transfers occurring before August 19, 2002.

It is anticipated that when final regulations are adopted with respect to FASITs, § 1.860H–6(g) of the proposed regulations will be adopted in substantially its present form, with the result that the final regulations contained in this document will also govern transfers of FASIT ownership interests with substantially the same applicability date as is contained in this document.

Effect on Other Documents

Rev. Proc. 2001–12, 2001–1 C.B. 335, is obsolete for transfers of noneconomic residual interests in REMICs occurring on or after August 19, 2002.

Special Analyses

It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that it is unlikely that a substantial number of small entities will hold REMIC residual interests. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. 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 sections 553(b) and 553(d) of the Administrative Procedure Act (5 U.S.C. chapter 5) do not apply to these regulations.

Drafting Information

The principal author of these regulations is Courtney Shepardson. 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 continues to read in part as follows:

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

Par. 2. In § 1.860A–0, entries in the outline for § 1.860E–1 (c)(5) through (c)(10) are added to read as follows:

§ 1.860A–0 Outline of REMIC provisions.

* * * * *

§ 1.860E–1 Treatment of taxable income of a residual interest holder in excess of daily accruals.

* * * * *

(c) * * *

(5) Asset test.

(6) Definitions for asset test.

(7) Formula test.

(8) Conditions and limitations on formula test.

(9) Examples.

(10) Effective dates.

* * * * *

Par. 3. Section 1.860E-1 is amended as follows:

1. Paragraph (c)(4)(i) is amended by removing the language "and" at the end of the paragraph.

2. Paragraph (c)(4)(ii) is amended by removing the period at the end of the paragraph and adding a semicolon in its place.

3. Paragraphs (c)(4)(iii) and (c)(4)(iv) are added.

4. Paragraphs (c)(5) through (c)(10) are added.

The additions read as follows:

§ 1.860E–1 Treatment of taxable income of a residual interest holder in excess of daily accruals.

* * * * *

(c) * * *

(4) * * *

(iii) The transferee represents that it will not cause income from the noneconomic residual interest to be attributable to a foreign permanent establishment or fixed base (within the meaning of an applicable income tax treaty) of the transferee or another U.S. taxpayer; and

(iv) The transfer satisfies either the asset test in paragraph (c)(5) of this section or the formula test in paragraph (c)(7) of this section.

(5) *Asset test*. The transfer satisfies the asset test if it meets the requirements of paragraphs (c)(5)(i), (ii) and (iii) of this section.

(i) At the time of the transfer, and at the close of each of the transferee's two fiscal years preceding the transferee's fiscal year of transfer, the transferee's gross assets for financial reporting purposes exceed $100 million and its net assets for financial reporting purposes exceed $10 million. For purposes of the preceding sentence, the gross assets and net assets of a transferee do not include any obligation of any related person (as defined in paragraph (c)(6)(ii) of this section) or any other asset if a principal purpose for holding or acquiring the other asset is to permit the transferee to satisfy the conditions of this paragraph (c)(5)(i).

(ii) The transferee must be an eligible corporation (defined in paragraph (c)(6)(i) of this section) and must agree in writing that any subsequent transfer of the interest will be to another eligible corporation in a transaction that satisfies paragraphs (c)(4)(i), (ii), and (iii) and this paragraph (c)(5). The direct or indirect transfer of the residual interest to a foreign permanent establishment (within the meaning of an applicable income tax treaty) of a domestic corporation is a transfer that is not a transfer to an eligible corporation. A transfer also fails to meet the requirements of this paragraph (c)(5)(ii) if the transferor knows, or has reason to know, that the transferee will not honor the restrictions on subsequent transfers of the residual interest.

(iii) A reasonable person would not conclude, based on the facts and circumstances known to the transferor on or before the date of the transfer, that the taxes associated with the residual interest will not be paid. The consideration given to the transferee to acquire the noneconomic residual interest in the REMIC is only one factor to be considered, but the transferor will be deemed to know that the transferee cannot or will not pay if the amount of consideration is so low compared to the liabilities assumed that a reasonable person would conclude that the taxes associated with holding the residual interest will not be paid. In determining whether the amount of consideration is too low, the specific terms of the formula test in paragraph (c)(7) of this section need not be used.

(6) *Definitions for asset test*. The following definitions apply for purposes of paragraph (c)(5) of this section:

(I) *Eligible corporation* means any domestic C corporation (as defined in section 1361(a)(2)) other than—

(A) A corporation which is exempt from, or is not subject to, tax under section 11;

(B) An entity described in section 851(a) or 856(a);

(C) A REMIC; or

(D) An organization to which part I of subchapter T of chapter 1 of subtitle A of the Internal Revenue Code applies.

(ii) *Related person* is any person that—

(A) Bears a relationship to the transferee enumerated in section 267(b) or 707(b)(1), using "20 percent" instead of "50 percent" where it appears under the provisions; or

(B) Is under common control (within the meaning of section 52(a) and (b)) with the transferee.

(7) *Formula test*. The transfer satisfies the formula test if the present value of the anticipated tax liabilities associated with holding the residual interest does not exceed the sum of—

(i) The present value of any consideration given to the transferee to acquire the interest;

(ii) The present value of the expected future distributions on the interest; and

(iii) The present value of the anticipated tax savings associated with holding the interest as the REMIC generates losses.

(8) *Conditions and limitations on formula test*. The following rules apply for purposes of the formula test in paragraph (c)(7) of this section.

(i) The transferee is assumed to pay tax at a rate equal to the highest rate of tax specified in section 11(b)(1). If the transferee has been subject to the alternative minimum tax under section 55 in the preceding two years and will compute its taxable income in the current taxable year using the alternative minimum tax rate, then the tax rate specified in section 55(b)(1)(B) may be used in lieu of the highest rate specified in section 11(b)(1).

(ii) The direct or indirect transfer of the residual interest to a foreign permanent establishment or fixed base (within the meaning of an applicable income tax treaty) of a domestic transferee is not eligible for the formula test.

(iii) Present values are computed using a discount rate equal to the Federal short-term rate prescribed by section 1274(d) for the month of the transfer and the compounding period used by the taxpayer.

(9) *Examples*. The following examples illustrate the rules of this section:

Example 1. Transfer to partnership. *X* transfers a noneconomic residual interest in a REMIC to Partnership *P* in a transaction that does not satisfy the formula test of paragraph (c)(7) of this section. *Y* and *Z* are the partners of *P*. Even if *Y* and *Z* are eligible corporations that satisfy the requirements of paragraph (c)(5)(i) of this section, the transfer fails to satisfy the asset test requirements found in paragraph (c)(5)(ii) of this section because *P* is a partnership rather than an eligible corporation within the meaning of (c)(6)(i) of this section.

Example 2. Transfer to a corporation without capacity to carry additional residual interests. During the first ten months of a year, Bank transfers five residual interests to Corporation *U* under circumstances meeting the requirements of the asset test in paragraph (c)(5) of this section. Bank is the major creditor of *U* and consequently has access to *U*'s financial records and has knowledge of *U*'s financial circumstances. During the last month of the year, Bank transfers three additional residual interests to *U* in a transaction that does not meet the formula test of paragraph (c)(7) of this section. At the time of this transfer, *U*'s financial records indicate it has retained the previously transferred residual interests. *U*'s financial circumstances, including the aggregate tax liabilities it has assumed with respect to REMIC residual interests, would cause a reasonable person to conclude that *U* will be unable to meet its tax liabilities when due. The transfers in the last month of the year fail to satisfy the investigation requirement in paragraph (c)(4)(i) of this section and the asset test requirement of paragraph (c)(5)(iii) of this section because Bank has reason to know that *U* will not be able to pay the tax due on those interests.

Example 3. Transfer to a foreign permanent establishment of an eligible corporation. *R* transfers a noneconomic residual interest in a REMIC to the foreign permanent establishment of Corporation *T*. Solely because of paragraph (c)(8)(ii) of this section, the transfer does not satisfy the formula test of paragraph (c)(7) of this section. In addition, even if *T* is an eligible corporation, the transfer does not satisfy the asset test because the transfer fails the requirements of paragraph (c)(5)(ii) of this section.

(10) *Effective dates*. Paragraphs (c)(4) through (c)(9) of this section are applicable to transfers occurring on or after February 4, 2000, except for paragraphs

(c)(4)(iii) and (c)(8)(iii) of this section, which are applicable for transfers occurring on or after August 19, 2002. For the dates of applicability of paragraphs (a) through (c)(3) and (d) of this section, see § 1.860A–1.

* * * * *

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 4. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 5. In § 602.101, paragraph (b) is amended by adding an entry in numerical order to the table to read in part as follows:

§ 602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.860E–1	1545–1675
* * * * *	

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved July 10, 2002.

Pamela F. Olson,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on July 18, 2002, 8:45 a.m., and published in the issue of the Federal Register for July 19, 2002, 67 F.R. 47451)

Section 952.—Subpart F Income Defined

26 CFR 1.952–1: Subpart F income defined.

T.D. 9008

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Guidance Under Subpart F Relating to Partnerships

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations providing guidance under subpart F relating to partnerships. The final regulations are necessary in order to clarify the treatment of a controlled foreign corporation's (CFC) distributive share of partnership income under subpart F. The final regulations will affect United States shareholders of CFCs that have an interest in a partnership.

DATES: *Effective dates:* July 23, 2002.

Applicability date: For dates of applicability of these regulations, see § 1.702–1 (a)(8)(ii), 1.952–1(g)(3), 1.954–1(g)(4), 1.954–2(a)(5)(v), 1.954–3(a)(6)(iii), 1.954–4(b)(2)(iii), 1.956–2(a)(3).

FOR FURTHER INFORMATION CONTACT: Jonathan A. Sambur at (202) 622–3840 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On September 20, 2000, the IRS and Treasury published in the **Federal Register** proposed amendments to the regulations (REG–112502–00, 2000–2 C.B. 316 [65 FR 56836]) under section 702 and subpart F of the Internal Revenue Code (Code). Those proposed regulations substantially restated rules in former proposed regulations, REG–104537–97 (1998–2 C.B. 892 [63 FR 14613]), that were withdrawn in REG–113909–98 (1999–2 C.B. 125 [64 FR 37727]). Written comments were solicited and a public hearing was scheduled for December 5, 2000. Several comments were received and are discussed below. No public hearing was requested, therefore the hearing was cancelled. After consideration of all the comments, the proposed regulations under section 702 and subpart F are adopted as revised by this Treasury decision.

Summary of Public Comments and Explanation of Revisions

A. § 1.702–1(a)(8)(ii) Characterization and Determination of Subpart F Income

Under the proposed regulations, gross income is characterized at the partnership level. If any part of the partnership's gross income is a type of income that would be subpart F income if received directly by partners that are CFCs, that part of the partnership's gross income must be separately taken into account by each partner under section 702. To the extent that the separately stated income results in subpart F income to the CFC partner, it will be taken into account in determining the CFC's total subpart F income for the taxable year.

The proposed regulations under section 702 clarify that an item must be separately taken into account when, if separately taken into account by any partner, the item would result in an income tax liability for that partner, or any other person, different from that which would result if the partner did not take the item into account separately.

One commentator noted that the proposed regulations are inconsistent with section 702(b), which requires that the character and source of an item of gross income be determined at the partnership level, because the proposed regulations require the determination of subpart F income as if the income had been earned by the CFC. That commentator asserted further that the addition of the phrase "or for any other person" in the first sentence of § 1.702–1(a)(8)(ii) goes beyond the regulatory authority provided in section 702(a)(7).

The IRS and Treasury believe there is ample statutory authority for these regulations. The regulations are based upon the authority of subchapter K and subpart F and the policies underlying those provisions. The legislative history of subchapter K provides that, for purposes of interpreting Internal Revenue Code provisions outside of subchapter K, a partnership may be treated as either an entity separate from its partners or an aggregate of its partners, depending on which characterization is more appropriate to carry out the purpose of the particular Internal Revenue Code or regulation section under consideration. *H.R. Conf. Rep. No. 2543, 83rd Cong. 2d. Sess. 59 (1954).*

To allow a CFC to avoid subpart F treatment for items of income through the simple expedient of receiving them as distributive shares of partnership income, rather than directly, is contrary to the intent of subpart F. Subpart F was intended to limit deferral of U.S. income tax on certain types of income received by CFCs. The IRS and Treasury believe that the approach set out in these regulations (which treats the partnership as an entity for certain purposes and as an aggregate for certain purposes) best achieves the purposes of subpart F and is consistent with the policies underlying subchapter K.

Another commentator stated that the requirement of a separate statement of subpart F income by the partnership would be difficult to administer because a foreign partnership generally is not required to prepare a Schedule K for its foreign partners.

The IRS and Treasury do not believe that applying the rules in the regulations will cause significant problems. Because the rules of subpart F target certain specific types of income (*e.g.*, passive income, certain income earned from transactions with related persons), the IRS and Treasury believe that, in most cases, either the partnership, the CFC partner, or both, will be able to determine without significant difficulty the income earned by the partnership that must be separately stated by the CFC partner.

B. § 1.952–1(g) Treatment of Distributive Share of Partnership Income by a CFC Partner

The proposed regulations clarify that the definition of subpart F income includes a CFC's distributive share of any item of gross income of a partnership to the extent the income would have been subpart F income if received directly by the CFC partner. The proposed regulations apply to all partnership interests owned by CFC partners. In the preamble to the proposed regulations, comments were requested about whether these rules should apply for ownership interests that fall below a minimum threshold. This comment was requested because the IRS and Treasury were considering whether to provide that CFCs with a *de minimis* interest in a partnership should not be subject to the regulations (*e.g.*, by analogy to the 10 percent ownership threshold that is used to determine a U.S. shareholder of a CFC).

One comment was received in response to this request. The commentator suggested that the proposed regulations should apply only to controlling partners, *i.e.* partners that hold more than a 50 percent interest. The commentator stated further that this result would be consistent with the subpart F ownership rules and would limit the rule to circumstances where the CFC partner could easily obtain the necessary information to determine whether its distributive share was subpart F income.

The commentator's suggestion of limiting the application of these rules to controlled partnerships was not adopted. The IRS and Treasury do not believe that the objective of the regulations (which, as noted above, is to prevent CFCs from avoiding subpart F by receiving items of income as distributive shares of partnership income, rather than directly) can be achieved by limiting the application of these rules only to controlled partnerships. Further, upon additional consideration, the IRS and Treasury believe that requiring all partnership interests held by a CFC to be subject to the rules of these regulations best effectuates the legislative intent of subpart F and generally should not give rise to significant difficulties for the CFC partner.

C. § 1.954–1(g) Test for Activity and Related Persons

Section 1.954–1(g) of the proposed regulations provides that, generally, in determining whether a distributive share of partnership income is subpart F income, whether an entity is a related person and whether an activity takes place in or outside the country under the laws of which the CFC is organized (*e.g.*, for purposes of determining whether the income qualifies for a "same country" exception to subpart F), shall be determined with respect to the CFC partner and not the partnership.

One commentator objected to the rules in § 1.954–1(g)(1). This commentator stated that the rule represented a "reverse" application of the aggregate theory of partnerships, and was inconsistent with the principles of subchapter K. The IRS and Treasury disagree with this comment. As noted above, subchapter K contemplates applying either an aggregate theory or an entity theory of partnerships, based on the approach that best serves the underlying purposes of the Code or regulations at issue. For purposes of applying the policies of subpart F, which focus in part on whether income is being shifted between a CFC and a related entity in a different country, the IRS and Treasury believe it is appropriate to make the determination of whether an entity is a related person with respect to the CFC, and whether an activity takes place in or outside a CFC's country of incorporation, at the CFC partner level.

The IRS and Treasury also have become aware that some uncertainty exists under the proposed regulations with respect to the application of the related person test to certain purchase and sales transactions occurring between a partnership and its CFC partner. Specifically, where a purchase or sales transaction occurs between the partnership and its CFC partner, including sales or purchases on behalf of the CFC by the partnership, the general rule fails to provide guidance on whether the CFC partner's distributive share of the partnership income is derived from a transaction with a related person.

As a result, the final regulations add a new rule for purposes of making that determination. In general, the final regulations provide that where the partnership enters into a purchase or sales transaction with the CFC partner, the transaction will be treated as a purchase or sales transaction with a related person where the CFC purchased the property that it sells to the partnership from a person related to the CFC or sells the property that it purchased from the partnership to such a related person. This rule also applies to purchases or sales by the CFC on behalf of a related person.

For example, if a partnership sells goods to its CFC partner that it bought from a person unrelated to the CFC, and the CFC partner then sells the goods to a person related to the CFC partner, the sale of goods by the partnership to the CFC will be treated as the sale of personal property to a related person for purposes of determining whether the CFC's distributive share of the partnership income relating to the sale of goods by the partnership is foreign base company sales income. An example has been included in the final regulations to illustrate this rule. In addition, the final regulations provide that when the CFC partner manufactures property that it sells to the partnership and the CFC conducts sales or manufacturing activities through a branch, if the CFC's income from the sale of property to the partnership is foreign base company sales income under the branch rule of section 954(d)(2), the partnership's purchase of this property from the CFC will be treated as the purchase of personal property from a related person. The effect of these two rules is to treat the CFC partner's distributive share of the income earned by the partnership as income earned from a related person transaction if it would have been so treated if the CFC had purchased or sold the property directly, rather than through a partnership.

D. § 1.954–2(a)(5)(ii) Exceptions Applicable to Foreign Personal Holding Company Income

Section 1.954–2(a)(5)(ii) of the proposed regulations provide that only the activities of, and property owned by, the partnership will be taken into account in determining whether the exceptions from foreign personal holding company income contained in section 954(c)(2), (h) and (i) apply.

One commentator argued that applying § 1.954–2(a)(5)(ii) to a CFC with a qualified business unit (QBU) partnership that is seeking to qualify for the active financing exception under section 954(h) produces a result that is inconsistent with the intent of section 954(h). Specifically, section 954(h)(2)(B)(i) provides that a CFC that is engaged in a lending or finance business will be considered an "eligible controlled foreign corporation" for purposes of the active financing exception if the CFC derives more than 70 percent of its gross income directly from the active and regular conduct of a lending or finance business from transactions with unrelated customers. In addition, section 954(h)(3)(B) provides that, in the case of a CFC that conducts a lending or finance business (other than a banking or securities business), no income of the CFC (or QBU of the CFC) will qualify for the active financing exception unless more than 30 percent of the CFC's or QBU's gross income is derived directly from the active conduct of a financing business from transactions with unrelated customers in the CFC or QBU's home country. The commentator stated that section 954(h) appears to provide that the 70 percent test must be applied at the CFC level based on the CFC's income (including branches and partnerships) and the 30 percent test must be applied at the partnership or QBU level.

The proposed regulations, however, require that the determination of whether the 70 percent test and the 30 percent test are met is based solely by reference to the activities of the partnership. The commentator concluded that the proposed regulations are inconsistent with the two-part test in section 954(h) and that applying the rule of the proposed regulations potentially could place a CFC that conducts a financial services business through a partnership in a significantly worse situation than a CFC that conducts a similar business through a branch or disregarded entity.

In response to this comment, the IRS and Treasury have included a new rule in the final regulations that applies the "eligible controlled foreign corporation" requirement under section 954(h)(2), including the 70 percent test of section 954(h)(2)(B)(i), at the CFC partner level (by including in the gross income of the CFC partner any gross income earned by partnerships or other QBUs of the CFC partner), and applies the qualified banking and financing income test (the 30 percent test) under section 954(h)(3) at the partnership level (by including only the gross income of the partnership). In addition, a new rule has been added under § 1.954–2(a)(5)(ii) to clarify that for purposes of applying the special rule for income derived in the active conduct of an insurance business under section 954(i), the exception will apply only if the CFC partner is a qualifying insurance company, as defined in section 953(e)(3) (determined by examining premiums written by the CFC partner and any partnerships or other QBUs of the CFC partner), and the partnership generates qualified insurance income, as defined in section 954(i)(2) (determined by examining only the income earned by the partnership). Two examples have been included in the final regulations that illustrate the operation of these rules.

Another comment was received suggesting that the proposed regulations inappropriately require the partnership, not the CFC partner, to satisfy the active trade or business tests to qualify for the exceptions to the foreign personal holding company rules. The commentator stated that such a rule allows a purely passive investor in a partnership to qualify for the exceptions, contrary to the purposes of subpart F. The commentator argued that, instead, the regulations should apply the active trade or business tests at the CFC partner level, but should provide a rule that limits the attribution of partnership activities to the CFC partners.

This suggestion was not adopted. In general, the IRS and Treasury believe that the policies underlying subpart F are best served by applying the relevant active trade or business tests at the level of the entity that actually earns the income (*i.e.*, the partnership). As noted above, however, the IRS and Treasury believe that, for purposes of determining whether a CFC qualifies for the active financing exception, applying the 70 percent test of section 954(h)(2) (and determining a CFC's qualification as a qualifying insurance company under section 954(i)(2)) at the CFC partner level is consistent with the statutory language of these provisions and best effectuates the legislative intent behind these provisions.

E. § 1.954–4(b)(2)(iii) Application of the Substantial Assistance Rule

The proposed regulations describe how the substantial assistance rules of § 1.954–4(b)(1)(iv) apply when the CFC partner earns services income through the partnership. When the partnership is performing services for a person unrelated to the CFC partner, but the CFC partner, or a related person, provides substantial assistance to the partnership, the CFC partner and the partnership are regarded as separate entities and the substantial assistance provided to the partnership by the CFC partner, or a related person, cause the CFC partner's distributive share of the services income to be treated as foreign base company services income.

Commentators argued that the proposed regulations should not treat the distributive share of the partnership's income as subpart F income if only the CFC partner provides substantial assistance to the partnership because, in that case, under an aggregate theory the CFC does not receive substantial assistance from a related person. This suggestion has not been adopted because the IRS and Treasury believe that excluding the CFC partner from the substantial assistance rule could potentially allow the CFC partner to circumvent the foreign base company service rules with respect to the services it is performing.

Special Analyses

It has been determined that this final regulation 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) and (d) of the Administrative Procedures Act (5 U.S.C. chapter 5) does not apply to these regulations and, because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the proposed regulations preceding these regulations were 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 regulations is Jonathan A. Sambur of the Office of the Associate Chief Counsel (International), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2 Section 1.702–1 is amended as follows:

1. Paragraph (a)(8)(ii) is revised.

2. Paragraph (c)(1)(iii) is amended by removing the word "and".

3. Paragraph (c)(1)(iv) is amended by removing the period at the end and adding "; and" in its place.

4. Paragraph (c)(1)(v) is added.

The addition and revision read as follows:

§ 1.702–1 Income and credits of partner.

(a) * * *

(8) * * *

(ii) Each partner must also take into account separately the partner's distributive share of any partnership item which, if separately taken into account by any partner, would result in an income tax liability for that partner, or for any other person, different from that which would result if that partner did not take the item into account separately. Thus, if any partner is a controlled foreign corporation, as defined in section 957, items of income that would be gross subpart F income if separately taken into account by the controlled foreign corporation must be separately stated for all partners. Under section 911(a), if any partner is a *bona fide* resident of a foreign country who may exclude from gross income the part of the partner's distributive share which qualifies as earned income, as defined in section 911(b), the earned income of the partnership for all partners must be separately stated. Similarly, all relevant items of income or deduction of the partnership must be separately stated for all partners in determining the applicability of section 183 (relating to activities not engaged in for profit) and the recomputation of tax thereunder for any partner. This paragraph (a)(8)(ii) applies to taxable years beginning on or after July 23, 2002.

* * * * *

(c) * * *

(1) * * *

(v) In determining whether the *de minimis* or full inclusion rules of section 954(b)(3) apply.

* * * * *

Par. 3. In § 1.952–1, paragraph (g) is added to read as follows:

§ 1.952–1 Subpart F income defined.

* * * * *

(g) *Treatment of distributive share of partnership income*—(1) *In general*. A controlled foreign corporation's distributive share of any item of income of a partnership is income that falls within a category of subpart F income described in section 952(a) to the extent the item of income would have been income in such category if received by the controlled foreign corporation directly. For specific rules regarding the treatment of a distributive share of partnership income under certain provisions of subpart F, see §§ 1.954–1(g), 1.954–2(a)(5), 1.954–3(a)(6), and 1.954–4(b)(2)(iii).

(2) *Example*. The application of this paragraph (g) may be illustrated by the following example:

Example. CFC, a controlled foreign corporation, is an 80-percent partner in PRS, a foreign partnership. PRS earns $100 of interest income that is not export financing interest as defined in section 954(c)(2)(B), or qualified banking or financing income as defined in section 954(h)(3)(A), from a person unrelated to CFC. This interest income would have been foreign personal holding company income to CFC, under section 954(c), if it had received this income directly. Accordingly, CFC's distributive share of this interest income, $80, is foreign personal holding company income.

(3) *Effective date*. This paragraph (g) applies to taxable years of a controlled foreign corporation beginning on or after July 23, 2002.

Par. 4. In § 1.954–1, paragraph (g) is added to read as follows:

§ 1.954–1 Foreign base company income.

* * * * *

(g) *Distributive share of partnership income*—(1) *Application of related person and country of organization tests*. Unless otherwise provided, to determine the extent to which a controlled foreign corporation's distributive share of any item of gross income of a partnership would have been subpart F income if received by it directly, under § 1.952–1(g), if a provision of subpart F requires a determination of whether an entity is a related person, within the meaning of section 954(d)(3), or whether an activity occurred within or outside the country under the laws of which the controlled foreign corporation is created or organized, this determination shall be made by reference to such controlled foreign corporation and not by reference to the partnership.

(2) *Application of related person test for sales and purchase transactions between a partnership and its controlled foreign corporation partner*. For purposes of determining whether a controlled foreign corporation's distributive share of any item of gross income of a partnership is foreign base company sales income under section 954(d)(1) when the item of income is derived from the sale by the partnership of personal property purchased by the partnership from (or sold by the partnership on behalf of) the controlled foreign corporation; or the sale by the partnership of personal property to (or the purchase of personal property by the partnership on behalf of) the controlled foreign corporation (CFC-partnership transaction), the CFC-partnership transaction will be treated as a transaction with an entity that is a related person, within the meaning of section 954(d)(3), under paragraph (g)(1) of this section, if—

(i) The controlled foreign corporation purchased such personal property from (or sold it to the partnership on behalf of), or sells such personal property to (or purchases it from the partnership on behalf of), a related person with respect to the controlled foreign corporation (other than the partnership), within the meaning of section 954(d)(3); or

(ii) The branch rule of section 954(d)(2) applies to treat as foreign base company sales income the income of the controlled foreign corporation from selling to the partnership (or a third party) personal property that the controlled foreign corporation has manufactured, in the case where the partnership purchases personal property from (or sells personal property on behalf of) the controlled foreign corporation.

(3) *Examples*. The application of this paragraph (g) is illustrated by the following examples:

Example 1. CFC, a controlled foreign corporation organized in Country A, is an 80-percent partner in Partnership, a partnership organized in Country A. All of the stock of CFC is owned by USP, a U.S. corporation. Partnership earns commission income from purchasing Product O on behalf of USP, from unrelated manufacturers in Country B, for sale in the United States. To determine whether CFC's distributive share of Partnership's commission income is foreign base company sales income under section 954(d), CFC is treated as if it purchased Product O on behalf of USP. Under section 954(d)(3), USP is a related person with respect to CFC. Thus, with respect to CFC, the sales income is deemed to be derived from the purchase of personal property on behalf of a related person. Because the property purchased is both manufactured and sold for use outside of Country A, CFC's country of organization, CFC's distributive share of the sales income is foreign base company sales income.

Example 2. (i) CFC1, a controlled foreign corporation organized in Country A, is an 80-percent partner in Partnership, a partnership organized in Country B. CFC2, a controlled foreign corporation organized in Country B, owns the remaining 20 percent interest in Partnership. CFC1 and CFC2 are owned by a common U.S. parent, USP. CFC2 manufactures Product A in Country B. Partnership earns sales income from purchasing Product A from CFC2 and selling it to third parties located in Country B that are not related persons with respect to CFC1 or CFC2. To determine whether CFC1's distributive share of Partnership's sales income is foreign base company sales income under section 954(d), CFC1 is treated as if it purchased Product A from CFC2 and sold it to third parties in Country B. Under section 954(d)(3), CFC2 is a related person with respect to CFC1. Thus, with respect to CFC1, the sales income is deemed to be derived from the purchase of personal property from a related person. Because the property purchased is both manufactured and sold for use outside of Country A, CFC1's country of organization, CFC1's distributive share of the sales income is foreign base company sales income.

(ii) Because Product A is both manufactured and sold for use within CFC2's country of organization, CFC2's distributive share of Partnership's sales income is not foreign base company sales income.

Example 3. CFC, a controlled foreign corporation organized in Country A, is an 80-percent partner in MJK Partnership, a Country B partnership. CFC purchased goods from J Corp, a Country C corporation that is a related person with respect to CFC. CFC sold the goods to MJK Partnership. In turn, MJK Partnership sold the goods to P Corp, a Country D corporation that is unrelated to CFC. P Corp sold the goods to unrelated customers in Country D. The goods were manufactured in Country C by persons unrelated to J Corp . CFC's distributive share of the income of MJK Partnership from the sale of goods to P Corp will be treated as income from the sale of goods purchased from a related person for purposes of section 954(d)(1) because CFC purchased the goods from J Corp, a related person. Because the goods were both manufactured and sold for use outside of Country A, CFC's distributive share of the income attributable to the sale of the goods is foreign base company sales income. Further, CFC's income from the sale of the goods to MJK Partnership will also be foreign base company sales income.

Example 4. The facts of are the same as *Example 3*, except that MJK Partnership purchased the goods from P Corp and sold those goods to CFC. CFC sold the goods to J Corp. J Corp sold the goods to unrelated customers in Country C. CFC's distributive share of the income of MJK Partnership from the sale of the goods by the partnership to itself will be treated as income from the sale of goods to a related person, for purposes of section 954(d)(1). Because the goods were both manufactured and sold for use outside of Country A, CFC's distributive share of income attributable to the sale of the goods is foreign base company sales income. Further, CFC's income from the sale of the goods to J Corp is also foreign base company sales income.

(4) *Effective date*. This paragraph (g) applies to taxable years of a controlled foreign corporation beginning on or after July 23, 2002.

Par. 5. In § 1.954–2, paragraph (a)(5) is added to read as follows:

§ 1.954–2 Foreign personal holding company income.

(a) * * *

(5) *Special rules applicable to distributive share of partnership income* — (i) [Reserved].

(ii) *Certain other exceptions applicable to foreign personal holding company income*. To determine the extent to which a controlled foreign corporation's distributive share of an item of income of a partnership is foreign personal holding company income —

(A) The exceptions contained in section 954(c) that are based on whether the controlled foreign corporation is engaged in the active conduct of a trade or business, including section 954(c)(2) and paragraphs (b)(2) and (6), (e)(1)(ii) and (3)(ii), (iii) and (iv), (f)(1)(ii), (g)(2)(ii), and (h)(3)(ii) of this section, shall apply only if any such exception would have applied to exclude the income from foreign personal holding company income if the controlled foreign corporation had earned the income directly, determined by taking into account only the activities of, and property owned by, the partnership and not the separate activities or property of the controlled foreign corporation or any other person;

(B) A controlled foreign corporation's distributive share of partnership income will not be excluded from foreign personal holding company income under the exception contained in section 954(h) unless the controlled foreign corporation is an eligible controlled foreign corporation within the meaning of section 954(h)(2) (taking into account the income of the controlled foreign corporation and any partnerships or other qualified business units, within the meaning of section 989(a), of the controlled foreign corporation, including the controlled foreign corporation's distributive share of partnership income) and the partnership, of which the controlled foreign corporation is a partner, generates qualified banking or financing income within the meaning of section 954(h)(3) (taking into account only the income of the partnership);

(C) A controlled foreign corporation's distributive share of partnership income will not be excluded from foreign personal holding company income under the exception contained in section 954(i) unless the controlled foreign corporation partner is a qualifying insurance company, as defined in section 953(e)(3) (determined by examining premiums written by the controlled foreign corporation and any partnerships or other qualified business units, within the meaning of section 989(a), of the CFC partner), and the partnership, of which the controlled foreign corporation is a partner, generates qualified insurance income within the meaning of section 954(i)(2) (taking into account only the income of the partnership).

(iii) *Examples*. The application of paragraph (a)(5)(ii) is demonstrated by the following examples:

Example 1. B Corp, a Country C corporation, is a controlled foreign corporation within the meaning of section 957(a). B Corp is an 80-percent partner of RKS Partnership, a Country D partnership whose principal office is located in Country D. RKS Partnership is a qualified business unit of B Corp, within the meaning of section 989(a). B Corp, including income earned through RKS Partnership, derives more than 70 percent of its gross income directly from the active and regular conduct of a lending or finance business, within the meaning of section 954(h)(4), from transactions in various countries with customers which are not related persons. Thus, B Corp is predominantly engaged in the active conduct of a banking, financing, or similar business within the meaning of section 954(h)(2)(A)(i). B Corp conducts substantial activity with respect to such business within the meaning of section 954(h)(2)(A)(ii). RKS Partnership derives more than 30 percent of its income from the active and regular conduct of a lending or finance business, within the meaning of section 954(h)(4), from transactions with customers which are not related persons and which are located solely within the home country of RKS Partnership, Country D. B Corp's distributive share of RKS Partnership's income from its lending or finance business will satisfy the special rule for income derived in the active conduct of banking, financing, or similar business of section 954(h). B Corp is an eligible controlled foreign corporation within the meaning of section 954(h)(2) and RKS Partnership generates qualified banking or financing income within the meaning of section 954(h)(3). B Corp does not have any foreign personal holding company income with respect to its distributive share of RKS Partnership income attributable to its lending or finance business income earned in Country D.

Example 2. D Corp, a Country F corporation, is a controlled foreign corporation within the meaning of section 957(a). D Corp satisfies the requirements of section 953(e)(3) and is a qualifying insurance company. D Corp is a 40-percent partner of DJ Partnership, a Country G partnership. DJ Partnership is a qualified business unit of D Corp, within the meaning of section 989(a), and is licensed by the applicable insurance regulatory body for Country G to sell insurance to persons other than related persons in its home country within the meaning of section 953(e)(4)(A). DJ Partnership receives income from persons who are not related persons, within the meaning of section 954(d)(3), from investments that satisfy the requirements of section 954(i)(2). D Corp's distributive share of DJ Partnership's income from investments that satisfy the requirements of section 954(i)(2) will not be treated as foreign personal holding company income because D Corp will satisfy the special rule of section 954(i) for income derived in the active conduct of insurance business. DJ Partnership is a qualifying insurance company branch within the meaning of section 953(e)(4) and its income is qualified insurance income within the meaning of section 954(i)(2). D Corp does not have any foreign personal holding company income as a result of its distributive share of DJ Partnership income that is attributable to the partnership's qualifying insurance income.

(iv) [Reserved].

(v) *Effective date*. This paragraph (a)(5) applies to taxable years of a controlled foreign corporation beginning on or after July 23, 2002.

* * * * *

Par. 6. In § 1.954–3, paragraph (a)(6) is added to read as follows:

§ 1.954–3 Foreign base company sales income.

(a) * * *

(6) *Special rule applicable to distributive share of partnership income*—(i) *In general*. To determine the extent to which a controlled foreign corporation's distributive share of any item of gross income of a partnership would have been foreign base company sales income if received by it directly, under § 1.952–1(g), the property sold will be considered to be manufactured, produced or constructed by the controlled foreign corporation, within the meaning of paragraph (a)(4) of this section, only if the manufacturing exception of paragraph (a)(4) of this section would have applied to exclude the income from foreign base company sales income if the controlled foreign corporation had earned the income directly, determined by taking into account only the activities of, and property owned by, the partnership and not the separate activities or property of the controlled foreign corporation or any other person.

(ii) *Example*. The application of paragraph (a)(6)(i) of this section is illustrated by the following example:

Example. CFC, a controlled foreign corporation organized under the laws of Country A, is an 80-percent partner in Partnership X, a partnership organized under the laws of Country B. Partnership X performs activities in Country B that would constitute the manufacture of Product O, within the meaning of paragraph (a)(4) of this section, if performed directly by CFC. Partnership X, through its sales offices in Country B, then sells Product O to Corp D, a corporation that is a related person with respect to CFC, within the meaning of section 954(d)(3), for use within Country B. CFC's distributive share of Partnership X's sales income is not foreign base company sales income because the manufacturing exception of paragraph (a)(4) of this section would have applied to exclude the income from foreign base company sales income if CFC had earned the income directly.

(iii) *Effective date*. This paragraph (a)(6) applies to taxable years of a controlled foreign corporation beginning on or after July 23, 2002.

* * * * *

Par. 7. In § 1.954–4, paragraph (b)(2)(iii) is added to read as follows:

§ 1.954–4 Foreign base company services income.

* * * * *

(b) * * *

(2) * * *

(iii) *Special rule applicable to distributive share of partnership income*. A controlled foreign corporation's distributive share of a partnership's services income will be deemed to be derived from services performed for or on behalf of a related person, within the meaning of section 954(e)(1)(A), if the partnership is a related person with respect to the controlled foreign corporation, under section 954(d)(3), and, in connection with the services performed by the partnership, the controlled foreign corporation, or a person that is a related person with respect to the controlled foreign corporation, provided assistance that would have constituted substantial assistance contributing to the performance of such services, under paragraph (b)(2)(ii) of this section, if furnished to the controlled foreign corporation by a related person. This paragraph (b)(2)(iii) applies to taxable years of a controlled foreign corporation beginning on or after July 23, 2002.

* * * * *

Par. 8. In § 1.956–2, paragraph (a)(3) is added to read as follows:

§ 1.956–2 Definition of United States property.

(a) * * *

(3) *Property owned through partnership*. For purposes of section 956, if a controlled foreign corporation is a partner in a partnership that owns property that would be United States property, within the meaning of paragraph (a)(1) of this section, if owned directly by the controlled foreign corporation, the controlled foreign corporation will be treated as holding an interest in the property equal to its interest in the partnership and such interest will be treated as an interest in United States property. This paragraph (a)(3) applies to taxable years of a controlled foreign corporation beginning on or after July 23, 2002.

* * * * *

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

Approved July 16, 2002.

Pamela F. Olson,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on July 22, 2002, 8:45 a.m., and published in the Federal Register for July 23, 2002, 67 F.R. 48020)

Section 6041.—Information at Source

26 CFR 1.6041–1: Return of information as to payments of $600 or more.

T.D. 9010

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1, 5f, 31, and 602

Information Reporting Requirements for Certain Payments Made on Behalf of Another Person, Payments to Joint Payees, and Payments of Gross Proceeds from Sales Involving Investment Advisors

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations

SUMMARY: This document contains regulations under section 6041 that provide information reporting requirements for escrow agents and other persons making payments on behalf of another person, clarify who is the payee for information reporting purposes if a check or other instrument is made payable to joint payees, and clarify the amount to be reported. This document also contains regulations under section 6045 that incorporate the provisions of temporary regulations, which are removed, and that remove investment advisors from the list of exempt recipients.

DATES: *Effective date:* These regulations are effective January 1, 2003.

Applicability date: For dates of applicability of these regulations, see §§ 1.6041–1(j), 1.6045–1(c)(3)(C)(xii), 1.6049–4(a)(2), and 31.3406(a)–2(d).

FOR FURTHER INFORMATION CONTACT: Nancy L. Rose at (202) 622–4910 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information requirement 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 1545–1705. Responses to this collection of information are mandatory.

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 estimate of the reporting burden in § 1.6041–1 is reflected in the burden of Form 1099-MISC. The estimate of the reporting burden in § 1.6045–1 is reflected in the burden of Form 1099-B.

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

Background

This document contains amendments to the Income Tax Regulations (26 CFR parts 1 and 5f) and Employment Tax Regulations (26 CFR part 31). These regulations finalize proposed regulations relating to payments to joint payees, payments made on behalf of another person, and payments of gross proceeds from sales involving investment advisors. A notice of proposed rulemaking (REG–246249–96, 2000–2 C.B. 439 [65 FR 61292]) was published in the **Federal Register** on October 17, 2000. A public hearing was held on February 7, 2001, at which two commentators presented oral comments. The IRS also received other written comments responding to the notice of proposed rulemaking. 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 and Summary of Comments

1. Payments Made on Behalf of Another Person

Comments were received requesting further clarification as to the meaning of the terms *management or oversight functions* and *significant economic interest* in § 1.6041–1(e)(1) of the proposed regulations. In response to these comments, the final regulations add language that was included in the preamble to the proposed regulations, explaining that a person who merely writes checks at another's direction is not exercising management or oversight with respect to the payment and that a person has a significant economic interest in a payment when such interest would be compromised if the payment were not made.

One commentator stated that an agent cannot perform management or oversight functions in connection with payments it receives and remits to its principal, and, therefore, an agent for a payee could never be required to report a payment to the payee under this standard. The commentator recommended that § 1.6041–1(e)(1) of the proposed regulations be revised to apply only to payments made by agents to third parties.

The determination of whether a person performs management or oversight functions with respect to a payment made on behalf of another, or has a significant economic interest in connection with such payment, is a factual one. Whether an agent has a reporting obligation under these standards must, therefore, be determined in each instance based on the particular facts and circumstances. The standards set forth in the proposed regulations are intended to apply to all persons making payments on behalf of another, whether they are making such payments on behalf of the payor or payee in a transaction. In keeping with the need for uniformity and consistency in this regard, the regulations also amend § 31.3406(a)–2 to eliminate the current distinction between payor agents and payee agents with respect to the obligation to backup withhold on payments. Therefore, while in some cases an agent for a payee may not be required to report a payment to its principal, the final regulation does not adopt the commentator's suggestion to eliminate the potential applicability of the regulation to all such payments.

With respect to one type of payee agent, however, the final regulation does contain an exception to the rules set forth in paragraph (e)(1). The final regulation adds paragraph (e)(3) exempting from information reporting payments made by an employee to his employer, in recognition of the principle that the employee received such payment from a third party and remitted it to his employer in the course of his employment. *Example 11* is added to illustrate this exception.

Comments were also received with respect to special reporting exceptions. One commentator asked that the current rule with respect to financial institutions be retained. The proposed regulations removed § 1.6041–3(n), which provided that banks making payments on an infrequent and isolated basis would not be subject to the reporting requirements. Banks will therefore now be subject to the same standards as other persons in determining whether they have an obligation to report payments. If a bank exercises management or oversight functions over a payment, or has a significant economic interest in the payment, it will have a reporting obligation regardless of how frequently it makes such payments. Although this is a change that imposes a new reporting burden on financial institutions, the burden is no different than the one that applies to other persons, and the final regulations therefore do not adopt this suggestion.

Another commentator asked that we eliminate the reporting requirements for real estate agents, found in § 1.6041–3(d), as they conflict with the proposed regulations under § 1.6041–1. The proposed regulations made conforming amendments to § 1.6041–3(d), but retained the existing provision that rent paid by real estate agents is reportable, by cross-reference to the provisions of § 1.6041–1 (a). We believe it is appropriate to require such agents to report under these regulations; therefore, we decline to adopt this comment. The final regulations do, however, change the term *real estate agents* to *rental agents* to more accurately describe the type of person who would be collecting rent from a tenant and remitting it to a landlord.

One commentator asked that the regulations clarify that insurance companies do not have a "significant economic interest" in payments they make to third parties pursuant to contracts with policyholders. Because this is a factual determination which should be made on a case by case basis, this suggestion was not adopted in the final regulations.

Several commentators expressed concern that more than one person might report the same payment pursuant to these rules. One commentator stated that a service-recipient might be obligated to report the payment made on his behalf, while the person making the payment might also report it. Another commentator described a situation where funds were transferred through several parties involved in a construction project before reaching the ultimate payee and each of the parties might meet the management or oversight/significant economic interest standard for reporting the payments.

Several of the examples illustrate the correct reporting of a payment by the parties to a transaction. In the event that several parties might be viewed as meeting the tests for reporting under § 1.6041–1(e) of the regulations, the final regulations set forth the rule that the party closest in the chain to the payee must report the payment, unless the parties agree, in writing, that one of the other parties meeting the test for reporting will report the payment. *Example 12* has been added to § 1.6041–1(e) of the regulations to illustrate this rule. This provision is not intended to preclude the optional method to report under § 1.6041–1(e)(4) of the regulations.

A commentator suggested that in *Ex-*

ample 3, dealing with an agent who performs real estate closings, we clarify that the term *settlement agent* can include a number of different persons who perform real estate closings, such as title companies or title insurance underwriters. Since these examples are meant to be illustrative only, and since any person making a payment on behalf of another person is subject to these regulations, it is not necessary to list all possible individuals who may be performing the functions described in this example. Therefore, the final regulations do not adopt this suggestion.

2. Amount to be Reported

One commentator objected to the rule in § 1.6041–1(f) of the proposed regulations that the amount to be reported is the gross amount, before fees and other expenses are deducted. The commentator pointed out the conflicting case law with respect to the issue of whether attorneys fees are income to the client. The final regulations provide that in cases in which the gross amount is income, the gross amount should be reported regardless of any expenses, commissions or other obligations, including backup withholding, that were deducted from the amount before the check was issued. To assist taxpayers in determining whether the gross amount or some lesser amount is includible in a particular payee's income, the Commissioner may provide guidance in the Internal Revenue Bulletin with examples. Example 1 in § 1.6041–1(f) has been modified to illustrate this rule.

In response to a comment, we have added a cross-reference to section 6045(f) of the Internal Revenue Code and the regulations thereunder in the examples in § 1.6041–1(f).

3. Obsolescence of Revenue Rulings

One commentator asked that we include a statement in the regulations or commentary that the regulations render obsolete any revenue rulings that are factually encompassed by the proposed rules and that all other revenue rulings pertaining to third party payments would remain in effect unless specifically deemed obsolete.

The preamble to the proposed regulations stated that "Rulings that are factually encompassed by the proposed regulations will be obsoleted." A list of revenue rulings to become obsolete was included. The notice of proposed rulemaking also requested comments that identified other factually relevant rulings. No such comments were received. As the proposed regulations made clear that revenue rulings factually encompassed by the proposed regulations would be obsoleted and enumerated those rulings, there is no need to include this commentator's suggestion.

Another commentator recommended that Rev. Rul. 69–595, 1969–2 C.B. 242, and Rev. Rul. 70–608, 1970–2 C.B. 286, both of which were listed in the notice of proposed rulemaking as obsoleted by the proposed regulations, be obsoleted only to the extent they are inconsistent with the proposed regulations. The two revenue rulings cited contain guidance relating to the definition of medical service payments, which the commentator felt should be retained.

Rev. Rul. 70–608 is listed in the notice of proposed rulemaking as obsoleted only with respect to Situations 1, 2, and 5. Therefore, Situation 4 of the revenue ruling, which includes a description of medical service payments, was not obsoleted. Rev. Rul. 69–595 will likewise not be obsoleted with respect to the definition of medical service payments.

Effect on Other Documents

The following revenue rulings are obsolete as of January 1, 2003:

Rev. Rul. 93–70, 1993–2 C.B. 294

Rev. Rul. 85–50, 1985–1 C.B. 345

Rev. Rul. 77–53, 1977–1 C.B. 368

Rev. Rul. 73–232, 1973–1 C.B. 541

Rev. Rul. 70–608, 1970–2 C.B. 286, Situations 1, 2, and 5

Rev. Rul. 69–595, 1969–2 C.B. 242, except with respect to the definition of medical service payments.

Rev. Rul. 67–197, 1967–1 C.B. 319

Rev. Rul. 65–129, 1965–1 C.B. 519

Rev. Rul. 64–36, 1964–1 C.B. 446

Rev. Rul. 59–328, 1959–2 C.B. 379

Rev. Rul. 55–606, 1955–2 C.B. 489

Rev. Rul. 54–571, 1954–2 C.B. 235

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. A final regulatory flexibility analysis under 5 U.S.C. section 604 has been prepared for the collection of information in this Treasury decision. This analysis is set forth in this preamble under the heading "Final Regulatory Flexibility Analysis." Pursuant to section 7805(f), the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Final Regulatory Flexibility Analysis

The collection of information contained in § 1.6041–1(e) is needed to clarify the requirements for filing an information return under section 6041 when a person makes a payment on behalf of another person or to joint payees. The objectives of the proposed regulations are to provide uniform, practicable, and administrable rules under section 6041 for persons making payments on behalf of another person or to joint payees. The types of small entities to which the regulations may apply are small businesses. An estimate of the number of small entities affected is not feasible because of the large variety of entities and transactions to which the regulations may apply.

There are no known Federal rules that duplicate, overlap or conflict with these regulations. The regulations are considered to have the least economic impact on small entities of all alternatives considered.

The collection of information contained in § 1.6045–1(c)(3) will not have a significant economic impact on a substantial number of small entities. The regulations will relieve investment advisors of the requirement to make information returns under section 6045(a), and few, if any, financial custodians that maybe affected by the regulations are small entities.

Drafting Information

The principal author of these regulations is Nancy L. Rose of Office of the Associate Chief Counsel (Procedure and Administration).

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1, 5f, 31, 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 1.6041–1 also issued under 26 U.S.C. 6041(a). * * *

Par. 2. Section 1.6041–1 is amended as follows:

1. In paragraph (b)(1), the second sentence is amended by removing the language "paragraph (g)" and adding the language "paragraph (i)" in its place.

2. Paragraph (c) is amended by adding two sentences after the penultimate sentence.

3. Paragraphs (e), (f), and (g) are redesignated as paragraphs (g), (h), and (i), respectively.

4. Adding new paragraphs (e), (f), and (j).

The additions read as follows:

§ 1.6041–1 Return of information as to payments of $600 or more.

* * * * *

(c) * * * A payment made jointly to two or more payees may be fixed and determinable income to one payee even though the payment is not fixed and determinable income to another payee. For example, property insurance proceeds paid jointly to the owner of damaged property and to a contractor that repairs the property may be fixed and determinable income to the contractor but not fixed and determinable income to the owner, and should be reported to the contractor. * * *

* * * * *

(e) *Payment made on behalf of another person*—(1) *In general*. A person that makes a payment in the course of its trade or business on behalf of another person is the payor that must make a return of information under this section with respect to that payment if the payment is described in paragraph (a) of this section and, under all the facts and circumstances, that person—

(i) Performs management or oversight functions in connection with the payment (this would exclude, for example, a person who performs mere administrative or ministerial functions such as writing checks at another's direction); or

(ii) Has a significant economic interest in the payment (*i.e.*, an economic interest that would be compromised if the payment were not made, such as by creation of a mechanic's lien on property to which the payment relates, or a loss of collateral).

(2) *Determination of payor obligated to report*. If two or more persons meet the requirements for making a return of information with respect to a payment, as set forth in paragraph (e)(1) of this section, the person obligated to report the payment is the person closest in the chain to the payee, unless the parties agree in writing that one of the other parties meeting the requirements set forth in paragraph (e)(1) of this section will report the payment.

(3) *Special rule for payment by employee to employer*. Notwithstanding the provisions of paragraph (e)(1) of this section, an employee acting in the course of his employment who makes a payment to his employer on behalf of another person is not required to make a return of information with respect to that payment.

(4) *Optional method to report*. A person that makes a payment on behalf of another person but is not required to make an information return under paragraph (e)(1) of this section may elect to do so pursuant to the procedures established by the Commissioner. See, *e.g.*, Rev. Proc. 84–33, 1984–1 C.B. 502, (optional method for a paying agent to report and deposit amounts withheld for payors under the statutory provisions of backup withholding) (see § 601.601(d)(2) of this chapter).

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

Example 1. Bank B provides financing to C, a real estate developer, for a construction project. B makes disbursements from the account for labor, materials, services, and other expenses related to the construction project. In connection with the payments, B performs the following functions: approves payments to the general contractor or subcontractors; ensures that loan proceeds are properly applied and that all approved bills are properly paid to avoid mechanics' or materialmen's liens; conducts site inspections to determine whether work has been completed (but does not check the quality of the work). B is performing management or oversight functions in connection with the payments and is subject to the information reporting requirements of section 6041 with respect to payments.

Example 2. Mortgage company D holds a mortgage on business property owned by E. When the property is damaged by a storm, E's insurance company issues a check payable to both D and E in settlement of E's claim. Pursuant to the contract between D and E, D holds the insurance proceeds in an escrow account and makes disbursements, according to E's instructions, to contractors and subcontractors performing repairs on the property. D is not performing management or oversight functions, but D has a significant economic interest in the payments because the purpose of the arrangement is to ensure that property on which D holds a mortgage is repaired or replaced. D is subject to the information reporting requirements of section 6041 with respect to the payments to contractors.

Example 3. Settlement agent F provides real estate closing services to real estate brokers and agents. F deposits money received from the buyer or lender in an escrow account and makes payments from the account to real estate agents or brokers, appraisers, land surveyors, building inspectors, or similar service providers according to the provisions of the real estate contract and written instructions from the lender. F may also make disbursements pursuant to oral instructions of the seller or purchaser at closing. F is not performing management or oversight functions and does not have a significant economic interest in the payments, and is not subject to the information reporting requirements of section 6041. For the rules relating to F's obligation to report the gross proceeds of the sale, see section 6045(e) and § 1.6045–4.

Example 4. Assume the same facts as in *Example 3*. In addition, the seller instructs F to hire a contractor to perform repairs on the property. F selects the contractor, negotiates the cost, monitors the progress of the project, and inspects the work to ensure it complies with the contract. With respect to the payments to the contractor, F is performing management or oversight functions and is subject to the information reporting requirements of section 6041.

Example 5. G is a rental agent who manages certain rental property on behalf of property owner H. G finds tenants, arranges leases, collects rent, responds to tenant inquiries regarding maintenance, and hires and makes payments to repairmen. G subtracts her commission and any maintenance payments from rental payments and remits the remainder to H. With respect to payments to repairmen, G is performing management or oversight functions and is subject to the information reporting requirements of section 6041. With respect to the payment of rent to H, G is subject to the information reporting requirements of section 6041 regardless of whether she performs management or oversight functions or has a significant economic interest in the payment. See § 1.6041–3(d) for rules relating to rental agents. See § 1.6041–1(f) to determine the amount that G should report to H as rent.

Example 6. Literary agent J receives a payment from publisher L of fees earned by J's client, author K. J deposits the payment into a bank account in J's name. From time to time and as directed by K, J makes payments from these funds to attorneys, managers, and other third parties for services rendered to K. After subtracting J's commission, J pays K the net amount. J does not order or direct the provision of services by the third parties to K, and J exercises no discretion in making the payments to the third parties or to K. J is not performing management or oversight functions and does not have a significant economic interest in the payments and is not subject to the information reporting requirements of section 6041 in connection with the payments to K or to the third parties. For the rules relating to L's obligation to report the payment of the fees to K, see paragraphs (a)(1)(i) and (f) of this section. For the rules relating to K's obligation to report the payment of the commission to J and the payments to the third parties for services, see paragraphs (a)(1)(i) and (d)(2) of this section.

Example 7. Attorney P deposits into a client trust fund a settlement payment from R, the defendant in a breach of contract action for lost profits in which P represented plaintiff Q. P makes payments from the client trust fund to service providers such as expert witnesses and private investigators for expenses incurred in the litigation. P decides whom to hire, negotiates the amount of payment, and determines that the services have been satisfactorily performed. In the event of a dispute with a service provider, P withholds payment until the dispute is settled. With respect to payments to the service providers, P is performing management or oversight functions and is subject to the information reporting requirements of section 6041.

Example 8. Assume the same facts as in *Example 7*. In addition, assume that after paying the service providers and deducting his legal fee, P pays Q the remaining funds that P had received from the settlement with R. With respect to the payment to Q, P is not performing management or oversight functions, does not have a significant economic interest in the payment, and is not subject to the information reporting requirements of section 6041. For the rules relating to R's obligation to report the payment of the settlement proceeds to P, see section 6045(f) and the regulations thereunder. For the rules relating to R's obligation to report the payment of the settlement proceeds to Q, see paragraphs (a)(1)(i) and (f) of this section. For the rules relating to Q's obligation to report the payment of attorney fees to P, see paragraphs (a)(1)(i) and (d)(2) of this section.

Example 9. Medical insurer S operates as the administrator of a health care program under a contract with a state. S makes payments of government funds to health care providers who provide care to eligible patients. S receives and reviews claims submitted by patients or health care providers, determines if the claims meet all the requirements of the program (*e.g.*, that the care is authorized and that the patients are eligible beneficiaries), and determines the amount of payment. S is performing management or oversight functions and is subject to the information reporting requirements of section 6041 with respect to the payments.

Example 10. Race track employee T holds deposits made by horse owner U in a special escrow account in U's name. U enters into a contract with jockey V to ride U's horse in a race at the track. As directed by U, T pays V the fee for riding U's horse from U's escrow account. T is not performing management or oversight functions, does not have a significant economic interest in the payment, and is not subject to the information reporting requirements of section 6041. For the rules relating to U's obligation to report the payment of the fee to V, see paragraph (a)(1)(i) of this section.

Example 11. X is a certified public accountant employed by Firm Y, and is not a partner. Client Z pays X directly for accounting services. X remits the amount received to Y, as required by the terms of his employment. X does not have any reporting obligation with respect to the payment to Y. For the rules relating to Z's obligation to report the payment to Y for services, see paragraphs (a)(1)(i) and (d)(2) of this section.

Example 12. Bank contracts with Title Company with respect to the disbursement of funds on a construction loan. Pursuant to their arrangement, the contractor sends draw requests to Title Company, which inspects the work, verifies the amount requested, and then sends the draw request to Bank with supporting documents. Bank pays Title Company the amount of the draw request, and Title Company insures Bank against any loss if it cannot obtain the necessary lien waivers. Bank has a significant economic interest in the payment as a mortgagee, and Title Company exercises management or oversight over the payment. Since Title Company is closest in the chain to the contractor, Title Company should report the payment, unless the parties agree in writing that Bank will report the payment.

(f) *Amount to be reported when fees, expenses or commissions are deducted*—(1) *In general*. The amount to be reported as paid to a payee is the amount includible in the gross income of the payee (which in many cases will be the gross amount of the payment or payments before fees, commissions, expenses, or other amounts owed by the payee to another person have been deducted), whether the payment is made jointly or separately to the payee and another person. The Commissioner may, by guidance published in the Internal Revenue Bulletin, illustrate the circumstances under which the gross amount or less than the gross amount may be reported.

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

Example 1. Attorney P represents client Q in a breach of contract action for lost profits against defendant R. R settles the case for $100,000 damages and $40,000 for attorney fees. Under applicable law, the full $140,000 is includible in Q's gross taxable income. R issues a check payable to P and Q in the amount of $140,000. R is required to make an information return reporting a payment to Q in the amount of $140,000. For the rules with respect to R's obligation to report the payment to P, see section 6045(f) and the regulations thereunder.

Example 2. Assume the same facts as in *Example 1*, except that R issues a check to Q for $100,000 and a separate check to P for $40,000. R is required to make an information return reporting a payment to Q in the amount of $140,000. For the rules with respect to R's obligation to report the payment to P, see section 6045(f) and the regulations thereunder.

* * * * *

(j) *Effective date*. The provisions of paragraphs (b), (c), (e), and (f) apply to payments made after December 31, 2002.

Par. 3. Section 1.6041–3 is amended as follows:

1. Revising paragraph (d).
2. Removing paragraph (n) and redesignating paragraphs (o), (p) and (q) as paragraphs (n), (o) and (p), respectively.

The revisions read as follows:

§ 1.6041–3 Payments for which no return of information is required under section 6041.

* * * * *

(d) Payments of rent made to rental agents (but the agent is required to report payments of rent to the landlord in accordance with § 1.6041–1(a)(1)(i)(B) and (2)).

* * * * *

Par. 4. Section 1.6045–1 is amended as follows:

1. Revising paragraph (a) introductory text.
2. Revising paragraphs (c)(3) and (c)(4).
3. In paragraph (g)(3)(iv), first and third sentences, removing the language "§ 5f.6045–1(c)(3) of this chapter" and adding "paragraph (c)(3) of this section" in its place.
4. In paragraph (g)(4) *Examples 1*, *4*,

5, *6*, *7*(i), *8*(i), and *9*(i), removing the language "§ 5f.6045–1(c)(3)(ii) of this chapter" and adding "paragraph (c)(3)(iii) of this section" in its place in each place it appears.

The revisions read as follows:

§ 1.6045–1 Returns of information of brokers and barter exchanges.

(a) *Definitions*. The following definitions apply for purposes of this section and §1.6045–2:

* * * * *

(c) * * *

(3) *Exceptions*—(i) *Sales effected for exempt recipients*—(A) *In general*. No return of information is required with respect to a sale effected for a customer that is an exempt recipient under paragraph (c)(3)(i)(B) of this section.

(B) *Exempt recipient defined*. The term *exempt recipient* means—

(*1*) A corporation as defined in section 7701(a)(3), whether domestic or foreign;

(*2*) An organization exempt from taxation under section 501(a) or an individual retirement plan;

(*3*) The United States or a State, the District of Columbia, a possession of the United States, a political subdivision of any of the foregoing, a wholly owned agency or instrumentality of any one or more of the foregoing, or a pool or partnership composed exclusively of any of the foregoing;

(*4*) A foreign government, a political subdivision thereof, an international organization, or any wholly owned agency or instrumentality of the foregoing;

(*5*) A foreign central bank of issue as defined in § 1.895–1(b)(1) (*i.e.*, a bank that is by law or government sanction the principal authority, other than the government itself, issuing instruments intended to circulate as currency);

(*6*) A dealer in securities or commodities registered as such under the laws of the United States or a State;

(*7*) A futures commission merchant registered as such with the Commodity Futures Trading Commission;

(*8*) A real estate investment trust (as defined in section 856);

(*9*) An entity registered at all times during the taxable year under the Investment Company Act of 1940 (15 U.S.C. 80a–1, *et seq.*);

(*10*) A common trust fund (as defined in section 584(a)); or

(*11*) A financial institution such as a bank, mutual savings bank, savings and loan association, building and loan association, cooperative bank, homestead association, credit union, industrial loan association or bank, or other similar organization.

(C) *Exemption certificate*. A broker may treat a person described in paragraph (c)(3)(i)(B) of this section as an exempt recipient based on a properly completed exemption certificate (as provided in § 31.3406(h)–3) of this chapter, on the broker's actual knowledge that the payee is a person described in paragraph (c)(3)(i)(B), or on the applicable indicators described in § 1.6049–4(c)(1)(ii)(A) through (M). A broker may require an exempt recipient to file a properly completed exemption certificate and may treat an exempt recipient that fails to do so as a recipient that is not exempt.

(ii) *Excepted sales*. No return of information is required with respect to a sale effected by a broker for a customer if the sale is an excepted sale. For this purpose, a sale is an excepted sale if it is so designated by the Internal Revenue Service in a revenue ruling or revenue procedure (see § 601.601(d)(2) of this chapter).

(iii) *Multiple brokers*. If a broker is instructed to initiate a sale by a person that is an exempt recipient described in paragraph (c)(3)(i)(B)(*6*), (*7*), or (*11*) of this section, no return of information is required with respect to the sale by that broker. In a redemption of stock or retirement of securities, only the broker responsible for paying the holder redeemed or retired, or crediting the gross proceeds on the sale to that holder's account, is required to report the sale.

(iv) *Cash on delivery transactions*. In the case of a sale of securities through a cash on delivery account, a delivery versus payment account, or other similar account or transaction, only the broker that receives the gross proceeds from the sale against delivery of the securities sold is required to report the sale. If, however, the broker's customer is another broker (second-party broker) that is an exempt recipient, then only the second-party broker is required to report the sale.

(v) *Fiduciaries and partnerships*. No return of information is required with respect to a sale effected by a custodian or trustee in its capacity as such or a redemption of a partnership interest by a partnership, provided the sale is otherwise reported by the custodian or trustee on a properly filed Form 1041, or the redemption is otherwise reported by the partnership on a properly filed Form 1065, and all Schedule K-1 reporting requirements are satisfied.

(vi) *Sales at issue price*. No return of information is required with respect to a sale of an interest in a regulated investment company that can hold itself out as a money market fund under Rule 2a–7 under the Investment Company Act of 1940 that computes its current price per share for purposes of distributions, redemptions, and purchases so as to stabilize the price per share at a constant amount that approximates its issue price or the price at which it was originally sold to the public.

(vii) *Obligor payments on certain obligations*. No return of information is required with respect to payments representing obligor payments on—

(A) Nontransferable obligations (including savings bonds, savings accounts, checking accounts, and NOW accounts);

(B) Obligations as to which the entire gross proceeds are reported by the broker on Form 1099 under provisions of the Internal Revenue Code other than section 6045 (including stripped coupons issued prior to July 1, 1982); or

(C) Retirement of short-term obligations (*i.e.*, obligations with a fixed maturity date not exceeding 1 year from the date of issue) that have original issue discount, as defined in section 1273(a)(1), with or without application of the *de minimis* rule.

(D) Demand obligations that also are callable by the obligor and that have no premium or discount.

(viii) *Foreign currency*. No return of information is required with respect to a sale of foreign currency other than a sale pursuant to a forward contract or regulated futures contract that requires delivery of foreign currency.

(ix) *Fractional share*. No return of information is required with respect to a sale of a fractional share of stock if the gross proceeds on the sale of the fractional share are less than $20.

(x) *Certain retirements*. No return of information is required from an issuer or its agent with respect to the retirement of book entry or registered form obligations as to which the relevant books and records indicate that no interim transfers have occurred.

(xi) *Cross reference*. For an exception for certain sales of agricultural commodities and certificates issued by the Commodity Credit Corporation after January 1, 1993, see paragraph (c)(7) of this section.

(xii) *Effective date*. The provisions of this paragraph (c)(3) apply for sales effected after December 31, 2002.

(4) *Examples*. The following examples illustrate the application of the rules in paragraph (c)(3) of this section:

Example 1. P, an individual who is not an exempt recipient, places an order with B, a person generally known in the investment community to be a federally registered broker/dealer, to effect a sale of P's stock in a publicly traded corporation. B, in turn, places an order to sell the stock with C, a second broker, who will execute the sale. B discloses to C the identity of the customer placing the order. C is not required to make a return of information with respect to the sale because C was instructed by B, an exempt recipient as defined in paragraph (c)(3)(i)(B)(*6*) of this section, to initiate the sale. B is required to make a return of information with respect to the sale because P is B's customer and is not an exempt recipient.

Example 2. Assume the same facts as in *Example 1* except that B has an omnibus account with C so that B does not disclose to C whether the transaction is for a customer of B or for B's own account. C is not required to make a return of information with respect to the sale because C was instructed by B, an exempt recipient as defined in paragraph (c)(3)(i)(B)(*6*) of this section, to initiate the sale. B is required to make a return of information with respect to the sale because P is B's customer and is not an exempt recipient.

Example 3. D, an individual who is not an exempt recipient, enters into a cash on delivery stock transaction by instructing K, a federally registered broker/dealer, to sell stock owned by D, and to deliver the proceeds to L, a custodian bank. Concurrently with the above instructions, D instructs L to deliver D's stock to K (or K's designee) against delivery of the proceeds from K. The records of both K and L with respect to this transaction show an account in the name of D. Pursuant to paragraph (h)(1) of this section, D is considered the customer of K and L. Under paragraph (c)(3)(iv) of this section, K is not required to make a return of information with respect to the sale because K will pay the gross proceeds to L against delivery of the securities sold. L is required to make a return of information with respect to the sale because D is L's customer and is not an exempt recipient.

Example 4. Assume the same facts as in *Example 3* except that E, a federally registered investment advisor, instructs K to sell stock owned by D and to deliver the proceeds to L. Concurrently with the above instructions, E instructs L to deliver D's stock to K (or K's designee) against delivery of the proceeds from K. The records of both K and L with respect to the transaction show an account in the name of D. Pursuant to paragraph (h)(1) of this section, D is considered the customer of K and L. Under paragraph (c)(3)(iv) of this section, K is not required to make a return of information with respect to the sale because K will pay the gross proceeds to L against delivery of the securities sold. L is required to make a return of information with respect to the sale because D is L's customer and is not an exempt recipient.

Example 5. Assume the same facts as in *Example 4* except that the records of both K and L with respect to the transaction show an account in the name of E. Pursuant to paragraph (h)(1) of this section, E is considered the customer of K and L. Under paragraph (c)(3)(iv) of this section, K is not required to make a return of information with respect to the sale because K will pay the gross proceeds to L against delivery of the securities sold. L is required to make a return of information with respect to the sale because E is L's customer and is not an exempt recipient. E is required to make a return of information with respect to the sale because D is E's customer and is not an exempt recipient.

Example 6. F, an individual who is not an exempt recipient, owns bonds that are held by G, a federally registered broker/dealer, in an account for F with G designated as nominee for F. Upon the retirement of the bonds, the gross proceeds are automatically credited to the account of F. G is required to make a return of information with respect to the retirement because G is the broker responsible for making payments of the gross proceeds to F.

* * * * *

Par. 5. In § 1.6045–2, paragraph (b)(2)(ii), is amended by removing the language "§ 5f.6045–1(c)(3)(i)(B) of the Temporary Income Tax Regulations under the Tax Equity and Fiscal Responsibility Act of 1982" and adding the language "§ 1.6045–1(c)(3)(i)(B)" in its place.

Par. 6. In § 1.6049–4, paragraph (a)(2) is revised to read as follows:

§ 1.6049–4 Return of information as to interest paid and original issue discount includible in gross income after December 31, 1982.

(a) * * *

(2) *Payor*. For payments made after December 31, 2002, a payor is a person described in paragraph (a)(2)(i) or (ii) of this section.

(i) Every person who makes a payment of the type and of the amount subject to reporting under this section (or under an applicable section under this chapter) to any other person during a calendar year.

(ii) Every person who collects on behalf of another person payments of the type and of the amount subject to reporting under this section (or under an applicable section under this chapter), or who otherwise acts as a middleman (as defined in paragraph (f)(4) of this section) with respect to such payment.

* * * * *

PART 5f—TEMPORARY INCOME TAX REGULATIONS UNDER THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982

Par. 7. The authority citation for part 5f is amended by removing the authority citation for "Sec. 5f.6045–1" to read in part as follows:

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

Par. 8. Section 5f.6045–1 is removed.

PART 31—EMPLOYMENT TAXES AND COLLECTION OF INCOME TAX AT SOURCE

Par. 9. The authority citation for part 31 continues to read in part as follows:

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

Par. 10. Section 31.3406–0 is amended by:

1. Revising the entry in the table for § 31.3406(a)–2, paragraph (b).

2. Adding an entry to the table for § 31.3406(a)–2, paragraph (d).

The revision and addition read as follows:

§ 31.3406–0 Outline of the backup withholding regulations.

* * * * *

§ 31.3406(a)–2 Definition of payors obligated to backup withhold.

* * * * *

(b) Persons treated as payors.

* * * * *

(d) Effective date.

* * * * *

Par. 11. Section 31.3406(a)–2 is revised to read as follows:

§ 31.3406(a)–2 Definition of payors obligated to backup withhold.

(a) *In general*. *Payor* means the person that is required to make an information return under section 6041, 6041A(a), 6042, 6044, 6045, 6049, 6050A, or 6050N, with respect to any reportable payment (as described in section 3406(b)), or that is described in paragraph (b) of this section.

(b) *Persons treated as payors*. The following persons are treated as payors for purposes of section 3406—

(1) A grantor trust established after December 31, 1995, all of which is owned by two or more grantors (treating for this purpose spouses filing a joint return as one grantor);

(2) A grantor trust with ten or more grantors established on or after January 1, 1984, but before January 1, 1996;

(3) A common trust fund; and

(4) A partnership or an S corporation that makes a reportable payment.

(c) *Persons not treated as payors*. A person on the following list is not treated as a payor for purposes of section 3406 if the person does not have a reporting obligation under the section on information reporting to which the payment relates—

(1) A trust (other than a grantor trust as described in paragraph (b)(1) or (2) of this section) that files a Form 1041 containing information required to be shown on an information return, including amounts withheld under section 3406; or

(2) A partnership making a payment of a distributive share or an S corporation making a similar distribution.

(d) *Effective date*. The provisions of this section apply to payments made after December 31, 2002.

Par. 12. Section 31.3406(a)–4 is amended as follows:

1. In paragraph (c)(1), first sentence, removing the language "Any middleman (as defined in § 31.3406(a)–2(b))" and adding "A person that is a middleman and is a person defined in § 31.3406(a)–2(b) or in the section on information reporting to which the payment relates" in its place.

2. In paragraph (c)(3), first sentence, removing the language "§ 31.3406(a)–2(b)(4)" and adding "§ 31.3406(a)–2(b)(1) or (2)" in its place.

Par. 13. In § 31.3406(b)(3)–2, paragraph (b)(5) is amended by removing the language "§ 5f.6045–1(c)(3)(ix)" and adding "§ 1.6045–1(c)(3)(x)" in its place.

Par. 14. In § 31.3406(d)–4, paragraph (a)(1) introductory text is amended by removing the language "the payor of the instrument (as defined in § 31.3406 (a)–2(b)(3))," and adding "a broker holding a security (including stock) for a customer in street name," in its place.

Par. 15. In § 31.3406(h)–1, paragraph (c), second sentence, is amended by removing the language "§ 5f.6045–1 (c)(3)(ii) and (iii)" and adding "§ 1.6045 –1(c)(3)(iii) and (iv)" in its place.

Par. 16. Section 31.3406(h)–2 is amended as follows:

1. In paragraph (c), third sentence, removing the language "with two or more grantors described in § 31.3406(a)–2(b) (4), which is treated as a middleman payor" and adding "described in § 31.3406(a)–2(b)(1) or (2), which is treated as a payor" in its place.

2. In paragraph (d), first sentence, removing the language "A middleman payor (as defined in § 31.3406(a)–2(b))" and adding "A middleman payor (as defined in § 31.3406(a)–2(b) or in the section on information reporting to which the payment relates)" in its place.

3. In paragraph (f)(6), removing the language § 31.3406(a)–2(a)" and adding "§ 31.3406(a)–2" in its place.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 17. The authority citation for part 602 continues to read in part as follows:

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

Par. 18. In section 602.101, paragraph (b) is amended by adding the following OMB Control numbers 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.
* * * * *	
1.6041–1	1545–1705
* * * * *	
1.6045–1	1545–1705
* * * * *	

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved July 17, 2002.

Pamela F. Olson,
Acting Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on July 25, 2002, 8:45 a.m., and published in the Federal Register for July 26, 2002, 67 F.R. 48754)

Section 7122.—Compromises

26 CFR 301.7122–1: Compromises.

T.D. 9007

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 301

Compromise of Tax Liabilities

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final regulations relating to the compromise of internal revenue taxes. The regulations adopt the rules of the temporary regulations and reflect changes to the law made by the Internal Revenue Service Restructuring and Reform Act of 1998 and the Taxpayer Bill of Rights 2.

EFFECTIVE DATE: These regulations are effective July 18, 2002.

FOR FURTHER INFORMATION CONTACT: Frederick W. Schindler at (202) 622–3620 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains final regulations amending the Procedure and Administration Regulations (26 CFR part 301) under section 7122 of the Internal Revenue Code (Code). The regulations reflect the amendment of section 7122 by section 3462 of the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 1998), Public Law 105–206 (112 Stat. 685, 764) and by section 503 of the Taxpayer Bill of Rights II, Public Law 104–168 (110 Stat. 1452, 1461).

As amended by RRA 1998, section 7122 provides that the Secretary will develop guidelines to determine when an offer to compromise is adequate and should be accepted to resolve a dispute. The legislative history accompanying RRA 1998 explains that Congress intended that, in certain circumstances, factors such as equity, hardship, and public policy be taken into account by the IRS in evaluating whether the compromise of individual tax liabilities would promote effective tax administration. H. Conf. Rep. 599, 105th Cong., 2d Sess. 289 (1998). On July 21, 1999, temporary regulations (T.D. 8829, 1999–2 C.B. 235 [64 FR 39020]) and a notice of proposed rulemaking (REG-116991–98, 1999–2 C.B. 242 [64 FR 39106]) reflecting these changes were published in the **Federal Register**. Four written comments on the temporary and proposed regulations were received. A public hearing on the regulations was requested but that request was later withdrawn. No public hearing was scheduled or held. The final regulations adopt the rules of the temporary regulations with minor changes.

Explanation of Provisions

A compromise is an agreement between a taxpayer and the Government that settles a tax liability for payment of less than the total amount determined and assessed. Consistent with its mission of applying the tax laws with integrity and fairness to all, the IRS generally expects that all taxpayers will pay the total amount due, regardless of amount. See Policy Statement P-5-2, Collecting Principles (Approved February 17, 2000), reprinted at IRM 1.2.1.5.2. When attempting to resolve a tax delinquency, the IRS will work with taxpayers to achieve full payment of all tax, penalties, and interest imposed by Congress. Where payment in full cannot immediately be achieved, the IRS may, at its discretion, allow taxpayers to pay over time through installment agreements.

The IRS recognizes that it is both sound business practice and good tax policy to settle some cases for less than the total amount due. Prior to issuance of the temporary regulations, the IRS had a longstanding practice of compromising where there was doubt as to the existence or amount of the tax liability or doubt that the total amount due could be collected. The final regulations continue these traditional grounds for compromise. In addition, to reflect the changes made by RRA 1998, the final regulations allow compromise where there is no doubt as to liability or as to collectibility, but where compromise would promote effective tax administration because either (1) collection of the liability would create economic hardship, or (2) compelling public policy or equity considerations provide a sufficient basis for compromising the liability. Compromise based on these hardship and public policy/equity bases, however, may not be authorized if compromise would undermine compliance with the tax laws.

Effective Tax Administration — Economic Hardship

The final regulations retain the reference in the temporary regulations to the economic hardship standard of § 301.6343–1, which defines economic hardship as the inability to pay reasonable basic living expenses. In determining reasonable basic living expenses, § 301.6343–1 directs the IRS to consider relevant information such as the taxpayer's age, employment status and history, number of dependents, and other "unique circumstances." The final regulations supplement this standard by providing a non-exclusive list of factors which support a finding of economic hardship, and by providing examples to illustrate application of the standard.

The fourth example of economic hardship in the temporary regulations, involving a business taxpayer, has been removed in order to eliminate an inconsistency. The economic hardship standard of § 301.6343–1 specifically applies only to individuals. The fourth example was included in the temporary regulations in the event that a standard for evaluating economic hardship with respect to non-individuals could be developed. After evaluating this issue further, the IRS and Treasury Department have concluded that an economic hardship standard for non-individuals does not necessarily promote effective tax administration. Permitting compromise in non-individual cases where there is no doubt as to collectibility, for instance, would raise the issue of whether the Government should be foregoing the collection of taxes to support a nonviable business.

Although economic hardship therefore is not a basis for compromise for non-individuals under the final regulations, IRS experience has shown that the doubt as to collectibility standard often may permit the resolution of cases involving businesses and other non-individual taxpayers. In addition, even if a business or other non-individual is unable to compromise on liability or collectibility grounds, compelling public policy or equity considerations (discussed below) may provide sufficient grounds to compromise the case.

A commenting party suggested that the economic hardship standard and examples were not inclusive enough, specifically stating that the first two examples of economic hardship in the temporary regulations were drawn too narrowly. The first example illustrating economic hardship described a taxpayer whose assets and income are likely to be exhausted caring for a dependent child. The commenting party believed that the regulations would better promote effective tax administration if the example were expanded to include care of a dependent parent or other family member. The second example described a retired taxpayer whose only income is from a pension and whose only asset is a retirement account. The taxpayer could pay the tax liability in full by liquidating his retirement account, but doing so would leave the taxpayer without adequate means of support. The commenting party suggested that the example should specifically state that the age of the taxpayer should be taken into account. Otherwise, a taxpayer close to retirement age may feel compelled to retire so as to eliminate other sources of income and qualify under this example since retirement funds would then be the only source of income. A second commenting party also suggested that the moral or legal obligation to support others be listed as a factor supporting a finding of economic hardship.

The final regulations adopt these suggestions, in part, by stating that one factor supporting a finding of economic hardship might be that all available funds are used for the care of a dependent. Although the final regulations include examples to illustrate the application of the economic hardship standard, the central inquiry is whether full collection of the liability would render the taxpayer unable to provide for reasonable basic living expenses. Facts such as the number of dependents and the age and health of taxpayers and their dependents are factors which § 301.6343–1 provides should be considered when making that economic hardship determination. Furthermore, the examples in the final regulations are not intended to be exclusive and should not be read to suggest that all of the facts discussed in a given example must be present in a case in order for compromise to be authorized.

Effective Tax Administration — Public Policy and Equity

The temporary regulations provided that the IRS may compromise a liability to promote effective tax administration even if no other basis for compromise is available. (As discussed above, compromise on the basis of economic hardship is not available to non-individuals under the final regulations.) The temporary regulations provided that the IRS may compromise under the non-hardship effective tax administration standard to promote effective tax administration when, "[r]egardless of the taxpayer's financial circumstances, exceptional circumstances exist such that collection of the full liability will be detrimental to voluntary compliance by taxpayers."

The "detrimental to voluntary compliance" standard in the temporary regulations was intended to indicate that the IRS may compromise in those rare cases where collection of the full liability would adversely affect the overall tax system. Based on public comments and on IRS experience in implementing the temporary regulations, this standard has been restated in the final regulations to clarify the types of cases that may qualify for compromise on these grounds. Compromise under the non-hardship effective tax administration standard in the final regulations, however, still is expected to be appropriate only in those rare cases where collection would adversely affect the overall tax system.

Under the final regulations, a taxpayer seeking to compromise a liability on this basis must identify compelling public policy or equity considerations providing a sufficient basis for compromising the liability. The circumstances must be such that compromise is justified even though a similarly situated taxpayer may have paid his liability in full. Before accepting an offer based on equity and public policy considerations, the IRS must conclude that collection of the full liability would undermine public confidence that the tax laws are being administered in a fair and equitable manner.

The clarification to the non-hardship effective tax administration standard in the final regulations recognizes that compromise on these grounds raises the issue of disparate treatment of taxpayers who are able to pay the full amount of their liabilities without economic hardship. Some taxpayers will pay less than the full amount owed, while others must pay in full. (Some taxpayers who pay in full also may be in situations similar to that of the taxpayer requesting compromise.) Accordingly, the final regulations specify that a taxpayer must demonstrate that the circumstances of the taxpayer's liability implicate public policy or equity concerns compelling enough to justify compromise notwithstanding this inherent inequity. As noted earlier, the cases satisfying the equity and public policy standard are expected to be rare. In applying this standard, the IRS will presume that the correct application of the tax laws produces a fair and equitable result, absent exceptional circumstances.

The notice of proposed rulemaking specifically encouraged the public to make comments or provide examples regarding the particular types of cases or situations in which the Secretary's authority to compromise should be used because: (1) collection of the full amount of tax liability would be detrimental to voluntary compliance (*i.e.*, may be appropriate for compromise under the non-hardship effective tax administration standard) or (2) IRS delay in determining the tax liability has resulted in the accumulation of significant interest and penalties. Parties providing comments regarding delay in interest and penalty cases were asked to consider the possible interplay between cases compromised under this provision and the relief accorded taxpayers under section 6404(e).

Two parties submitted comments in response to this request. Both suggested that the regulations be expanded to authorize compromise in situations where delay in determining the taxpayer's liability caused substantial interest and penalties to accrue. The first suggested that compromise on the basis that collection in full would be detrimental to voluntary compliance was warranted when any undue delay by the IRS resulted in the accumulation of penalties and interest. The commenting party suggested that the regulations include delay by the IRS in determining the taxpayer's liability, issuing a revenue agent's report or notice of deficiency, or litigating the issues as factors and examples supporting compromise on these grounds. The commenting party did not suggest a standard for determining "undue delay" and did not discuss whether this kind of expansion of the compromise regulations would undermine the interest abatement provisions of section 6404(e).

The second party to comment on this provision in the regulations suggested compromise should be authorized where a liability results from factors beyond the taxpayer's control and the accumulation of interest and penalties is disproportionately large compared to the initial liability. The specific example suggested by the commenting party was one in which the Tax Matters Partner (TMP) in a partnership subject to the unified audit procedures of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) fraudulently sells shares in a sham business to other partners and those partners incur substantial interest and penalties attributable to partnership items. According to the commenting party, the failure of the IRS to remove a TMP being investigated for fraud relating to the partnership, and to allow the TMP to continue to represent the partnership during the audit, creates "exceptional circumstances" warranting compromise with other partners. The commenting party acknowledged that section 6404(e) would not usually authorize the abatement of interest under such circumstances because the interest does not result from an unreasonable error or delay by an IRS official in performing a ministerial or managerial act. The commenting party also acknowledged that it would be unwise to craft a rule that would make the Government an insurer of individual taxpayer liabilities attributable to the misdeeds of a tax shelter promoter. However, the commenting party believed that where the IRS's failure to remove the TMP contributed to the problem, compromise is warranted.

The IRS and Treasury Department do not believe that it would promote effective tax administration to authorize compromise solely on the basis of an asserted delay by the IRS, particularly delay that does not support relief under section 6404(e) with respect to accrued interest, or on the basis that a third party, such as the taxpayer's partner, is claimed to have defrauded or otherwise caused financial harm to the taxpayer. Nevertheless, cases in which a taxpayer believes the liability was caused, in whole or in part, by delay on the part of the IRS or by the actions of third parties may be appropriate for compromise under the public policy and equity standard. Such cases, however, are expected to be rare, as the taxpayer must identify compelling public policy or equity concerns that satisfy the standard set forth above.

The IRS and Treasury Department are mindful that the Congressional Conference Committee, in adding section 7122(c) as part of RRA 1998, anticipated that the IRS may use the authority provided in section 7122(c) to resolve longstanding cases by foregoing penalties and interest resulting from delays in determining a taxpayer's liability. See H. Conf. Rep. 599, 105th Cong., 2d Sess. 289 (1998). The IRS' experience in applying the temporary regulations is that these regulations have given effect to the intent of Congress, as expressed in the Conference Report, since cases involving substantial interest and penalties often can be compromised under the standards of doubt as to collectibility and economic hardship. Similarly, although a taxpayer is in the best position to anticipate, and protect himself or herself from, the risks of business associations and transactions, the misdeeds of third parties that may have contributed to a tax liability may be taken into account when determining whether to accept a compromise based on doubt as to collectibility or on a finding that collection would cause economic hardship.

Amount of Compromise if Basis for Compromise Exists

The final regulations set forth the permissible bases for compromise, one of which must be established in order to accept an offer to compromise liabilities arising under the internal revenue laws. They do not, however, prescribe the amount which must be offered in order for an offer to be acceptable. The amount to be paid, future compliance, or other conditions precedent to satisfaction of a liability for less than the full amount due are matters left to the discretion of the Secretary. For the sake of clarity, the final regulations now expressly state this principle, which was stated only in the preamble to the temporary regulations.

As required by section 7122(c)(2)(A) and (B), added by RRA 1998, the final regulations provide for the development and publication of national and local living allowances that permit taxpayers entering into offers to compromise to have an adequate means to provide for their basic living expenses. The determination of whether the published standards should be applied in any particular case must be based upon an evaluation of the individual facts and circumstances presented. The Secretary will continue to determine the appropriate means to publish these national and local living allowances.

A commenting party suggested that the national and local living allowance standards be eliminated in favor of a rule requiring all offer specialists to look only to an individual taxpayer's actual facts and circumstances to determine the amount necessary to provide for reasonable basic living expenses. According to the commenting party, IRS employees rarely depart from the national and local standards, which, in practice, serve as a "cap" on expenses, rather than as a general guide to be applied based on the specific facts of a case.

Because publication of the national and local standards is required by section 7122(c)(2)(A), the suggestion that the standards be eliminated has not been adopted. In accordance with section 7122(c)(2)(B), the final regulations require that the IRS consider the facts and circumstances of the case when determining basic living expenses. Consistent with this requirement in the statute and regulations, the IRS has issued internal guidance requiring that the particular facts and circumstance of a taxpayer's case be considered whenever the expense standards are applied, and that expense allowances beyond the standards be used whenever use of the standards would result in a taxpayer not having adequate means to provide for basic living expenses.

Other Provisions

Section 7122(c)(3)(A) prohibits the rejection of an offer to compromise by a low income taxpayer based solely on the amount of the offer. The final regulations expand this rule to apply to all taxpayers regardless of income level. The final regulations state that no offer may be rejected based solely on the amount of the offer. Offers will only be rejected when the IRS determines that no basis for compromise under this section is present or that the offer is unacceptable under the Secretary's policies and procedures.

In accordance with section 7122(d)(1), the final regulations provide that all proposed rejections of offers to compromise will receive independent administrative review prior to final rejection. Section 7122(d)(2) requires and the regulations also provide that the taxpayer may appeal any rejection of an offer to compromise to the IRS Office of Appeals. The final regulations provide, however, that when the IRS returns an offer to compromise because the offer was submitted solely to delay collection, or because the taxpayer failed to provide requested information required by the IRS to evaluate or process the offer under IRS procedures, the return of the offer does not constitute a rejection and, thus, is not subject to appeal. In the event that the IRS institutes collection action following the return of an offer to compromise, the taxpayer may have the right to consideration of the whole of his collection case under other provisions of the Code.

Although not required by any provision of the Code, the temporary regulations provided that an offer could not be returned to a taxpayer for failure to submit requested financial information until an independent administrative review of the proposed return was completed. The requirement of an independent administrative review of proposed returns was the source of significant delays and was redundant because an IRS manager must review and approve all returns of offers for failure to submit requested financial information. The final regulations therefore require review only by an IRS manager in these cases.

Pursuant to section 6331(k), the final regulations also provide that the IRS may not levy to collect a liability while an offer to compromise is pending, or for the 30 days following any rejection of an offer to compromise, or during any period that an appeal of any rejection is being considered, when such appeal is instituted within the 30 days following rejection. Levy will not, however, be precluded in any case where collection is in jeopardy or the offer to compromise was submitted solely to delay collection. The regulations also correct for an omission in the temporary regulations by providing that the IRS may not refer a case to the Department of Justice to collect an unpaid tax through a judicial proceeding while an offer to compromise that tax is pending or while a rejection of such an offer is being considered by the IRS Office of Appeals. The IRS may, however, authorize the Department of Justice to file a counterclaim in any refund proceeding commenced by a taxpayer, participate in bankruptcy or insolvency cases commenced by or against the taxpayer, or join a taxpayer in any other proceeding in which liability for the tax at issue may be established or disputed.

The final regulations also implement section 503(a) of the Taxpayer Bill of Rights II by specifying that Chief Counsel review of an accepted offer to compromise is required only for offers in compromise involving $50,000 or more in unpaid liabilities.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the preceding temporary 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 author of these regulations is Frederick W. Schindler of the Office of Associate Chief Counsel (Procedure and Administration), Collection, Bankruptcy & Summonses Division.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 301 is 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. Sections 301.7122–0 and 301.7122–1 are added to read as follows:

§ 301.7122–0 Table of contents.

This section lists the major captions that appear in the regulations under § 301. 7122–1.

§ 301.7122–1 Compromises.

(a) In general.

(b) Grounds for compromise.

(c) Special rules for the evaluation of offers to compromise.

(d) Procedures for submission and consideration of offers.

(e) Acceptance of an offer to compromise a tax liability.

(f) Rejection of an offer to compromise.

(g) Effect of offer to compromise on collection activity

(h) Deposits.

(i) Statute of limitations.

(j) Inspection with respect to accepted offers to compromise.

(k) Effective date.

§ 301.7122–1 Compromises.

(a) *In general*—(1) If the Secretary determines that there are grounds for compromise under this section, the Secretary may, at the Secretary's discretion, compromise any civil or criminal liability arising under the internal revenue laws prior to reference of a case involving such a liability to the Department of Justice for prosecution or defense.

(2) An agreement to compromise may relate to a civil or criminal liability for taxes, interest, or penalties. Unless the terms of the offer and acceptance expressly provide otherwise, acceptance of an offer to compromise a civil liability does not remit a criminal liability, nor does acceptance of an offer to compromise a criminal liability remit a civil liability.

(b) *Grounds for compromise*—(1) *Doubt as to liability*. Doubt as to liability exists where there is a genuine dispute as to the existence or amount of the correct tax liability under the law. Doubt as to liability does not exist where the liability has been established by a final court decision or judgment concerning the existence or amount of the liability. See paragraph (f)(4) of this section for special rules applicable to rejection of offers in cases where the Internal Revenue Service (IRS) is unable to locate the taxpayer's return or return information to verify the liability.

(2) *Doubt as to collectibility*. Doubt as to collectibility exists in any case where the taxpayer's assets and income are less than the full amount of the liability.

(3) *Promote effective tax administration*. (i) A compromise may be entered into to promote effective tax administration when the Secretary determines that, although collection in full could be achieved, collection of the full liability would cause the taxpayer economic hardship within the meaning of § 301.6343–1.

(ii) If there are no grounds for compromise under paragraphs (b)(1), (2), or (3)(i) of this section, the IRS may compromise to promote effective tax administration where compelling public policy or equity considerations identified by the taxpayer provide a sufficient basis for compromising the liability. Compromise will be justified only where, due to exceptional circumstances, collection of the full liability would undermine public confidence that the tax laws are being administered in a fair and equitable manner. A taxpayer proposing compromise under this paragraph (b)(3)(ii) will be expected to demonstrate circumstances that justify compromise even though a similarly situated taxpayer may have paid his liability in full.

(iii) No compromise to promote effective tax administration may be entered into if compromise of the liability would undermine compliance by taxpayers with the tax laws.

(c) *Special rules for evaluating offers to compromise*—(1) *In general*. Once a basis for compromise under paragraph (b) of this section has been identified, the decision to accept or reject an offer to compromise, as well as the terms and conditions agreed to, is left to the discretion of the Secretary. The determination whether to accept or reject an offer to compromise will be based upon consideration of all the facts and circumstances, including whether the circumstances of a particular case warrant acceptance of an amount that might not otherwise be acceptable under the Secretary's policies and procedures.

(2) *Doubt as to collectibility*—(i) *Allowable Expenses*. A determination of doubt as to collectibility will include a determination of ability to pay. In determining ability to pay, the Secretary will permit taxpayers to retain sufficient funds to pay basic living expenses. The determination of the amount of such basic living expenses will be founded upon an evaluation of the individual facts and circumstances presented by the taxpayer's case. To guide this determination, guidelines published by the Secretary on national and local living expense standards will be taken into account.

(ii) *Nonliable spouses*—(A) *In general*. Where a taxpayer is offering to compromise a liability for which the taxpayer's spouse has no liability, the assets and income of the nonliable spouse will not be considered in determining the amount of an adequate offer. The assets and income of a nonliable spouse may be considered, however, to the extent property has been transferred by the taxpayer to the nonliable spouse under circumstances that would permit the IRS to effect collection of the taxpayer's liability from such property (*e.g.*, property that was conveyed in fraud of creditors), property has been transferred by the taxpayer to the nonliable spouse for the purpose of removing the property from consideration by the IRS in evaluating the compromise, or as provided in paragraph (c)(2)(ii)(B) of this section. The IRS also may request information regarding the assets and income of the nonliable spouse for the purpose of verifying the amount of and responsibility for expenses claimed by the taxpayer.

(B) *Exception*. Where collection of the taxpayer's liability from the assets and income of the nonliable spouse is permitted by applicable state law (*e.g.*, under state community property laws), the assets and income of the nonliable spouse will be considered in determining the amount of an adequate offer except to the extent that the taxpayer and the nonliable spouse demonstrate that collection of such assets and income would have a material and adverse impact on the standard of living of the taxpayer, the nonliable spouse, and their dependents.

(3) *Compromises to promote effective tax administration*—(i) Factors supporting (but not conclusive of) a determination that collection would cause economic hardship within the meaning of paragraph (b)(3)(i) of this section include, but are not limited to—

(A) Taxpayer is incapable of earning a living because of a long term illness, medical condition, or disability, and it is reasonably foreseeable that taxpayer's financial resources will be exhausted providing for care and support during the course of the condition;

(B) Although taxpayer has certain monthly income, that income is exhausted each month in providing for the care of dependents with no other means of support; and

(C) Although taxpayer has certain assets, the taxpayer is unable to borrow against the equity in those assets and liquidation of those assets to pay outstanding tax liabilities would render the taxpayer unable to meet basic living expenses.

(ii) Factors supporting (but not conclusive of) a determination that compromise would undermine compliance within the meaning of paragraph (b)(3)(iii) of this section include, but are not limited to—

(A) Taxpayer has a history of noncompliance with the filing and payment requirements of the Internal Revenue Code;

(B) Taxpayer has taken deliberate actions to avoid the payment of taxes; and

(C) Taxpayer has encouraged others to refuse to comply with the tax laws.

(iii) The following examples illustrate the types of cases that may be compromised by the Secretary, at the Secretary's discretion, under the economic hardship provisions of paragraph (b)(3)(i) of this section:

Example 1. The taxpayer has assets sufficient to satisfy the tax liability. The taxpayer provides full time care and assistance to her dependent child, who has a serious long-term illness. It is expected that the taxpayer will need to use the equity in his assets to provide for adequate basic living expenses and medical care for his child. The taxpayer's overall compliance history does not weigh against compromise.

Example 2. The taxpayer is retired and his only income is from a pension. The taxpayer's only asset is a retirement account, and the funds in the account are sufficient to satisfy the liability. Liquidation of the retirement account would leave the taxpayer without an adequate means to provide for basic living expenses. The taxpayer's overall compliance history does not weigh against compromise.

Example 3. The taxpayer is disabled and lives on a fixed income that will not, after allowance of basic living expenses, permit full payment of his liability under an installment agreement. The taxpayer also owns a modest house that has been specially equipped to accommodate his disability. The taxpayer's equity in the house is sufficient to permit payment of the liability he owes. However, because of his disability and limited earning potential, the taxpayer is unable to obtain a mortgage or otherwise borrow against this equity. In addition, because the taxpayer's home has been specially equipped to accommodate his disability, forced sale of the taxpayer's residence would create severe adverse consequences for the taxpayer. The taxpayer's overall compliance history does not weigh against compromise.

(iv) The following examples illustrate the types of cases that may be compromised by the Secretary, at the Secretary's discretion, under the public policy and equity provisions of paragraph (b)(3)(ii) of this section:

Example 1. In October of 1986, the taxpayer developed a serious illness that resulted in almost continuous hospitalizations for a number of years. The taxpayer's medical condition was such that during this period the taxpayer was unable to manage any of his financial affairs. The taxpayer has not filed tax returns since that time. The taxpayer's health has now improved and he has promptly begun to attend to his tax affairs. He discovers that the IRS prepared a substitute for return for the 1986 tax year on the basis of information returns it had received and had assessed a tax deficiency. When the taxpayer discovered the liability, with penalties and interest, the tax bill is more than three times the original tax liability. The taxpayer's overall compliance history does not weigh against compromise.

Example 2. The taxpayer is a salaried sales manager at a department store who has been able to place $2,000 in a tax-deductible IRA account for each of the last two years. The taxpayer learns that he can earn a higher rate of interest on his IRA savings by moving those savings from a money management account to a certificate of deposit at a different financial institution. Prior to transferring his savings, the taxpayer submits an e-mail inquiry to the IRS at its Web Page, requesting information about the steps he must take to preserve the tax benefits he has enjoyed and to avoid penalties. The IRS responds in an answering e-mail that the taxpayer may withdraw his IRA savings from his neighborhood bank, but he must redeposit those savings in a new IRA account within 90 days. The taxpayer withdraws the funds and redeposits them in a new IRA account 63 days later. Upon audit, the taxpayer learns that he has been misinformed about the required rollover period and that he is liable for additional taxes, penalties and additions to tax for not having redeposited the amount within 60 days. Had it not been for the erroneous advice that is reflected in the taxpayer's retained copy of the IRS e-mail response to his inquiry, the taxpayer would have redeposited the amount within the required 60-day period. The taxpayer's overall compliance history does not weigh against compromise.

(d) *Procedures for submission and consideration of offers*—(1) *In general*. An offer to compromise a tax liability pursuant to section 7122 must be submitted according to the procedures, and in the form and manner, prescribed by the Secretary. An offer to compromise a tax liability must be made in writing, must be signed by the taxpayer under penalty of perjury, and must contain all of the information prescribed or requested by the Secretary. However, taxpayers submitting offers to compromise liabilities solely on the basis of doubt as to liability will not be required to provide financial statements.

(2) *When offers become pending and return of offers*. An offer to compromise becomes pending when it is accepted for processing. The IRS may not accept for processing any offer to compromise a liability following reference of a case involving such liability to the Department of Justice for prosecution or defense. If an offer accepted for processing does not contain sufficient information to permit the IRS to evaluate whether the offer should be accepted, the IRS will request that the taxpayer provide the needed additional information. If the taxpayer does not submit the additional information that the IRS has requested within a reasonable time period after such a request, the IRS may return the offer to the taxpayer. The IRS may also return an offer to compromise a tax liability if it determines that the offer was submitted solely to delay collection or was otherwise nonprocessable. An offer returned following acceptance for processing is deemed pending only for the period between the date the offer is accepted for processing and the date the IRS returns the offer to the taxpayer. See paragraphs (f)(5)(ii) and (g)(4) of this section for rules regarding the effect of such returns of offers.

(3) *Withdrawal*. An offer to compromise a tax liability may be withdrawn by the taxpayer or the taxpayer's representative at any time prior to the IRS' acceptance of the offer to compromise. An offer will be considered withdrawn upon the IRS' receipt of written notification of the withdrawal of the offer either by personal delivery or certified mail, or upon issuance of a letter by the IRS confirming the taxpayer's intent to withdraw the offer.

(e) *Acceptance of an offer to compromise a tax liability*. (1) An offer to compromise has not been accepted until the IRS issues a written notification of acceptance to the taxpayer or the taxpayer's representative.

(2) As additional consideration for the acceptance of an offer to compromise, the IRS may request that taxpayer enter into any collateral agreement or post any security which is deemed necessary for the protection of the interests of the United States.

(3) Offers may be accepted when they provide for payment of compromised amounts in one or more equal or unequal installments.

(4) If the final payment on an accepted offer to compromise is contingent upon the immediate and simultaneous release of a tax lien in whole or in part, such payment must be made in accordance with the forms, instructions, or procedures prescribed by the Secretary.

(5) Acceptance of an offer to compromise will conclusively settle the liability of the taxpayer specified in the offer. Compromise with one taxpayer does not extinguish the liability of, nor prevent the IRS from taking action to collect from, any person not named in the offer who is also liable for the tax to which the compromise relates. Neither the taxpayer nor the Government will, following acceptance of an offer to compromise, be permitted to reopen the case except in instances where—

(i) False information or documents are supplied in conjunction with the offer;

(ii) The ability to pay or the assets of the taxpayer are concealed; or

(iii) A mutual mistake of material fact sufficient to cause the offer agreement to be reformed or set aside is discovered.

(6) *Opinion of Chief Counsel*. Except as otherwise provided in this paragraph (e)(6), if an offer to compromise is accepted, there will be placed on file the opinion of the Chief Counsel for the IRS with respect to such compromise, along with the reasons therefor. However, no such opinion will be required with respect to the compromise of any civil case in which the unpaid amount of tax assessed (including any interest, additional amount, addition to the tax, or assessable penalty) is less than $50,000. Also placed on file will be a statement of—

(i) The amount of tax assessed;

(ii) The amount of interest, additional amount, addition to the tax, or assessable penalty, imposed by law on the person against whom the tax is assessed; and

(iii) The amount actually paid in accordance with the terms of the compromise.

(f) *Rejection of an offer to compromise*.

(1) An offer to compromise has not been rejected until the IRS issues a written notice to the taxpayer or his representative, advising of the rejection, the reason(s) for rejection, and the right to an appeal.

(2) The IRS may not notify a taxpayer or taxpayer's representative of the rejection of an offer to compromise until an independent administrative review of the proposed rejection is completed.

(3) No offer to compromise may be rejected solely on the basis of the amount of the offer without evaluating that offer under the provisions of this section and the Secretary's policies and procedures regarding the compromise of cases.

(4) *Offers based upon doubt as to liability*. Offers submitted on the basis of doubt as to liability cannot be rejected solely because the IRS is unable to locate the taxpayer's return or return information for verification of the liability.

(5) *Appeal of rejection of an offer to compromise*—(i) *In general*. The taxpayer may administratively appeal a rejection of an offer to compromise to the IRS Office of Appeals (Appeals) if, within the 30-day period commencing the day after the date on the letter of rejection, the taxpayer requests such an administrative review in the manner provided by the Secretary.

(ii) *Offer to compromise returned following a determination that the offer was nonprocessable, a failure by the taxpayer to provide requested information, or a determination that the offer was submitted for purposes of delay*. Where a determination is made to return offer documents because the offer to compromise was nonprocessable, because the taxpayer failed to provide requested information, or because the IRS determined that the offer to compromise was submitted solely for purposes of delay under paragraph (d)(2) of this section, the return of the offer does not constitute a rejection of the offer for purposes of this provision and does not entitle the taxpayer to appeal the matter to Appeals under the provisions of this paragraph (f)(5). However, if the offer is returned because the taxpayer failed to provide requested financial information, the offer will not be returned until a managerial review of the proposed return is completed.

(g) *Effect of offer to compromise on collection activity*—(1) *In general.* The IRS will not levy against the property or rights to property of a taxpayer who submits an offer to compromise, to collect the liability that is the subject of the offer, during the period the offer is pending, for 30 days immediately following the rejection of the offer, and for any period when a timely filed appeal from the rejection is being considered by Appeals.

(2) *Revised offers submitted following rejection*. If, following the rejection of an offer to compromise, the taxpayer makes a good faith revision of that offer and submits the revised offer within 30 days after the date of rejection, the IRS will not levy to collect from the taxpayer the liability that is the subject of the revised offer to compromise while that revised offer is pending.

(3) *Jeopardy*. The IRS may levy to collect the liability that is the subject of an offer to compromise during the period the IRS is evaluating whether that offer will be accepted if it determines that collection of the liability is in jeopardy.

(4) *Offers to compromise determined by IRS to be nonprocessable or submitted solely for purposes of delay*. If the IRS determines, under paragraph (d)(2) of this section, that a pending offer did not contain sufficient information to permit evaluation of whether the offer should be accepted, that the offer was submitted solely to delay collection, or that the offer was otherwise nonprocessable, then the IRS may levy to collect the liability that is the subject of that offer at any time after it returns the offer to the taxpayer.

(5) *Offsets under section 6402*. Notwithstanding the evaluation and processing of an offer to compromise, the IRS may, in accordance with section 6402, credit any overpayments made by the taxpayer against a liability that is the subject of an offer to compromise and may offset such overpayments against other liabilities owed by the taxpayer to the extent authorized by section 6402.

(6) *Proceedings in court*. Except as otherwise provided in this paragraph (g)(6), the IRS will not refer a case to the Department of Justice for the commencement of a proceeding in court, against a person named in a pending offer to compromise, if levy to collect the liability is prohibited by paragraph (g)(1) of this section. Without regard to whether a person is named in a pending offer to compromise, however, the IRS may authorize the Department of Justice to file a counterclaim or third-party complaint in a refund action or to join that person in any other proceeding in which liability for the tax that is the subject of the pending offer to compromise may be established or disputed, including a suit against the United States under 28 U.S.C. 2410. In addition, the United States may file a claim in any bankruptcy proceeding or insolvency action brought by or against such person.

(h) *Deposits*. Sums submitted with an offer to compromise a liability or during the pendency of an offer to compromise are considered deposits and will not be applied to the liability until the offer is accepted unless the taxpayer provides written authorization for application of the payments. If an offer to compromise is withdrawn, is determined to be nonprocessable, or is submitted solely for purposes of delay and returned to the taxpayer, any amount tendered with the offer, including all installments paid on the offer, will be refunded without interest. If an offer is rejected, any amount tendered with the offer, including all installments paid on the offer, will be refunded, without interest, after the conclusion of any review sought by the taxpayer with Appeals. Refund will not be required if the taxpayer has agreed in writing that amounts tendered pursuant to the offer may be applied to the liability for which the offer was submitted.

(i) *Statute of limitations*—(1) *Suspension of the statute of limitations on collection*. The statute of limitations on collection will be suspended while levy is prohibited under paragraph (g)(1) of this section.

(2) *Extension of the statute of limitations on assessment*. For any offer to compromise, the IRS may require, where appropriate, the extension of the statute of limitations on assessment. However, in any case where waiver of the running of the statutory period of limitations on assessment is sought, the taxpayer must be notified of the right to refuse to extend the period of limitations or to limit the extension to particular issues or particular periods of time.

(j) *Inspection with respect to accepted offers to compromise*. For provisions relating to the inspection of returns and accepted offers to compromise, see section 6103(k)(1).

(k) *Effective date*. This section applies to offers to compromise pending on or submitted on or after July 18, 2002.

§§ 301.7122–0T and 301.7122–1T [Removed]

Par. 3. Sections 301.7122–0T and 301.7122–1T are removed.

Charles O. Rossotti,
Commissioner of Internal Revenue.

Approved July 15, 2002.

Pamela F. Olson,
Acting Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on July 18, 2002, 12:32 p.m., and published in the issue of the Federal Register for July 23, 2002, 67 F.R. 48025)

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31 CFR 10.0: Scope of part.

T.D. 9011

DEPARTMENT OF THE TREASURY
Office of the Secretary
31 CFR Part 10

Regulations Governing Practice Before the Internal Revenue Service

AGENCY: Office of the Secretary, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations governing practice before the Internal Revenue Service (Circular 230). These regulations affect individuals who are eligible to practice before the Internal Revenue Service. These regulations modify the general standards of practice before the Internal Revenue Service.

DATES: *Effective date:* These regulations are effective July 26, 2002.

Applicability date: For dates of applicability, see § 10.91.

FOR FURTHER INFORMATION CONTACT: Brinton Warren at (202) 622–4940 (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 1545–1726. The collection of information in these final regulations is in §§ 10.6, 10.29, and 10.30.

Section 10.6 requires an enrolled agent to maintain records and educational materials regarding his or her satisfaction of the qualifying continuing professional education credit. Section 10.6 also requires sponsors of qualifying continuing professional education programs to maintain records and educational material concerning these programs and those who attended them. The collection of this material helps to ensure that individuals enrolled to practice before the Internal Revenue Service are informed of the newest developments in Federal tax practice.

Section 10.29 requires a practitioner to obtain and retain for a reasonable period written consents to representation whenever such representation conflicts with the interests of the practitioner or the interests of another client of the practitioner. The consents are to be obtained after full disclosure of the conflict is provided to each party. Section 10.30 requires a practitioner to retain for a reasonable period any communication and the list of persons to whom that communication was provided with respect to public dissemination of fee information. The collection of consents to representation and communications concerning practitioner fees protects the practitioner against claims of impropriety and ensures the integrity of the tax administration system.

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.

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

Section 330 of title 31 of the United States Code authorizes the Secretary of the Treasury to regulate the practice of representatives before the Treasury Department. The Secretary of the Treasury is authorized, after notice and an opportunity for a proceeding, to suspend or disbar from practice before the Department those representatives who are, *inter alia*, incompetent, disreputable, or who violate regulations prescribed under section 330 of title 31. Pursuant to section 330 of title 31, the Secretary has published the regulations in Circular 230 (31 CFR part 10). These regulations authorize the Director of Practice to act upon applications for enrollment to practice before the Internal Revenue Service, to make inquiries with respect to matters under the Director of Practice's jurisdiction, to institute proceedings for suspension or disbarment from practice before the Internal Revenue

Service, and to perform such other duties as are necessary to carry out these functions.

The regulations have been amended from time to time to address various specific issues in need of resolution. For example, on February 23, 1984, the regulations were amended to provide standards for providing opinions used in tax shelter offerings (49 FR 6719). On October 17, 1985, the regulations were amended to conform to legislative changes requiring the disqualification of an appraiser who is assessed a penalty under section 6701 of the Internal Revenue Code for aiding and abetting the understatement of a tax liability (50 FR 42014). The regulations were most recently amended on June 20, 1994 (T.D. 8545, 1994–2 C.B. 415 [59 FR 31523]), to provide standards for tax return preparation, to limit the use of contingent fees in tax return or refund claim preparation, to provide expedited rules for suspension, and to clarify or amend certain other items.

On June 15, 1999, an advance notice of proposed rulemaking was published (64 FR 31994) requesting comments on amendments to the regulations that would take into account legal developments, professional integrity and fairness to practitioners, taxpayer service, and sound tax administration. On May 5, 2000, an advance notice of proposed rulemaking was published (65 FR 30375) requesting comments on amendments to the regulations relating to standards of practice governing tax shelters and other general matters. On January 12, 2001, a notice of proposed rulemaking (REG–111835–99, 2001–1 C.B. 834 [66 FR 3276]) was published that proposed amendments to the regulations, requested comments on the proposed amendments, and announced a public hearing on the subject of the proposed amendments. The January 12, 2001, notice of proposed rulemaking addressed both general matters pertaining to practice before the Internal Revenue Service and also matters pertaining specifically to tax shelter opinions. A public hearing was held on these proposals on May 2, 2001. The final regulations in this document encompass only those proposals addressing non-tax shelter related matters pertaining to practice before the Internal Revenue Service. Accordingly, this document does not contain final regulations governing standards for tax shelter opinions. The standards that currently govern tax shelter opinions remain in effect. The Department of Treasury and Internal Revenue Service intend to issue a second notice of proposed rulemaking that re-proposes amendments for such standards. The Department of Treasury and Internal Revenue Service also intend to issue an additional advance notice of proposed rulemaking that will cover additional non-tax shelter matters pertaining to practice before the Internal Revenue Service. Many of the matters covered by the advance notice of proposed rulemaking will be distinct from those that have been the focus of the non-tax shelter revisions of Circular 230 to this point, *e.g.*, matters concerning unenrolled practice and whether the use of contingent fee arrangements should be further restricted.

Summary of Comments

Fifty-one written comments were received concerning revisions to Circular 230. All comments were considered and are available for public inspection upon request. These comments addressed both the tax shelter and non-tax shelter related proposed amendments. Many commentators expressed general support for amending Circular 230. The following paragraphs provide a summary of significant comments concerning the non-tax shelter proposals.

One commentator recommended specific language for proposed § 10.6 with respect to determining credits for continuing professional education through distance learning programs, and another recommended that the standards for continuing professional education classes be modified to include more diverse subjects beyond those strictly related to taxation, such as in the fields of financial services and practice management.

With regard to unenrolled practice under proposed § 10.7(c)(1)(viii), one commentator argued that a restriction on the right of non-practitioners to practice hampers the ability of taxpayers to obtain a speedy and inexpensive resolution of matters before the Internal Revenue Service. In contrast, some commentators recommended that unenrolled practice as permitted by § 10.7(c)(1)(viii) be further restricted or eliminated outright. One of these commentators suggested that it is not appropriate to allow a tax return preparer who may not have demonstrated knowledge of tax law or tax procedure to represent a taxpayer during an examination merely because the preparer has signed the return under examination.

A number of commentators expressed concern regarding the information to be furnished to the Internal Revenue Service under proposed § 10.20. Commentators were concerned that the proposal is overly burdensome, puts an improper affirmative obligation on a practitioner, fails to respect privileged communications, and impairs a represented taxpayer's right to challenge an unlawful request for information by the Internal Revenue Service. Particular concern was expressed as to the removal of the phrase "of doubtful legality," appearing in the current section governing the topic.

Commentators both supported and criticized the proposed amendment to § 10.21 regarding a practitioner's duties when discovering a client's error or omission on a return, claim for refund, or other document. Two commentators suggested that the proposal to mandate that a practitioner advise a client regarding the consequences of not taking corrective action was a good one, but should be expanded to include advice regarding the consequences of taking corrective action. Some commentators criticized the proposal on the ground that it would require some practitioners to offer advice beyond their competence.

Commentators suggested that the Internal Revenue Service's interpretation of § 10.26 is too strict and thus imposes obligations on the firms of former government employees that are more burdensome than the related criminal statute.

With regard to the proposed clarification of the prohibition on contingent fees in § 10.27, one commentator was supportive of the clarification, but recommended further amendments to address ambiguities, uncertainties, and opportunities for abuse with regard to the section's application. Another commentator urged that the section be amended so that contingent fees can be charged for advice regarding return positions on original returns when the practitioner reasonably anticipates that the return position will be substantively reviewed by the Internal Revenue Service prior to the filing of the return.

A number of commentators expressed concern regarding the proposed amendment in § 10.28 that would require a practitioner to return a client's records upon a client's request regardless of a dispute over fees. One commentator recommended that the section distinguish between records pertaining to tax and non-tax matters because Circular 230 should not attempt to regulate a practitioner's conduct with respect to non-tax matters. A number of commentators urged that the section be revised to distinguish more completely the records of the client from the practitioner's work product, so that a client may not take advantage of a practitioner by obtaining the practitioner's work product without paying for it. A number of commentators objected to the section on the grounds that it conflicts with state laws governing attorneys' liens.

With regard to the proposal regarding representation of conflicting interests in § 10.29, many commentators expressed concern with the use of the word "potential" to modify "conflicting interests," arguing that the use of the word made the section's application too ambiguous. A number of commentators objected to the proposal that consents from taxpayers be in writing, some arguing that the requirement could create disharmony among clients. Some commentators observed that the section incongruously failed to require written consents when the conflict arises with the practitioner's own interest.

Some commentators objected to the proposal in § 10.30 to prohibit enrolled agents from using the term *licensed* in describing their professional designation. These commentators argued that the term "licensed" is not misleading to the public and does accurately describe the professional status of enrolled agents.

With regard to the proposal to add censure as a sanction available under Circular 230, as proposed in § 10.50, some commentators questioned the statutory authority for the censure sanction. One commentator expressed concern that the censure sanction as proposed did not fulfill the role of an intermediate sanction because the remedial conditions proposed for censured practitioners appear to be of indefinite duration.

With regard to proposed § 10.53, governing the receipt of information by the Director of Practice concerning practitioners, some commentators recommended that the section provide for the destruction of information determined to be frivolous and also establish a timetable for the Director of Practice's destruction of records in general.

With regard to the proposed amendments in Subpart D, governing the conduct of disciplinary proceedings under Circular 230, one commentator praised the proposal to merge the provisions governing proceedings for appraisers into the same subpart. One commentator urged that the standard of proof in a Circular 230 hearing be specified, and that such standard should be one of clear and convincing evidence. This commentator also recommended that Subpart D be amended to provide for additional discovery procedures.

Explanation of Provisions

The final regulations adopted in this document concern only the non-tax shelter related provisions as proposed in the January 12, 2001, notice of proposed rulemaking. The Department of Treasury and Internal Revenue Service intend to issue a second notice of proposed rulemaking that re-proposes amendments for the standards governing tax shelter opinions.

Who May Practice

Paragraph (d)(2) of § 10.3 of the regulations adopts the proposed changes that expanded the list of issues with respect to which an enrolled actuary is authorized to represent a taxpayer in limited practice before the Internal Revenue Service. The list is expanded to include issues involving 26 U.S.C. 419 (treatment of funded welfare benefits), 419A (qualified asset accounts), 420 (transfers of excess pension assets to retiree health accounts), 4972 (tax on nondeductible contributions to qualified employer plans), 4976 (taxes with respect to funded welfare benefit plans), and 4980 (tax on reversion of qualified plan assets to employer).

Enrollment

Section 10.6 sets forth the conditions and process for renewal of enrollment to practice before the Internal Revenue Service. One condition for renewal of enrollment is that the enrolled agent complete a minimum number of hours of continuing professional education in programs comprised of current subject matter in Federal taxation or Federal tax related matters. The final regulations do not adopt the commentator's suggestion to expand the subjects of qualifying tax programs to non-tax related matters, nor do they adopt the suggested language for determining distance learning credits.

Section 10.6 as adopted differs from the proposed section in that it incorporates a system of rolling renewals for enrollment. The year in which enrolled agents will be required to apply for renewal of enrollment will vary based on the last digit of the enrolled agent's social security number. This change is ministerial only and is made in order to balance the workflow involved in processing renewals.

The final regulations adopt new paragraph 10.6(a) that clarifies that enrollment and the renewal of enrollment of actuaries is also governed by the regulations of the Joint Board for the Enrollment of Actuaries at 20 CFR 901.1 *et seq.*

Unenrolled Practice

The final regulations adopt the provisions governing unenrolled practice as proposed in paragraph 10.7(c)(viii). This amendment preserves the scope of unenrolled practice as it has existed and only makes non-substantive changes in nomenclature that are necessitated by the organizational restructuring of the Internal Revenue Service.

Information to be Furnished

Section 10.20 of the regulations adopts the proposed changes in modified form. Paragraph (a) of § 10.20 requires a practitioner to respond promptly to a proper and lawful request for records and information, unless the practitioner believes in good faith and on reasonable grounds that the records or information are privileged. The right and ability of practitioners to resist efforts that the practitioner believes to be of doubtful legality is preserved. The phrase "of doubtful legality" was excised from § 10.20 merely to eliminate the redundancy in the section's text, which requires requests from the Internal Revenue Service to be "proper and lawful," not to effectuate a substantive change with regard to a practitioner's ability to resist efforts by the government to obtain documents or information that are irrelevant to an inquiry, confidential, privileged, or otherwise immune from compulsion.

The final regulations adopt, with amendment and clarification, the proposed amendment to require a practitioner to provide information regarding the identity of persons the practitioner reasonably believes may have possession or control of requested documents. The requirement, in paragraph (a)(2) of § 10.20, applies only when requested records or information are not in the possession or control of the practitioner or the practitioner's client. The paragraph is modified from its proposed form to clarify that the practitioner's duty is limited only to making reasonable inquiry of the practitioner's client and that there exists no obligation on the practitioner to make inquiry of any other person or to independently verify information provided by a client.

The right and ability of a practitioner to resist a request by the Director of Practice regarding an alleged violation of Circular 230 that the practitioner believes to be of doubtful legality is similarly unchanged in paragraph (b), which requires practitioners to provide information to the Director of Practice regarding the alleged violations of Circular 230 by any person. An alleged violation under paragraph (b) is not limited to a violation that is the subject of a proceeding under subpart D, for the necessary reason that the Director of Practice should be able to obtain evidence regarding alleged violations to determine whether they merit formal charges.

Knowledge of client's omission

Section 10.21 of Circular 230 has historically required a practitioner to advise a client promptly of any noncompliance, error, or omission. The proposed rules expanded the practitioner's duty under § 10.21 to include providing advice to the client regarding the manner in which the error or omission might be corrected and the possible consequences of a failure to take such corrective action. Rather than adopting § 10.21 as proposed, the final regulations modify the preexisting duty by simply requiring that, in addition to notifying the client of the fact of the noncompliance, error, or omission, the practitioner advise the client of the consequences as provided under the Code and regulations of the noncompliance, error, or omission. This change requires practitioners to provide information that taxpayers who consult tax professionals typically expect to receive.

Diligence as to Accuracy

The final regulations adopt the proposed clarification in § 10.22 that a practitioner is presumed to have exercised due diligence if the practitioner relies on the work product of another person and the practitioner uses reasonable care in engaging, supervising, training, and evaluating such person, taking proper account of the relationship between the practitioner and the person. It is expected that practitioners will use common sense and experience in guiding their conduct under this section. The section applies both in the context of a firm and in circumstances involving a practitioner's engagement of an outside practitioner. For example, in circumstances in which a practitioner must hire another practitioner for a specialized or complicated matter, such practitioner's duty under the section will be more focused on the reasonable care taken in the engagement of the specialist. Supervising and training are not part of a practitioner's engagement of a specialist. Conversely, in the context of a firm, the section's application will focus more on supervising and training, if there is an issue with regard to a supervisory practitioner's reliance on a subordinate. Finally, the presumption of due diligence provided by this section does not apply for purposes of § 10.33 and § 10.34, governing tax shelter opinions and standards for advising with respect to tax return positions, respectively, which have their own rules concerning due diligence.

Practice by Former Government Employees, Their Partners and Their Associates

The final regulations adopt without change the proposed amendments found in § 10.25 (former § 10.26) governing the restrictions on the practice of former Government employees, their partners, and their associates with respect to matters that the former Government employees participated in during the course of their Government employment. This section reflects changes to the Federal statutes governing post-employment restrictions applicable to former Government employees. The former § 10.25, governing the practice of partners of former Government employees, is removed, as was proposed, because the statutory prohibition implemented by the provision was repealed.

Contingent Fees

The final regulations adopt the proposed clarification governing the prohibition on contingent fees in connection with advice rendered in connection with a position taken or to be taken on an original tax return. The Department of the Treasury and the Internal Revenue Service remain concerned regarding the use of contingent fees and will request further public comments regarding contingent fees in the upcoming advance notice of proposed rulemaking.

Return of Client's Records

The final regulations adopt, with substantial changes, the proposed amendment to § 10.28 that requires a practitioner to return a client's records upon the client's request, regardless of a fee dispute. As recommended by one commentator, the section's application is restricted by paragraph (a) to the client's records that are necessary for the client to comply with his or her Federal tax obligations.

Further, as recommended by a number of commentators, the term *records of the client* is defined to exclude items such as returns or other documents prepared by the practitioner that the practitioner is withholding pending the client's payment of fees for those documents. These changes are incorporated to protect practitioners from being disadvantaged or compromised by clients seeking to obtain an unfair advantage under this section. In consideration of various state laws that may permit liens on a client's records in favor of practitioners during the course of fee disputes, the regulations provide that a practitioner must only return those records that must be attached to the client's return if a fee dispute has triggered an applicable state lien provision. The practitioner, however, must provide the client access to review and copy any of the client's records retained by the practitioner under state law that are necessary for the client to comply with his Federal tax obligations.

Conflicting Interests

The final regulations adopt the amendments as proposed in § 10.29, with modification. The modifier *potential* has been removed in the identification of conflicts of interest. The final regulations have been modified from the proposed regulations to conform more closely with the approach of the recently revised Model Rule 1.7 of the American Bar Association Rules of Professional Conduct. Section 10.29 requires a client to give informed consent, confirmed in writing, to representation by a practitioner when the representation of one client will be directly adverse to another client or there is a significant risk that the representation of one or more clients will be materially limited by the practitioner's responsibilities to another client, a former client or a third person or by a personal interest of the practitioner. The adoption of this requirement results in parallel application to conflicts with another client and conflicts with the practitioner's own interest. The section requires a practitioner to retain the written consent for at least 36 months after the conclusion of the representation and to provide the written consents to the Internal Revenue Service, if requested to do so.

Solicitation

The final regulations adopt some but not all of the changes to the solicitation standards from the proposed regulations. Under the final regulations, a practitioner is prohibited from making written and oral solicitations of employment in matters related to the Internal Revenue Service if such solicitations would violate Federal or State statutes or other rules applicable to the practitioner regarding the uninvited solicitation of prospective clients. For example, if an attorney is prohibited under that attorney's governing State bar rules from making a certain type of uninvited solicitation, the attorney's uninvited solicitation with respect to a matter related to the Internal Revenue Service will constitute a violation of § 10.30. Conversely, if such a solicitation is permissible under the relevant State bar rule, the making of the solicitation with respect to a matter related to the Internal Revenue Service is permissible under § 10.30.

Section 10.30 also expands the prohibition of deceptive and other improper solicitation practices to cover private, as well as public, solicitations. The final regulations provide that a practitioner may not, in matters related to the Internal Revenue Service, assist, or accept assistance from, any person or entity who, to the knowledge of the practitioner, obtains clients, or otherwise practices in a manner forbidden under this section.

In consideration of the comments received, the final regulations do not adopt the change that would have prohibited enrolled agents from using the term *licensed* in describing their professional designation. The Department of Treasury and the Internal Revenue Service recognize the valuable services provided by the over thirty-thousand enrolled agents in the United States, but want to ensure that the respective roles of enrolled agents, attorneys and certified public accountants are understood by taxpayers. The Treasury Department and Internal Revenue Service will solicit comments in an advance notice of proposed rulemaking regarding whether an additional designation may be employed to describe the professional services of enrolled agents.

Sanctions

The final regulations adopt the additional sanction of censure, which is defined as a public reprimand, as proposed in the amendments to § 10.50. The sanction of censure is not listed with disbarment or suspension in 31 U.S.C. 330(b), but the authority of the Secretary to regulate practice before the Internal Revenue Service is not limited to those specific sanctions. A censure sanction is authorized by the general grant of authority to "regulate the practice of representatives of persons before the Department of the Treasury" as provided in 31 U.S.C. 330(a). Additionally, the final regulations are modified in § 10.79 to clarify that suspended representatives may be subject to conditions and the conditions placed upon suspended or censured practitioners may only be imposed for a period that is reasonable in light of the gravity of a practitioner's violations.

Disreputable Conduct

Section 10.51 defines disreputable conduct for which a practitioner may be censured, suspended, or disbarred. Such disreputable conduct includes the filing of a complaint against Internal Revenue Service personnel under section 1203 of the Internal Revenue Service Restructuring and Reform Act of 1998, if the practitioner knows the complaint is false. Similarly, disreputable conduct also includes knowingly advancing frivolous arguments in collection due process hearings, or in connection with offers in compromise, installment agreements, or the appeals process. Additionally, the definition of disreputable conduct is amended, as proposed, to include conviction of any felony involving conduct that renders the practitioner unfit to practice before the Internal Revenue Service.

Receipt of Information Concerning Practitioner

The final regulations incorporate provisions for the destruction of documents by the Director of Practice. Section 10.53 of the final regulations requires the Director of Practice to destroy reports as soon as permissible under the applicable record control schedules approved by the National Archives and Records Administration and designated in the Internal Revenue Manual.

Evidence that alleges practitioner misconduct, but which is on its face without merit, should not be maintained in a manner that falsely conveys a willingness of the Director of Practice to use such evidence at an indefinite time in the future. This same principle applies to evidence that merits investigation, but is eventually determined to be insufficient to justify the initiation of disciplinary proceedings. If the currently applicable records control schedule proves to be unsuitable in assuring fairness to practitioners, or if it proves to be unworkable given the demands placed upon the Director of Practice, the Internal Revenue Service will initiate the public process required to request a change of the records control schedule through the National Archives and Records Administration.

Consolidation of Appraiser Disqualification Rules

The final regulations adopt without change the consolidation of the virtually identical rules applicable to disciplinary proceedings against practitioners and appraisers that heretofore have been separately set out in separate subparts. The final regulations consolidate the rules regarding sanctions of practitioners and appraisers under subpart D.

Various Aspects of Disciplinary Proceedings

The final regulations adopt the proposed rules of subpart D regarding the conduct of disciplinary proceedings largely without change. In response to the request of a commentator, § 10.76 has been modified to specifically provide that the standard of proof in Circular 230 proceedings is that of a preponderance of the evidence, if the sanction sought by the Director of Practice is censure or a suspension of less than six month's duration. If the Director of Practice seeks a sanction of disbarment or a suspension of six months or longer or the disqualification of an appraiser, the standard of proof is clear and convincing evidence. The Treasury Department and Internal Revenue Service conclude that the preponderance of evidence standard is justified in the case of the less severe sanctions of censure and suspension of a short duration. When the Director of Practice seeks a more significant sanction, the clear and convincing evidence standard is adopted to protect the interests of the practitioner.

Effective Date

These regulations are effective on July 26, 2002.

Special Analyses

It has been determined that these regulations are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities because the general requirements, including the collection of information requirements, of these regulations are substantially the same as the requirements of the regulations that these regulations replace. Persons authorized to practice have long been required to comply with certain standards of conduct when practicing before the Internal Revenue Service. These regulations do not alter the basic nature of the obligations and responsibilities of these practitioners. These regulations clarify those obligations in response to public comments and judicial decisions, and make other modifications to reflect the development of electronic media. Therefore, a regulatory flexibility analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

Drafting Information

The principal authors of these regulations are Richard S. Goldstein and Brinton T. Warren, of the Office of Associate Chief counsel (Procedure and Administration), Administrative Provisions and Judicial Practice Division.

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Adoption of Amendments to the Regulations

Accordingly, 31 CFR part 10 is amended as follows:

Paragraph 1. The table of contents reads as follows:

PART 10 — PRACTICE BEFORE THE INTERNAL REVENUE SERVICE

Authority: Sec. 3, 23 Stat. 258, secs. 2–12, 60 Stat. 237 *et. seq.*; 5 U.S.C. 301, 500, 551–559; 31 U.S.C. 321; 31 U.S.C. 330;

§ 10.0 Scope of part.

This part contains rules governing the recognition of attorneys, certified public accountants, enrolled agents, and other persons representing taxpayers before the Internal Revenue Service. Subpart A of this part sets forth rules relating to the authority to practice before the Internal Revenue Service; subpart B of this part prescribes the duties and restrictions relating to such practice; subpart C of this part prescribes the sanctions for violating the regulations; subpart D of this part contains the rules applicable to disciplinary proceedings; and subpart E of this part contains general provisions including provisions relating to the availability of official records.

Par. 2. In part 10, subpart A is revised to read as follows:

Subpart A — Rules Governing Authority to Practice

§ 10.1 Director of Practice.

(a) *Establishment of office.* The Office of Director of Practice is established in the Office of the Secretary of the Treasury. The Director of Practice is appointed by the Secretary of the Treasury, or his or her designate.

(b) *Duties.* The Director of Practice acts on applications for enrollment to practice before the Internal Revenue Service; makes inquiries with respect to matters under his or her jurisdiction; institutes and provides for the conduct of disciplinary proceedings relating to attorneys, certified public accountants, enrolled agents, enrolled actuaries and appraisers; and performs other duties as are necessary or appropriate to carry out his or her functions under this part or as are prescribed by the Secretary of the Treasury, or his or her delegate.

(c) *Acting Director of Practice.* The Secretary of the Treasury, or his or her delegate, will designate an officer or employee of the Treasury Department to act as Director of Practice in the absence of the Director or a vacancy in that office.

§ 10.2 Definitions.

As used in this part, except where the text clearly provides otherwise:

(a) *Attorney* means any person who is a member in good standing of the bar of the highest court of any State, territory, or possession of the United States, including a Commonwealth, or the District of Columbia.

(b) *Certified public accountant* means any person who is duly qualified to practice as a certified public accountant in any State, territory, or possession of the United States, including a Commonwealth, or the District of Columbia.

(c) *Commissioner* refers to the Commissioner of Internal Revenue.

(d) *Practice before the Internal Revenue Service* comprehends all matters connected with a presentation to the Internal Revenue Service or any of its officers or employees relating to a taxpayer's rights, privileges, or liabilities under laws or regulations administered by the Internal Revenue Service. Such presentations include, but are not limited to, preparing and filing documents, corresponding and communicating with the Internal Revenue Service, and representing a client at conferences, hearings, and meetings.

(e) *Practitioner* means any individual described in paragraphs (a), (b), (c), or (d) of § 10.3.

(f) A *tax return* includes an amended tax return and a claim for refund.

(g) *Service* means the Internal Revenue Service.

§ 10.3 Who may practice.

(a) *Attorneys.* Any attorney who is not currently under suspension or disbarment from practice before the Internal Revenue Service may practice before the Internal Revenue Service by filing with the Internal Revenue Service a written declaration that he or she is currently qualified as an attorney and is authorized to represent the party or parties on whose behalf he or she acts.

(b) *Certified public accountants.* Any certified public accountant who is not currently under suspension or disbarment from practice before the Internal Revenue Service may practice before the Internal Revenue Service by filing with the Internal Revenue Service a written declaration that he or she is currently qualified as a certified public accountant and is authorized to represent the party or parties on whose behalf he or she acts.

(c) *Enrolled agents*. Any individual enrolled as an agent pursuant to this part who is not currently under suspension or disbarment from practice before the Internal Revenue Service may practice before the Internal Revenue Service.

(d) *Enrolled actuaries.* (1) Any individual who is enrolled as an actuary by the Joint Board for the Enrollment of Actuaries pursuant to 29 U.S.C. 1242 who is not currently under suspension or disbarment from practice before the Internal Revenue Service may practice before the Internal Revenue Service by filing with the Internal Revenue Service a written declaration stating that he or she is currently qualified as an enrolled actuary and is authorized to represent the party or parties on whose behalf he or she acts.

(2) Practice as an enrolled actuary is limited to representation with respect to issues involving the following statutory provisions in title 26 of the United States Code: sections 401 (relating to qualification of employee plans), 403(a) (relating to whether an annuity plan meets the requirements of section 404(a)(2)), 404 (relating to deductibility of employer contributions), 405 (relating to qualification of bond purchase plans), 412 (relating to funding requirements for certain employee plans), 413 (relating to application of qualification requirements to collectively bargained plans and to plans maintained by more than one employer), 414 (relating to definitions and special rules with respect to the employee plan area), 419 (relating to treatment of funded wel-

fare benefits), 419A (relating to qualified asset accounts), 420 (relating to transfers of excess pension assets to retiree health accounts), 4971 (relating to excise taxes payable as a result of an accumulated funding deficiency under section 412), 4972 (relating to tax on nondeductible contributions to qualified employer plans), 4976 (relating to taxes with respect to funded welfare benefit plans), 4980 (relating to tax on reversion of qualified plan assets to employer), 6057 (relating to annual registration of plans), 6058 (relating to information required in connection with certain plans of deferred compensation), 6059 (relating to periodic report of actuary), 6652(e) (relating to the failure to file annual registration and other notifications by pension plan), 6652(f) (relating to the failure to file information required in connection with certain plans of deferred compensation), 6692 (relating to the failure to file actuarial report), 7805(b) (relating to the extent to which an Internal Revenue Service ruling or determination letter coming under the statutory provisions listed here will be applied without retroactive effect); and 29 U.S.C. 1083 (relating to the waiver of funding for nonqualified plans).

(3) An individual who practices before the Internal Revenue Service pursuant to paragraph (d)(1) of this section is subject to the provisions of this part in the same manner as attorneys, certified public accountants and enrolled agents.

(e) *Others*. Any individual qualifying under paragraph (d) of § 10.5 or § 10.7 is eligible to practice before the Internal Revenue Service to the extent provided in those sections.

(f) *Government officers and employees, and others.* An individual, who is an officer or employee of the executive, legislative, or judicial branch of the United States Government; an officer or employee of the District of Columbia; a Member of Congress; or a Resident Commissioner may not practice before the Internal Revenue Service if such practice violates 18 U.S.C. 203 or 205.

(g) *State officers and employees.* No officer or employee of any State, or subdivision of any State, whose duties require him or her to pass upon, investigate, or deal with tax matters for such State or subdivision, may practice before the Internal Revenue Service, if such employment may disclose facts or information applicable to Federal tax matters.

§ 10.4 Eligibility for enrollment.

(a) *Enrollment upon examination.* The Director of Practice may grant enrollment to an applicant who demonstrates special competence in tax matters by written examination administered by, or administered under the oversight of, the Director of Practice and who has not engaged in any conduct that would justify the censure, suspension, or disbarment of any practitioner under the provisions of this part.

(b) *Enrollment of former Internal Revenue Service employees.* The Director of Practice may grant enrollment to an applicant who, by virtue of his or her past service and technical experience in the Internal Revenue Service, has qualified for such enrollment and who has not engaged in any conduct that would justify the censure, suspension, or disbarment of any practitioner under the provisions of this part, under the following circumstances—

(1) The former employee applies for enrollment to the Director of Practice on a form supplied by the Director of Practice and supplies the information requested on the form and such other information regarding the experience and training of the applicant as may be relevant.

(2) An appropriate office of the Internal Revenue Service, at the request of the Director of Practice, will provide the Director of Practice with a detailed report of the nature and rating of the applicant's work while employed by the Internal Revenue Service and a recommendation whether such employment qualifies the applicant technically or otherwise for the desired authorization.

(3) Enrollment based on an applicant's former employment with the Internal Revenue Service may be of unlimited scope or it may be limited to permit the presentation of matters only of the particular class or only before the particular unit or division of the Internal Revenue Service for which the applicant's former employment has qualified the applicant.

(4) Application for enrollment based on an applicant's former employment with the Internal Revenue Service must be made within 3 years from the date of separation from such employment.

(5) An applicant for enrollment who is requesting such enrollment based on his or her former employment with the Internal Revenue Service must have had a minimum of 5 years continuous employment with the Internal Revenue Service during which he or she must have been regularly engaged in applying and interpreting the provisions of the Internal Revenue Code and the regulations thereunder relating to income, estate, gift, employment, or excise taxes.

(6) For the purposes of paragraph (b)(5) of this section, an aggregate of 10 or more years of employment in positions involving the application and interpretation of the provisions of the Internal Revenue Code, at least 3 of which occurred within the 5 years preceding the date of application, is the equivalent of 5 years continuous employment.

(c) *Natural persons.* Enrollment to practice may be granted only to natural persons.

§ 10.5 Application for enrollment.

(a) *Form; address.* An applicant for enrollment must file an application on Form 23, "*Application for Enrollment to Practice Before the Internal Revenue Service*," properly executed under oath or affirmation, with the Director of Practice. The address of the applicant entered on Form 23 will be the address under which a successful applicant is enrolled and is the address to which the Director of Practice will send correspondence concerning enrollment. An enrolled agent must send notification of any change to his or her enrollment address to the Director of Practice, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224, or at such other address specified by the Director of Practice. This notification must include the enrolled agent's name, old address, new address, social security number or tax identification number, signature, and the date.

(b) *Fee.* The application for enrollment must be accompanied by a check or money order in the amount set forth on Form 23, payable to the Internal Revenue Service, which amount constitutes a fee charged to each applicant for enrollment. This fee will be retained by the United States whether or not the applicant is granted enrollment.

(c) *Additional information; examina-*

tion. The Director of Practice, as a condition to consideration of an application for enrollment, may require the applicant to file additional information and to submit to any written or oral examination under oath or otherwise. The Director of Practice will, on written request filed by an applicant, afford such applicant the opportunity to be heard with respect to his or her application for enrollment.

(d) *Temporary recognition.* On receipt of a properly executed application, the Director of Practice may grant the applicant temporary recognition to practice pending a determination as to whether enrollment to practice should be granted. Temporary recognition will be granted only in unusual circumstances and it will not be granted, in any circumstance, if the application is not regular on its face, if the information stated in the application, if true, is not sufficient to warrant enrollment to practice, or if there is any information before the Director of Practice indicating that the statements in the application are untrue or that the applicant would not otherwise qualify for enrollment. Issuance of temporary recognition does not constitute enrollment to practice or a finding of eligibility for enrollment, and the temporary recognition may be withdrawn at any time by the Director of Practice.

(e) *Appeal from denial of application.* The Director of Practice must inform the applicant as to the reason(s) for any denial of an application for enrollment. The applicant may, within 30 days after receipt of the notice of denial of enrollment, file a written appeal of the denial of enrollment with the Secretary of the Treasury or his or her delegate. A decision on the appeal will be rendered by the Secretary of the Treasury, or his or her delegate, as soon as practicable.

§ 10.6 Enrollment.

(a) *Roster.* The Director of Practice will maintain rosters of all individuals—

(1) Who have been granted active enrollment to practice before the Internal Revenue Service;

(2) Whose enrollment has been placed in inactive status for failure to meet the requirements for renewal of enrollment;

(3) Whose enrollment has been placed in inactive retirement status;

(4) Who have been censured, suspended, or disbarred from practice before the Internal Revenue Service;

(5) Whose offer of consent to resign from enrollment to practice before the Internal Revenue Service has been accepted by the Director of Practice under § 10.61; and

(6) Whose application for enrollment has been denied.

(b) *Enrollment card.* The Director of Practice will issue an enrollment card to each individual whose application for enrollment to practice before the Internal Revenue Service is approved after July 26, 2002. Each enrollment card will be valid for the period stated on the enrollment card. An individual is not eligible to practice before the Internal Revenue Service if his or her enrollment card is not valid.

(c) *Term of enrollment.* Each individual enrolled to practice before the Internal Revenue Service will be accorded active enrollment status subject to his or her renewal of enrollment as provided in this part.

(d) *Renewal of enrollment.* To maintain active enrollment to practice before the Internal Revenue Service, each individual enrolled is required to have his or her enrollment renewed. Failure by an individual to receive notification from the Director of Practice of the renewal requirement will not be justification for the failure to satisfy this requirement.

(1) All individuals licensed to practice before the Internal Revenue Service who have a social security number or tax identification number that ends with the numbers 0, 1, 2, or 3, except for those individuals who received their initial enrollment after November 1, 2003, must apply for renewal between November 1, 2003, and January 31, 2004. The renewal will be effective April 1, 2004.

(2) All individuals licensed to practice before the Internal Revenue Service who have a social security number or tax identification number that ends with the numbers 4, 5, or 6, except for those individuals who received their initial enrollment after November 1, 2004, must apply for renewal between November 1, 2004, and January 31, 2005. The renewal will be effective April 1, 2005.

(3) All individuals licensed to practice before the Internal Revenue Service who have a social security number or tax identification number that ends with the numbers 7, 8, or 9, except for those individuals who received their initial enrollment after November 1, 2005, must apply for renewal between November 1, 2005, and January 31, 2006. The renewal will be effective April 1, 2006.

(4) Thereafter, applications for renewal will be required between November 1 and January 31 of every subsequent third year as specified in paragraphs (d)(1), (2) or (3) of this section according to the last number of the individual's social security number or tax identification number. Those individuals who receive initial enrollment after November 1 and before April 2 of the applicable renewal period will not be required to renew their enrollment before the first full renewal period following the receipt of their initial enrollment.

(5) The Director of Practice will notify the individual of his or her renewal of enrollment and will issue the individual a card evidencing enrollment.

(6) A reasonable nonrefundable fee may be charged for each application for renewal of enrollment filed with the Director of Practice.

(7) Forms required for renewal may be obtained from the Director of Practice, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224.

(e) *Condition for renewal: Continuing professional education.* In order to qualify for renewal of enrollment, an individual enrolled to practice before the Internal Revenue Service must certify, on the application for renewal form prescribed by the Director of Practice, that he or she has satisfied the following continuing professional education requirements.

(1) *For renewed enrollment effective after March 31, 2004.* (i) A minimum of 16 hours of continuing education credit must be completed during each calendar year in the enrollment term.

(2) *For renewed enrollment effective after April 1, 2007.* (i) A minimum of 72 hours of continuing education credit must be completed during each three year period described in paragraph (d)(4) of this section. Each such three year period is known as an enrollment cycle.

(ii) A minimum of 16 hours of continuing education credit, including 2 hours of ethics or professional conduct, must be completed in each year of an enrollment cycle.

(iii) An individual who receives initial enrollment during an enrollment cycle must complete two (2) hours of qualifying continuing education credit for each month enrolled during the enrollment cycle. Enrollment for any part of a month is considered enrollment for the entire month.

(f) *Qualifying continuing education*—(1) *General.* To qualify for continuing education credit, a course of learning must—

(i) Be a qualifying program designed to enhance professional knowledge in Federal taxation or Federal tax related matters, *i.e.*, programs comprised of current subject matter in Federal taxation or Federal tax related matters, including accounting, tax preparation software and taxation or ethics; and

(ii) Be conducted by a qualifying sponsor.

(2) *Qualifying programs*—(i) *Formal programs.* A formal program qualifies as continuing education programs if it—

(A) Requires attendance. Additionally, the program sponsor must provide each attendee with a certificate of attendance; and

(B) Requires that the program be conducted by a qualified instructor, discussion leader, or speaker, *i.e.*, a person whose background, training, education and experience is appropriate for instructing or leading a discussion on the subject matter of the particular program; and

(C) Provides or requires a written outline, textbook, or suitable electronic educational materials.

(ii) *Correspondence or individual study programs (including taped programs).* Qualifying continuing education programs include correspondence or individual study programs that are conducted by qualifying sponsors and completed on an individual basis by the enrolled individual. The allowable credit hours for such programs will be measured on a basis comparable to the measurement of a seminar or course for credit in an accredited educational institution. Such programs qualify as continuing education programs if they—

(A) Require registration of the participants by the sponsor;

(B) Provide a means for measuring completion by the participants (*e.g.*, a written examination), including the issuance of a certificate of completion by the sponsor; and

(C) Provide a written outline, textbook, or suitable electronic educational materials.

(iii) *Serving as an instructor, discussion leader or speaker.* (A) One hour of continuing education credit will be awarded for each contact hour completed as an instructor, discussion leader, or speaker at an educational program that meets the continuing education requirements of paragraph (f) of this section.

(B) Two hours of continuing education credit will be awarded for actual subject preparation time for each contact hour completed as an instructor, discussion leader, or speaker at such programs. It is the responsibility of the individual claiming such credit to maintain records to verify preparation time.

(C) The maximum credit for instruction and preparation may not exceed 50 percent of the continuing education requirement for an enrollment cycle.

(D) An instructor, discussion leader, or speaker who makes more than one presentation on the same subject matter during an enrollment cycle, will receive continuing education credit for only one such presentation for the enrollment cycle.

(iv) *Credit for published articles, books, etc.* (A) Continuing education credit will be awarded for publications on Federal taxation or Federal tax related matters, including accounting, financial management, tax preparation software, and taxation, provided the content of such publications is current and designed for the enhancement of the professional knowledge of an individual enrolled to practice before the Internal Revenue Service.

(B) The credit allowed will be on the basis of one hour credit for each hour of preparation time for the material. It is the responsibility of the person claiming the credit to maintain records to verify preparation time.

(C) The maximum credit for publications may not exceed 25 percent of the continuing education requirement of any enrollment cycle.

(3) *Periodic examination.* (i) Individuals may establish eligibility for renewal of enrollment for any enrollment cycle by—

(A) Achieving a passing score on each part of the Special Enrollment Examination administered under this part during the three year period prior to renewal; and

(B) Completing a minimum of 16 hours of qualifying continuing education during the last year of an enrollment cycle.

(ii) Courses designed to help an applicant prepare for the examination specified in paragraph (a) of § 10.4 are considered basic in nature and are not qualifying continuing education.

(g) *Sponsors.* (1) Sponsors are those responsible for presenting programs.

(2) To qualify as a sponsor, a program presenter must—

(i) Be an accredited educational institution;

(ii) Be recognized for continuing education purposes by the licensing body of any State, territory, or possession of the United States, including a Commonwealth, or the District of Columbia.

(iii) Be recognized by the Director of Practice as a professional organization or society whose programs include offering continuing professional education opportunities in subject matters within the scope of paragraph (f)(1)(i) of this section; or

(iv) File a sponsor agreement with the Director of Practice and obtain approval of the program as a qualified continuing education program.

(3) A qualifying sponsor must ensure the program complies with the following requirements—

(i) Programs must be developed by individual(s) qualified in the subject matter;

(ii) Program subject matter must be current;

(iii) Instructors, discussion leaders, and speakers must be qualified with respect to program content;

(iv) Programs must include some means for evaluation of technical content and presentation;

(v) Certificates of completion must be provided to the participants who successfully complete the program; and

(vi) Records must be maintained by the sponsor to verify the participants who attended and completed the program for a period of three years following completion of the program. In the case of continuous conferences, conventions, and the like, records must be maintained to verify completion of the program and attendance by each participant at each segment of the program.

(4) Professional organizations or societies wishing to be considered as qualified sponsors must request this status from the Director of Practice and furnish information in support of the request together with any further information deemed necessary by the Director of Practice.

(5) A professional organization or society recognized as a qualified sponsor by the Director of Practice will retain its status for one enrollment cycle. The Director of Practice will publish the names of such sponsors on a periodic basis.

(h) *Measurement of continuing education coursework.* (1) All continuing education programs will be measured in terms of contact hours. The shortest recognized program will be one contact hour.

(2) A contact hour is 50 minutes of continuous participation in a program. Credit is granted only for a full contact hour, *i.e.*, 50 minutes or multiples thereof. For example, a program lasting more than 50 minutes but less than 100 minutes will count as one contact hour.

(3) Individual segments at continuous conferences, conventions and the like will be considered one total program. For example, two 90-minute segments (180 minutes) at a continuous conference will count as three contact hours.

(4) For university or college courses, each semester hour credit will equal 15 contact hours and a quarter hour credit will equal 10 contact hours.

(i) *Recordkeeping requirements.* (1) Each individual applying for renewal must retain for a period of three years following the date of renewal of enrollment the information required with regard to qualifying continuing professional education credit hours. Such information includes—

(i) The name of the sponsoring organization;

(ii) The location of the program;

(iii) The title of the program and description of its content;

(iv) Written outlines, course syllibi, textbook, and/or electronic materials provided or required for the course;

(v) The dates attended;

(vi) The credit hours claimed;

(vii) The name(s) of the instructor(s), discussion leader(s), or speaker(s), if appropriate; and

(viii) The certificate of completion and/or signed statement of the hours of attendance obtained from the sponsor.

(2) To receive continuing education credit for service completed as an instructor, discussion leader, or speaker, the following information must be maintained for a period of three years following the date of renewal of enrollment—

(i) The name of the sponsoring organization;

(ii) The location of the program;

(iii) The title of the program and description of its content;

(iv) The dates of the program; and

(v) The credit hours claimed.

(3) To receive continuing education credit for publications, the following information must be maintained for a period of three years following the date of renewal of enrollment—

(i) The publisher;

(ii) The title of the publication;

(iii) A copy of the publication;

(iv) The date of publication; and

(v) Records that substantiate the hours worked on the publication.

(j) *Waivers.* (1) Waiver from the continuing education requirements for a given period may be granted by the Director of Practice for the following reasons—

(i) Health, which prevented compliance with the continuing education requirements;

(ii) Extended active military duty;

(iii) Absence from the United States for an extended period of time due to employment or other reasons, provided the individual does not practice before the Internal Revenue Service during such absence; and

(iv) Other compelling reasons, which will be considered on a case-by-case basis.

(2) A request for waiver must be accompanied by appropriate documentation. The individual is required to furnish any additional documentation or explanation deemed necessary by the Director of Practice. Examples of appropriate documentation could be a medical certificate or military orders.

(3) A request for waiver must be filed no later than the last day of the renewal application period.

(4) If a request for waiver is not approved, the individual will be placed in inactive status, so notified by the Director of Practice, and placed on a roster of inactive enrolled individuals.

(5) If a request for waiver is approved, the individual will be notified and issued a card evidencing renewal.

(6) Those who are granted waivers are required to file timely applications for renewal of enrollment.

(k) *Failure to comply.* (1) Compliance by an individual with the requirements of this part is determined by the Director of Practice. An individual who fails to meet the requirements of eligibility for renewal of enrollment will be notified by the Director of Practice at his or her enrollment address by first class mail. The notice will state the basis for the determination of noncompliance and will provide the individual an opportunity to furnish information in writing relating to the matter within 60 days of the date of the notice. Such information will be considered by the Director of Practice in making a final determination as to eligibility for renewal of enrollment.

(2) The Director of Practice may require any individual, by notice sent by first class mail to his or her enrollment address, to provide copies of any records required to be maintained under this part. The Director of Practice may disallow any continuing professional education hours claimed if the individual fails to comply with this requirement.

(3) An individual who has not filed a timely application for renewal of enrollment, who has not made a timely response to the notice of noncompliance with the renewal requirements, or who has not satisfied the requirements of eligibility for renewal will be placed on a roster of inactive enrolled individuals. During this time, the individual will be ineligible to practice before the Internal Revenue Service.

(4) Individuals placed in inactive enrollment status and individuals ineligible to practice before the Internal Revenue Service may not state or imply that they are enrolled to practice before the Internal Revenue Service, or use the term *enrolled agent*, the designation "E. A.," or other form of reference to eligibility to practice before the Internal Revenue Service.

(5) An individual placed in an inactive status may be reinstated to an active enrollment status by filing an application for renewal of enrollment and providing evi-

dence of the completion of all required continuing professional education hours for the enrollment cycle. Continuing education credit under this paragraph (k)(5) may not be used to satisfy the requirements of the enrollment cycle in which the individual has been placed back on the active roster.

(6) An individual placed in an inactive status must file an application for renewal of enrollment and satisfy the requirements for renewal as set forth in this section within three years of being placed in an inactive status. The name of such individual otherwise will be removed from the inactive enrollment roster and his or her enrollment will terminate. Eligibility for enrollment must then be reestablished by the individual as provided in this section.

(7) Inactive enrollment status is not available to an individual who is the subject of a disciplinary matter in the Office of Director of Practice.

(l) *Inactive retirement status.* An individual who no longer practices before the Internal Revenue Service may request being placed in an inactive status at any time and such individual will be placed in an inactive retirement status. The individual will be ineligible to practice before the Internal Revenue Service. Such individual must file a timely application for renewal of enrollment at each applicable renewal or enrollment period as provided in this section. An individual who is placed in an inactive retirement status may be reinstated to an active enrollment status by filing an application for renewal of enrollment and providing evidence of the completion of the required continuing professional education hours for the enrollment cycle. Inactive retirement status is not available to an individual who is subject of a disciplinary matter in the Office of Director of Practice.

(m) *Renewal while under suspension or disbarment.* An individual who is ineligible to practice before the Internal Revenue Service by virtue of disciplinary action is required to be in conformance with the requirements for renewal of enrollment before his or her eligibility is restored.

(n) *Verification.* The Director of Practice may review the continuing education records of an enrolled individual and/or qualified sponsor in a manner deemed appropriate to determine compliance with the requirements and standards for renewal of enrollment as provided in paragraph (f) of this section.

(o) *Enrolled Actuaries.* The enrollment and the renewal of enrollment of actuaries authorized to practice under paragraph (d) of § 10.3 are governed by the regulations of the Joint Board for the Enrollment of Actuaries at 20 CFR 901.1 through 901.71. (Approved by the Office of Management and Budget under Control No. 1545–0946 and 1545–1726)

§ 10.7 Representing oneself; participating in rulemaking; limited practice; special appearances; and return preparation.

(a) Representing oneself. Individuals may appear on their own behalf before the Internal Revenue Service provided they present satisfactory identification.

(b) *Participating in rulemaking.* Individuals may participate in rulemaking as provided by the Administrative Procedure Act. See 5 U.S.C. 553.

(c) *Limited practice*—(1) *In general.* Subject to the limitations in paragraph (c)(2) of this section, an individual who is not a practitioner may represent a taxpayer before the Internal Revenue Service in the circumstances described in this paragraph (c)(1), even if the taxpayer is not present, provided the individual presents satisfactory identification and proof of his or her authority to represent the taxpayer. The circumstances described in this paragraph (c)(1) are as follows:

(i) An individual may represent a member of his or her immediate family.

(ii) A regular full-time employee of an individual employer may represent the employer.

(iii) A general partner or a regular full-time employee of a partnership may represent the partnership.

(iv) A *bona fide* officer or a regular full-time employee of a corporation (including a parent, subsidiary, or other affiliated corporation), association, or organized group may represent the corporation, association, or organized group.

(v) A regular full-time employee of a trust, receivership, guardianship, or estate may represent the trust, receivership, guardianship, or estate.

(vi) An officer or a regular employee of a governmental unit, agency, or authority may represent the governmental unit, agency, or authority in the course of his or her official duties.

(vii) An individual may represent any individual or entity, who is outside the United States, before personnel of the Internal Revenue Service when such representation takes place outside the United States.

(viii) An individual who prepares and signs a taxpayer's tax return as the preparer, or who prepares a tax return but is not required (by the instructions to the tax return or regulations) to sign the tax return, may represent the taxpayer before revenue agents, customer service representatives or similar officers and employees of the Internal Revenue Service during an examination of the taxable year or period covered by that tax return, but, unless otherwise prescribed by regulation or notice, this right does not permit such individual to represent the taxpayer, regardless of the circumstances requiring representation, before appeals officers, revenue officers, Counsel or similar officers or employees of the Internal Revenue Service or the Department of Treasury.

(2) *Limitations.* (i) An individual who is under suspension or disbarment from practice before the Internal Revenue Service may not engage in limited practice before the Internal Revenue Service under paragraph (c)(1) of this section.

(ii) The Director, after notice and opportunity for a conference, may deny eligibility to engage in limited practice before the Internal Revenue Service under paragraph (c)(1) of this section to any individual who has engaged in conduct that would justify censuring, suspending, or disbarring a practitioner from practice before the Internal Revenue Service.

(iii) An individual who represents a taxpayer under the authority of paragraph (c)(1) of this section is subject, to the extent of his or her authority, to such rules of general applicability regarding standards of conduct and other matters as the Director of Practice prescribes.

(d) *Special appearances.* The Director of Practice may, subject to such conditions as he or she deems appropriate, authorize an individual who is not otherwise eligible to practice before the Internal Revenue Service to represent another person in a particular matter.

(e) *Preparing tax returns and furnish-*

ing information. Any individual may prepare a tax return, appear as a witness for the taxpayer before the Internal Revenue Service, or furnish information at the request of the Internal Revenue Service or any of its officers or employees.

(f) *Fiduciaries.* For purposes of this part, a fiduciary (*i.e.*, a trustee, receiver, guardian, personal representative, administrator, or executor) is considered to be the taxpayer and not a representative of the taxpayer.

§ 10.8 Customhouse brokers.

Nothing contained in the regulations in this part will affect or limit the right of a customhouse broker, licensed as such by the Commissioner of Customs in accordance with the regulations prescribed therefor, in any customs district in which he or she is so licensed, at a relevant local office of the Internal Revenue Service or before the National Office of the Internal Revenue Service, to act as a representative in respect to any matters relating specifically to the importation or exportation of merchandise under the customs or internal revenue laws, for any person for whom he or she has acted as a customhouse broker.

Par. 3. In part 10, subpart B is amended by revising §§ 10.20 through 10.32 and revising § 10.34.

Subpart B — Duties and Restrictions Relating to Practice Before the Internal Revenue Service

§ 10.20 Information to be furnished.

(a) *To the Internal Revenue Service.* (1) A practitioner must, on a proper and lawful request by a duly authorized officer or employee of the Internal Revenue Service, promptly submit records or information in any matter before the Internal Revenue Service unless the practitioner believes in good faith and on reasonable grounds that the records or information are privileged.

(2) Where the requested records or information are not in the possession of, or subject to the control of, the practitioner or the practitioner's client, the practitioner must promptly notify the requesting Internal Revenue Service officer or employee and the practitioner must provide any information that the practitioner has regarding the identity of any person who the practitioner believes may have possession or control of the requested records or information. The practitioner must make reasonable inquiry of his or her client regarding the identity of any person who may have possession or control of the requested records or information, but the practitioner is not required to make inquiry of any other person or independently verify any information provided by the practitioner's client regarding the identity of such persons.

(b) *To the Director of Practice.* When a proper and lawful request is made by the Director of Practice, a practitioner must provide the Director of Practice with any information the practitioner has concerning an inquiry by the Director of Practice into an alleged violation of the regulations in this part by any person, and to testify regarding this information in any proceeding instituted under this part, unless the practitioner believes in good faith and on reasonable grounds that the information is privileged.

(c) *Interference with a proper and lawful request for records or information.* A practitioner may not interfere, or attempt to interfere, with any proper and lawful effort by the Internal Revenue Service, its officers or employees, or the Director of Practice, or his or her employees, to obtain any record or information unless the practitioner believes in good faith and on reasonable grounds that the record or information is privileged.

§ 10.21 Knowledge of client's omission.

A practitioner who, having been retained by a client with respect to a matter administered by the Internal Revenue Service, knows that the client has not complied with the revenue laws of the United States or has made an error in or omission from any return, document, affidavit, or other paper which the client submitted or executed under the revenue laws of the United States, must advise the client promptly of the fact of such noncompliance, error, or omission. The practitioner must advise the client of the consequences as provided under the Code and regulations of such noncompliance, error, or omission.

§ 10.22 Diligence as to accuracy.

(a) *In general.* A practitioner must exercise due diligence—

(1) In preparing or assisting in the preparation of, approving, and filing tax returns, documents, affidavits, and other papers relating to Internal Revenue Service matters;

(2) In determining the correctness of oral or written representations made by the practitioner to the Department of the Treasury; and

(3) In determining the correctness of oral or written representations made by the practitioner to clients with reference to any matter administered by the Internal Revenue Service.

(b) Reliance on others. Except as provided in §§ 10.33 and 10.34, a practitioner will be presumed to have exercised due diligence for purposes of this section if the practitioner relies on the work product of another person and the practitioner used reasonable care in engaging, supervising, training, and evaluating the person, taking proper account of the nature of the relationship between the practitioner and the person.

§ 10.23 Prompt disposition of pending matters.

A practitioner may not unreasonably delay the prompt disposition of any matter before the Internal Revenue Service.

§ 10.24 Assistance from or to disbarred or suspended persons and former Internal Revenue Service employees.

A practitioner may not, knowingly and directly or indirectly:

(a) Accept assistance from or assist any person who is under disbarment or suspension from practice before the Internal Revenue Service if the assistance relates to a matter or matters constituting practice before the Internal Revenue Service.

(b) Accept assistance from any former government employee where the provisions of § 10.25 or any Federal law would be violated.

§ 10.25 Practice by former Government employees, their partners and their associates.

(a) *Definitions.* For purposes of this section—

(1) *Assist* means to act in such a way as to advise, furnish information to, or

otherwise aid another person, directly or indirectly.

(2) *Government employee* is an officer or employee of the United States or any agency of the United States, including a *special government employee* as defined in 18 U.S.C. 202(a), or of the District of Columbia, or of any State, or a member of Congress or of any State legislature.

(3) *Member of a firm* is a sole practitioner or an employee or associate thereof, or a partner, stockholder, associate, affiliate or employee of a partnership, joint venture, corporation, professional association or other affiliation of two or more practitioners who represent nongovernmental parties.

(4) *Practitioner* includes any individual described in paragraph (f) of § 10.2.

(5) *Official responsibility* means the direct administrative or operating authority, whether intermediate or final, and either exercisable alone or with others, and either personally or through subordinates, to approve, disapprove, or otherwise direct Government action, with or without knowledge of the action.

(6) *Participate or participation* means substantial involvement as a Government employee by making decisions, or preparing or reviewing documents with or without the right to exercise a judgment of approval or disapproval, or participating in conferences or investigations, or rendering advice of a substantial nature.

(7) *Rule* includes Treasury Regulations, whether issued or under preparation for issuance as Notices of Proposed Rule Making or as Treasury Decisions; revenue rulings; and revenue procedures published in the Internal Revenue Bulletin. *Rule* does not include a *transaction* as defined in paragraph (a)(8) of this section.

(8) *Transaction* means any decision, determination, finding, letter ruling, technical advice, Chief Counsel advice, or contract or the approval or disapproval thereof, relating to a particular factual situation or situations involving a specific party or parties whose rights, privileges, or liabilities under laws or regulations administered by the Internal Revenue Service, or other legal rights, are determined or immediately affected therein and to which the United States is a party or in which it has a direct and substantial interest, whether or not the same taxable periods are involved. *Transaction* does not include *rule* as defined in paragraph (a)(7) of this section.

(b) *General rules.* (1) No former Government employee may, subsequent to his or her Government employment, represent anyone in any matter administered by the Internal Revenue Service if the representation would violate 18 U.S.C. 207 or any other laws of the United States.

(2) No former Government employee who participated in a transaction may, subsequent to his or her Government employment, represent or knowingly assist, in that transaction, any person who is or was a specific party to that transaction.

(3) A former Government employee who within a period of one year prior to the termination of Government employment had official responsibility for a transaction may not, within two years after his or her Government employment is ended, represent or knowingly assist in that transaction any person who is or was a specific party to that transaction.

(4) No former Government employee may, within one year after his or her Government employment is ended, appear before any employee of the Treasury Department in connection with the publication, withdrawal, amendment, modification, or interpretation of a rule in the development of which the former Government employee participated or for which, within a period of one year prior to the termination of his or her Government employment, he or she had official responsibility. This paragraph (b)(4) does not, however, preclude such former employee from appearing on his or her own behalf or from representing a taxpayer before the Internal Revenue Service in connection with a transaction involving the application or interpretation of such a rule with respect to that transaction, provided that such former employee does not utilize or disclose any confidential information acquired by the former employee in the development of the rule.

(c) *Firm representation.* (1) No member of a firm of which a former Government employee is a member may represent or knowingly assist a person who was or is a specific party in any transaction with respect to which the restrictions of paragraph (b)(2) or (3) of this section apply to the former Government employee, in that transaction, unless the firm isolates the former Government employee in such a way to ensure that the former Government employee cannot assist in the representation.

(2) When isolation of a former Government employee is required under paragraph (c)(1) of this section, a statement affirming the fact of such isolation must be executed under oath by the former Government employee and by another member of the firm acting on behalf of the firm. The statement must clearly identify the firm, the former Government employee, and the transaction(s) requiring isolation and it must be filed with the Director of Practice (and at such other place(s) directed by the Director of Practice) and in such other place and in the manner prescribed by rule or regulation.

(d) *Pending representation.* Practice by former Government employees, their partners and associates with respect to representation in specific matters where actual representation commenced before July 26, 2002, is governed by the regulations set forth at 31 CFR Part 10 revised as of July 1, 2002. The burden of showing that representation commenced before July 26, 2002, lies with the former Government employees, and their partners and associates.

§ 10.26 Notaries.

A practitioner may not take acknowledgments, administer oaths, certify papers, or perform any official act as a notary public with respect to any matter administered by the Internal Revenue Service and for which he or she is employed as counsel, attorney, or agent, or in which he or she may be in any way interested.

§ 10.27 Fees.

(a) *Generally.* A practitioner may not charge an unconscionable fee for representing a client in a matter before the Internal Revenue Service.

(b) *Contingent fees.* (1) For purposes of this section, a contingent fee is any fee that is based, in whole or in part, on whether or not a position taken on a tax return or other filing avoids challenge by the Internal Revenue Service or is sustained either by the Internal Revenue Service or in litigation. A contingent fee includes any fee arrangement in which the practitioner will reimburse the client for all or a portion of the client's fee in the event that a position taken on a tax return or other filing is challenged by the Internal Revenue Service or is not sustained, whether pursuant to an indemnity agreement, a guarantee, rescission rights, or any other arrangement with a similar effect.

(2) A practitioner may not charge a contingent fee for preparing an original tax return or for any advice rendered in connection with a position taken or to be taken on an original tax return.

(3) A contingent fee may be charged for preparation of or advice in connection with an amended tax return or a claim for refund (other than a claim for refund made on an original tax return), but only if the practitioner reasonably anticipates at the time the fee arrangement is entered into that the amended tax return or refund claim will receive substantive review by the Internal Revenue Service.

§ 10.28 Return of client's records.

(a) In general, a practitioner must, at the request of a client, promptly return any and all records of the client that are necessary for the client to comply with his or her Federal tax obligations. The practitioner may retain copies of the records returned to a client. The existence of a dispute over fees generally does not relieve the practitioner of his or her responsibility under this section. Nevertheless, if applicable state law allows or permits the retention of a client's records by a practitioner in the case of a dispute over fees for services rendered, the practitioner need only return those records that must be attached to the taxpayer's return. The practitioner, however, must provide the client with reasonable access to review and copy any additional records of the client retained by the practitioner under state law that are necessary for the client to comply with his or her Federal tax obligations.

(b) For purposes of this section—*Records of the client* include all documents or written or electronic materials provided to the practitioner, or obtained by the practitioner in the course of the practitioner's representation of the client, that preexisted the retention of the practitioner by the client. The term also includes materials that were prepared by the client or a third party (not including an employee or agent of the practitioner) at any time and provided to the practitioner with respect to the subject matter of the representation. The term also includes any return, claim for refund, schedule, affidavit, appraisal or any other document prepared by the practitioner, or his or her employee or agent, that was presented to the client with respect to a prior representation if such document is necessary for the taxpayer to comply with his or her current Federal tax obligations. The term does not include any return, claim for refund, schedule, affidavit, appraisal or any other document prepared by the practitioner or the practitioner's firm, employees or agents if the practitioner is withholding such document pending the client's performance of its contractual obligation to pay fees with respect to such document.

§ 10.29 Conflicting interests.

(a) Except as provided by paragraph (b) of this section, a practitioner shall not represent a client in his or her practice before the Internal Revenue Service if the representation involves a conflict of interest. A conflict of interest exists if:

(1) The representation of one client will be directly adverse to another client; or

(2) There is a significant risk that the representation of one or more clients will be materially limited by the practitioner's responsibilities to another client, a former client or a third person or by a personal interest of the practitioner.

(b) Notwithstanding the existence of a conflict of interest under paragraph (a) of this section, the practitioner may represent a client if:

(1) The practitioner reasonably believes that the practitioner will be able to provide competent and diligent representation to each affected client;

(2) The representation is not prohibited by law;

(3) Each affected client gives informed consent, confirmed in writing.

(c) Copies of the written consents must be retained by the practitioner for at least 36 months from the date of the conclusion of the representation of the affected clients and the written consents must be provided to any officer or employee of the Internal Revenue Service on request.

(Approved by the Office of Management and Budget under Control No. 1545–1726)

§ 10.30 Solicitation.

(a) *Advertising and solicitation restrictions*. (1) A practitioner may not, with respect to any Internal Revenue Service matter, in any way use or participate in the use of any form of public communication or private solicitation containing a false, fraudulent, or coercive statement or claim; or a misleading or deceptive statement or claim. Enrolled agents, in describing their professional designation, may not utilize the term of art "certified" or imply an employer/employee relationship with the Internal Revenue Service. Examples of acceptable descriptions are "enrolled to represent taxpayers before the Internal Revenue Service," "enrolled to practice before the Internal Revenue Service," and "admitted to practice before the Internal Revenue Service."

(2) A practitioner may not make, directly or indirectly, an uninvited written or oral solicitation of employment in matters related to the Internal Revenue Service if the solicitation violates Federal or State law or other applicable rule, *e.g.*, attorneys are precluded from making a solicitation that is prohibited by conduct rules applicable to all attorneys in their State(s) of licensure. Any lawful solicitation made by or on behalf of a practitioner eligible to practice before the Internal Revenue Service must, nevertheless, clearly identify the solicitation as such and, if applicable, identify the source of the information used in choosing the recipient.

(b) *Fee information*. (1)(i) A practitioner may publish the availability of a written schedule of fees and disseminate the following fee information—

(A) Fixed fees for specific routine services.

(B) Hourly rates.

(C) Range of fees for particular services.

(D) Fee charged for an initial consultation.

(ii) Any statement of fee information concerning matters in which costs may be incurred must include a statement disclosing whether clients will be responsible for such costs.

(2) A practitioner may charge no more than the rate(s) published under paragraph

(b)(1) of this section for at least 30 calendar days after the last date on which the schedule of fees was published.

(c) *Communication of fee information.* Fee information may be communicated in professional lists, telephone directories, print media, mailings, electronic mail, facsimile, hand delivered flyers, radio, television, and any other method. The method chosen, however, must not cause the communication to become untruthful, deceptive, or otherwise in violation of this part. A practitioner may not persist in attempting to contact a prospective client if the prospective client has made it known to the practitioner that he or she does not desire to be solicited. In the case of radio and television broadcasting, the broadcast must be recorded and the practitioner must retain a recording of the actual transmission. In the case of direct mail and e-commerce communications, the practitioner must retain a copy of the actual communication, along with a list or other description of persons to whom the communication was mailed or otherwise distributed. The copy must be retained by the practitioner for a period of at least 36 months from the date of the last transmission or use.

(d) *Improper associations.* A practitioner may not, in matters related to the Internal Revenue Service, assist, or accept assistance from, any person or entity who, to the knowledge of the practitioner, obtains clients or otherwise practices in a manner forbidden under this section.

(Approved by the Office of Management and Budget under Control No. 1545–1726)

§ 10.31 Negotiation of taxpayer checks.

A practitioner who prepares tax returns may not endorse or otherwise negotiate any check issued to a client by the government in respect of a Federal tax liability.

§ 10.32 Practice of law.

Nothing in the regulations in this part may be construed as authorizing persons not members of the bar to practice law.

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§ 10.34 Standards for advising with respect to tax return positions and for preparing or signing returns.

(a) *Realistic possibility standard.* A practitioner may not sign a tax return as a preparer if the practitioner determines that the tax return contains a position that does not have a realistic possibility of being sustained on its merits (the realistic possibility standard) unless the position is not frivolous and is adequately disclosed to the Internal Revenue Service. A practitioner may not advise a client to take a position on a tax return, or prepare the portion of a tax return on which a position is taken, unless—

(1) The practitioner determines that the position satisfies the realistic possibility standard; or

(2) The position is not frivolous and the practitioner advises the client of any opportunity to avoid the accuracy-related penalty in section 6662 of the Internal Revenue Code by adequately disclosing the position and of the requirements for adequate disclosure.

(b) *Advising clients on potential penalties.* A practitioner advising a client to take a position on a tax return, or preparing or signing a tax return as a preparer, must inform the client of the penalties reasonably likely to apply to the client with respect to the position advised, prepared, or reported. The practitioner also must inform the client of any opportunity to avoid any such penalty by disclosure, if relevant, and of the requirements for adequate disclosure. This paragraph (b) applies even if the practitioner is not subject to a penalty with respect to the position.

(c) *Relying on information furnished by clients.* A practitioner advising a client to take a position on a tax return, or preparing or signing a tax return as a preparer, generally may rely in good faith without verification upon information furnished by the client. The practitioner may not, however, ignore the implications of information furnished to, or actually known by, the practitioner, and must make reasonable inquiries if the information as furnished appears to be incorrect, inconsistent with an important fact or another factual assumption, or incomplete.

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

(1) *Realistic possibility.* A position is considered to have a realistic possibility of being sustained on its merits if a reasonable and well informed analysis of the law and the facts by a person knowledgeable in the tax law would lead such a person to conclude that the position has approximately a one in three, or greater, likelihood of being sustained on its merits. The authorities described in 26 CFR 1.6662–4(d)(3)(iii), or any successor provision, of the substantial understatement penalty regulations may be taken into account for purposes of this analysis. The possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be settled may not be taken into account.

(2) *Frivolous.* A position is frivolous if it is patently improper.

Par. 4. In part 10, subparts C, D, and E are revised to read as follows:

Subpart C — Sanctions for Violation of the Regulations

§ 10.50 Sanctions.

(a) *Authority to censure, suspend, or disbar.* The Secretary of the Treasury, or his or her delegate, after notice and an opportunity for a proceeding, may censure, suspend or disbar any practitioner from practice before the Internal Revenue Service if the practitioner is shown to be incompetent or disreputable, fails to comply with any regulation in this part, or with intent to defraud, willfully and knowingly misleads or threatens a client or prospective client. Censure is a public reprimand.

(b) *Authority to disqualify.* The Secretary of the Treasury, or his or her delegate, after due notice and opportunity for hearing, may disqualify any appraiser with respect to whom a penalty has been assessed under section 6701(a) of the Internal Revenue Code.

(1) If any appraiser is disqualified pursuant to this subpart C, such appraiser is barred from presenting evidence or testimony in any administrative proceeding before the Department of Treasury or the Internal Revenue Service, unless and until authorized to do so by the Director of Practice pursuant to § 10.81, regardless of whether such evidence or testimony would pertain to an appraisal made prior to or after such date.

(2) Any appraisal made by a disqualified appraiser after the effective date of disqualification will not have any proba-

tive effect in any administrative proceeding before the Department of the Treasury or the Internal Revenue Service. An appraisal otherwise barred from admission into evidence pursuant to this section may be admitted into evidence solely for the purpose of determining the taxpayer's reliance in good faith on such appraisal.

§ 10.51 Incompetence and disreputable conduct.

Incompetence and disreputable conduct for which a practitioner may be censured, suspended or disbarred from practice before the Internal Revenue Service includes, but is not limited to—

(a) Conviction of any criminal offense under the revenue laws of the United States;

(b) Conviction of any criminal offense involving dishonesty or breach of trust;

(c) Conviction of any felony under Federal or State law for which the conduct involved renders the practitioner unfit to practice before the Internal Revenue Service;

(d) Giving false or misleading information, or participating in any way in the giving of false or misleading information to the Department of the Treasury or any officer or employee thereof, or to any tribunal authorized to pass upon Federal tax matters, in connection with any matter pending or likely to be pending before them, knowing such information to be false or misleading. Facts or other matters contained in testimony, Federal tax returns, financial statements, applications for enrollment, affidavits, declarations, or any other document or statement, written or oral, are included in the term *information.*

(e) Solicitation of employment as prohibited under § 10.30, the use of false or misleading representations with intent to deceive a client or prospective client in order to procure employment, or intimating that the practitioner is able improperly to obtain special consideration or action from the Internal Revenue Service or officer or employee thereof.

(f) Willfully failing to make a Federal tax return in violation of the revenue laws of the United States, willfully evading, attempting to evade, or participating in any way in evading or attempting to evade any assessment or payment of any Federal tax, or knowingly counseling or suggesting to a client or prospective client an illegal plan to evade Federal taxes or payment thereof.

(g) Misappropriation of, or failure properly and promptly to remit funds received from a client for the purpose of payment of taxes or other obligations due the United States.

(h) Directly or indirectly attempting to influence, or offering or agreeing to attempt to influence, the official action of any officer or employee of the Internal Revenue Service by the use of threats, false accusations, duress or coercion, by the offer of any special inducement or promise of advantage or by the bestowing of any gift, favor or thing of value.

(i) Disbarment or suspension from practice as an attorney, certified public accountant, public accountant, or actuary by any duly constituted authority of any State, territory, possession of the United States, including a Commonwealth, or the District of Columbia, any Federal court of record or any Federal agency, body or board.

(j) Knowingly aiding and abetting another person to practice before the Internal Revenue Service during a period of suspension, disbarment, or ineligibility of such other person.

(k) Contemptuous conduct in connection with practice before the Internal Revenue Service, including the use of abusive language, making false accusations and statements, knowing them to be false, or circulating or publishing malicious or libelous matter.

(l) Giving a false opinion, knowingly, recklessly, or through gross incompetence, including an opinion which is intentionally or recklessly misleading, or engaging in a pattern of providing incompetent opinions on questions arising under the Federal tax laws. False opinions described in this paragraph (l) include those which reflect or result from a knowing misstatement of fact or law, from an assertion of a position known to be unwarranted under existing law, from counseling or assisting in conduct known to be illegal or fraudulent, from concealing matters required by law to be revealed, or from consciously disregarding information indicating that material facts expressed in the tax opinion or offering material are false or misleading. For purposes of this paragraph (l), reckless conduct is a highly unreasonable omission or misrepresentation involving an extreme departure from the standards of ordinary care that a practitioner should observe under the circumstances. A pattern of conduct is a factor that will be taken into account in determining whether a practitioner acted knowingly, recklessly, or through gross incompetence. Gross incompetence includes conduct that reflects gross indifference, preparation which is grossly inadequate under the circumstances, and a consistent failure to perform obligations to the client.

§ 10.52 Violation of regulations.

A practitioner may be censured, suspended or disbarred from practice before the Internal Revenue Service for any of the following:

(a) Willfully violating any of the regulations contained in this part.

(b) Recklessly or through gross incompetence (within the meaning of § 10.51(l)) violating § 10.33 or 10.34.

§ 10.53 Receipt of information concerning practitioner.

(a) *Officer or employee of the Internal Revenue Service.* If an officer or employee of the Internal Revenue Service has reason to believe that a practitioner has violated any provision of this part, the officer or employee will promptly make a written report to the Director of Practice of the suspected violation. The report will explain the facts and reasons upon which the officer's or employee's belief rests.

(b) *Other persons.* Any person other than an officer or employee of the Internal Revenue Service having information of a violation of any provision of this part may make an oral or written report of the alleged violation to the Director of Practice or any officer or employee of the Internal Revenue Service. If the report is made to an officer or employee of the Internal Revenue Service, the officer or employee will make a written report of the suspected violation to the Director of Practice.

(c) *Destruction of report.* No report made under paragraph (a) or (b) of this section shall be maintained by the Director of Practice unless retention of such record is permissible under the applicable records control schedule as approved by the National Archives and Records Administration and designated in the Internal Revenue Manual. The Director of Practice must destroy such reports as soon as permissible under the applicable records control schedule.

(d) *Effect on proceedings under subpart D.* The destruction of any report will not bar any proceeding under subpart D of this part, but precludes the Director of Practice's use of a copy of such report in a proceeding under subpart D of this part.

Subpart D — Rules Applicable to Disciplinary Proceedings

§ 10.60 Institution of proceeding.

(a) Whenever the Director of Practice determines that a practitioner violated any provision of the laws or regulations in this part, the Director of Practice may reprimand the practitioner or, in accordance with § 10.62, institute a proceeding for censure, suspension, or disbarment of the practitioner. A proceeding for censure, suspension, or disbarment of a practitioner is instituted by the filing of a complaint, the contents of which are more fully described in § 10.62.

(b) Whenever the Director of Practice is advised or becomes aware that a penalty has been assessed against an appraiser under section 6701(a) of the Internal Revenue Code, the Director of Practice may reprimand the appraiser or, in accordance with § 10.62, institute a proceeding for disqualification of the appraiser. A proceeding for disqualification of an appraiser is instituted by the filing of a complaint, the contents of which are more fully described in § 10.62.

(c) Except as provided in § 10.82, a proceeding will not be instituted under this section unless the proposed respondent previously has been advised in writing of the law, facts and conduct warranting such action and has been accorded an opportunity to dispute facts, assert additional facts, and make arguments (including an explanation or description of mitigating circumstances).

§ 10.61 Conferences.

(a) *In general.* The Director of Practice may confer with a practitioner or an appraiser concerning allegations of misconduct irrespective of whether a proceeding for censure, suspension, disbarment, or disqualification has been instituted against the practitioner or appraiser. If the conference results in a stipulation in connection with an ongoing proceeding in which the practitioner or appraiser is the respondent, the stipulation may be entered in the record by either party to the proceeding.

(b) *Resignation or voluntary censure, suspension or disbarment.* In lieu of a proceeding being instituted or continued under paragraph (a) of § 10.60, a practitioner may offer his or her consent to the issuance of a censure, suspension or disbarment, or, if the practitioner is an enrolled agent, may offer to resign. The Director of Practice may, in his or her discretion, accept or decline the offered censure, suspension, disbarment, or offer of resignation by an enrolled agent, in accordance with the consent offered. In any declination, the Director of Practice may state that he or she would accept an offer of censure, suspension, or disbarment, or, if the practitioner is an enrolled agent, offer of resignation, containing different terms; the Director of Practice may, in his or her discretion, accept or reject a revised offer of censure, suspension, disbarment, or offer of resignation by an enrolled agent, submitted in response to the declination or may counteroffer and act upon any accepted counteroffer.

(c) *Voluntary disqualification.* In lieu of a proceeding being instituted or continued under paragraph (b) of § 10.60, an appraiser may offer his or her consent to disqualification. The Director of Practice may, in his or her discretion, accept or decline the offered disqualification, in accordance with the consent offered. In any declination, the Director of Practice may state that he or she would accept an offer of disqualification containing different terms; the Director of Practice may, in his or her discretion, accept or reject a revised offer of censure, suspension or disbarment submitted in response to the declination or may counteroffer and act upon any accepted counteroffer.

§ 10.62 Contents of complaint.

(a) *Charges.* A complaint must name the respondent, provide a clear and concise description of the facts and law that constitute the basis for the proceeding, and be signed by the Director of Practice or a person representing the Director of Practice under § 10.69(a)(1). A complaint is sufficient if it fairly informs the respondent of the charges brought so that he or she is able to prepare a defense. In the case of a complaint filed against an appraiser, the complaint is sufficient if it refers to a penalty imposed previously on the respondent under section 6701(a) of the Internal Revenue Code.

(b) *Specification of sanction.* The complaint must specify the sanction sought by the Director of Practice against the practitioner or appraiser. If the sanction sought is a suspension, the duration of the suspension sought must be specified.

(c) *Demand for answer.* The Director of Practice must, in the complaint or in a separate paper attached to the complaint, notify the respondent of the time for answering the complaint, the time for which may not be less than15 days from the date of service of the complaint, the name and address of the Administrative Law Judge with whom the answer must be filed, the name and address of the person representing the Director of Practice to whom a copy of the answer must be served, and that a decision by default may be rendered against the respondent in the event an answer is not filed as required.

§ 10.63 Service of complaint; service and filing of other papers.

(a) *Service of complaint.*

(1) *In general.* The complaint or a copy of the complaint must be served on the respondent by any manner described in paragraphs (a)(2) or (3) of this section.

(2) *Service by certified or first class mail.* (i) Service of the complaint may be made on the respondent by mailing the complaint by certified mail to the last known address (as determined under section 6212 of the Internal Revenue Code and the regulations thereunder) of the respondent. Where service is by certified mail, the returned post office receipt duly signed by the respondent will be proof of service.

(ii) If the certified mail is not claimed or accepted by the respondent, or is returned undelivered, service may be made on the respondent, by mailing the complaint to the respondent by first class mail. Service by this method will be considered complete upon mailing, provided the complaint is addressed to the respondent at the respondent's last known address as determined under section 6212 of the Internal Revenue Code and the regulations thereunder.

(3) *Service by other than certified or first class mail.* (i) Service of the complaint may be made on the respondent by delivery by a private delivery service designated pursuant to section 7502(f) of the Internal Revenue Code to the last known address (as determined under section 6212 of the Internal Revenue Code and the regulations thereunder) of the respondent. Service by this method will be considered complete, provided the complaint is addressed to the respondent at the respondent's last known address as determined under section 6212 of the Internal Revenue Code and the regulations thereunder.

(ii) Service of the complaint may be made in person on, or by leaving the complaint at the office or place of business of, the respondent. Service by this method will be considered complete and proof of service will be a written statement, sworn or affirmed by the person who served the complaint, identifying the manner of service, including the recipient, relationship of recipient to respondent, place, date and time of service.

(iii) Service may be made by any other means agreed to by the respondent. Proof of service will be a written statement, sworn or affirmed by the person who served the complaint, identifying the manner of service, including the recipient, relationship of recipient to respondent, place, date and time of service.

(4) For purposes of this paragraph (a), "respondent" means the practitioner or appraiser named in the complaint or any other person having the authority to accept mail on behalf of the practitioner or appraiser.

(b) *Service of papers other than complaint.* Any paper other than the complaint may be served on the respondent, or his or her authorized representative under § 10.69(a)(2) by:

(1) mailing the paper by first class mail to the last known address (as determined under section 6212 of the Internal Revenue Code and the regulations thereunder) of the respondent or the respondent's authorized representative,

(2) delivery by a private delivery service designated pursuant to section 7502(f) of the Internal Revenue Code to the last known address (as determined under section 6212 of the Internal Revenue Code and the regulations thereunder) of the respondent or the respondent's authorized representative, or

(3) as provided in paragraphs (a)(3)(ii) and (a)(3)(iii) of this section.

(c) *Service of papers on the Director of Practice.* Whenever a paper is required or permitted to be served on the Director of Practice in connection with a proceeding under this part, the paper will be served on the Director of Practice's authorized representative under §10.69(a)(1) at the address designated in the complaint, or at an address provided in a notice of appearance. If no address is designated in the complaint or provided in a notice of appearance, service will be made on the Director of Practice, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224.

(d) *Filing of papers*. Whenever the filing of a paper is required or permitted in connection with a proceeding under this part, the original paper, plus one additional copy, must be filed with the Administrative Law Judge at the address specified in the complaint or at an address otherwise specified by the Administrative Law Judge. All papers filed in connection with a proceeding under this part must be served on the other party, unless the Administrative Law Judge directs otherwise. A certificate evidencing such must be attached to the original paper filed with the Administrative Law Judge.

§ 10.64 Answer; default.

(a) *Filing.* The respondent's answer must be filed with the Administrative Law Judge, and served on the Director of Practice, within the time specified in the complaint unless, on request or application of the respondent, the time is extended by the Administrative Law Judge.

(b) Contents. The answer must be written and contain a statement of facts that constitute the respondent's grounds of defense. General denials are not permitted. The respondent must specifically admit or deny each allegation set forth in the complaint, except that the respondent may state that the respondent is without sufficient information to admit or deny a specific allegation. The respondent, nevertheless, may not deny a material allegation in the complaint that the respondent knows to be true, or state that the respondent is without sufficient information to form a belief, when the respondent possesses the required information. The respondent also must state affirmatively any special matters of defense on which he or she relies.

(c) *Failure to deny or answer allegations in the complaint.* Every allegation in the complaint that is not denied in the answer is deemed admitted and will be considered proved; no further evidence in respect of such allegation need be adduced at a hearing.

(d) *Default.* Failure to file an answer within the time prescribed (or within the time for answer as extended by the Administrative Law Judge), constitutes an admission of the allegations of the complaint and a waiver of hearing, and the Administrative Law Judge may make the decision by default without a hearing or further procedure. A decision by default constitutes a decision under § 10.76.

(e) *Signature.* The answer must be signed by the respondent or the respondent's authorized representative under § 10.69(a)(2) and must include a statement directly above the signature acknowledging that the statements made in the answer are true and correct and that knowing and willful false statements may be punishable under 18 U.S.C. 1001.

§ 10.65 Supplemental charges.

If it appears that the respondent, in his or her answer, falsely and in bad faith, denies a material allegation of fact in the complaint or states that the respondent has insufficient knowledge to form a belief, when the respondent in fact possesses such information, or if it appears that the respondent has knowingly introduced false testimony during proceedings for his or her censure, suspension, disbarment, or disqualification, the Director of Practice may file supplemental charges against the respondent. The supplemental charges may be heard with other charges in the case, provided the respondent is given due notice of the charges and is afforded an opportunity to prepare a defense to such charges.

§ 10.66 Reply to answer.

The Director of Practice may file a reply to the respondent's answer, but unless otherwise ordered by the Administrative Law Judge, no reply to the respondent's answer is required. If a reply is not filed, new matter in the answer is deemed denied.

§ 10.67 Proof; variance; amendment of pleadings.

In the case of a variance between the allegations in pleadings and the evidence adduced in support of the pleadings, the Administrative Law Judge, at any time before decision, may order or authorize amendment of the pleadings to conform to the evidence. The party who would otherwise be prejudiced by the amendment must be given a reasonable opportunity to address the allegations of the pleadings as amended and the Administrative Law Judge must make findings on any issue presented by the pleadings as amended.

§ 10.68 Motions and requests.

(a) *Motions.* At any time after the filing of the complaint, any party may file a motion with the Administrative Law Judge. Unless otherwise ordered by the Administrative Law Judge, motions must be in writing and must be served on the opposing party as provided in § 10.63(b). A motion must concisely specify its grounds and the relief sought, and, if appropriate, must contain a memorandum of facts and law in support. Before moving, a party must make a good faith effort to resolve with the other party any dispute that gives rise to, or is a concern of, the motion. The movant must certify such an attempt was made and state, if it is known, whether the opposing party opposes the motion.

(b) *Response.* Unless otherwise ordered by the Administrative Law Judge, the nonmoving party is not required to file a response to a motion. If the Administrative Law Judge does not order the nonmoving party to file a response, the nonmoving party is deemed to oppose the motion.

(c) *Oral motions and arguments.* The Administrative Law Judge may, for good cause and with notice to the parties, permit oral motions and oral opposition to motions. The Administrative Law Judge may, within his or her discretion, permit oral argument on any motion.

§ 10.69 Representation; ex parte communication.

(a) *Representation.* (1) The Director of Practice may be represented in proceedings under this part by an attorney or other employee of the Internal Revenue Service. An attorney or an employee of the Internal Revenue Service representing the Director of Practice in a proceeding under this part may sign the complaint or any document required to be filed in the proceeding on behalf of the Director of Practice.

(2) A respondent may appear in person, be represented by a practitioner, or be represented by an attorney who has not filed a declaration with the Internal Revenue Service pursuant to § 10.3. A practitioner or an attorney representing a respondent or proposed respondent may sign the answer or any document required to be filed in the proceeding on behalf of the respondent.

(b) *Ex parte communication.* The Director of Practice, the respondent, and any representatives of either party, may not attempt to initiate or participate in *ex parte* discussions concerning a proceeding or potential proceeding with the Administrative Law Judge (or any person who is likely to advise the Administrative Law Judge on a ruling or decision) in the proceeding before or during the pendency of the proceeding. Any memorandum, letter or other communication concerning the merits of the proceeding, addressed to the Administrative Law Judge, by or on behalf of any party shall be regarded as an argument in the proceeding and shall be served on the other party.

§ 10.70 Administrative Law Judge.

(a) *Appointment.* Proceedings on complaints for the censure, suspension or disbarment of a practitioner or the disqualification of an appraiser will be conducted by an Administrative Law Judge appointed as provided by 5 U.S.C. 3105.

(b) *Powers of the Administrative Law Judge.* The Administrative Law Judge, among other powers, has the authority, in connection with any proceeding under § 10.60 assigned or referred to him or her, to do the following:

(1) Administer oaths and affirmations;

(2) Make rulings on motions and requests, which rulings may not be appealed prior to the close of a hearing except in extraordinary circumstances and at the discretion of the Administrative Law Judge;

(3) Determine the time and place of hearing and regulate its course and conduct;

(4) Adopt rules of procedure and modify the same from time to time as needed for the orderly disposition of proceedings;

(5) Rule on offers of proof, receive relevant evidence, and examine witnesses;

(6) Take or authorize the taking of depositions;

(7) Receive and consider oral or written argument on facts or law;

(8) Hold or provide for the holding of conferences for the settlement or simplification of the issues with the consent of the parties;

(9) Perform such acts and take such measures as are necessary or appropriate to the efficient conduct of any proceeding; and

(10) Make decisions.

§ 10.71 Hearings.

(a) *In general.* An Administrative Law Judge will preside at the hearing on a complaint filed under paragraph (c) of § 10.60 for the censure, suspension, or disbarment of a practitioner or disqualification of an appraiser. Hearings will be stenographically recorded and transcribed and the testimony of witnesses will be taken under oath or affirmation. Hearings will be conducted pursuant to 5 U.S.C. 556. A hearing in a proceeding requested under paragraph (g) of § 10.82 will be conducted *de novo*. An evidentiary hearing must be held in all proceedings prior to the issuance of a decision by the Administrative Law Judge unless: the Director of Practice withdraws the complaint; the practitioner consents to a sanction pursuant to § 10.61(b); a decision is issued by default pursuant to § 10.64(d), a decision is issued under § 10.82(e); the respondent requests a decision on the record without a hearing; or the Administrative Law Judge issues a decision on a motion that disposes of the case prior to the hearing.

(b) *Publicity of Proceedings.* A request by a practitioner or appraiser that a hearing in a disciplinary proceeding concerning him or her be public, and that the record of such disciplinary proceeding be made available for inspection by interested persons may be granted by the Administrative Law Judge where the parties stipulate in advance to protect from disclosure confidential tax information in accordance with all applicable statutes and regulations.

(c) *Location.* The location of the hearing will be determined by the agreement of the parties with the approval of the Administrative Law Judge, but, in the absence of such agreement and approval, the hearing will be held in Washington, D.C.

(d) *Failure to appear.* If either party to the proceeding fails to appear at the hearing, after notice of the proceeding has been sent to him or her, the party will be deemed to have waived the right to a hearing and the Administrative Law Judge may make his or her decision against the absent party by default.

§ 10.72 Evidence.

(a) *In general.* The rules of evidence prevailing in courts of law and equity are not controlling in hearings or proceedings conducted under this part. The Administrative Law Judge may, however, exclude evidence that is irrelevant, immaterial, or unduly repetitious,

(b) *Depositions.* The deposition of any witness taken pursuant to § 10.73 may be admitted into evidence in any proceeding instituted under § 10.60.

(c) *Proof of documents.* Official documents, records, and papers of the Internal Revenue Service and the Office of Director of Practice are admissible in evidence without the production of an officer or employee to authenticate them. Any such documents, records, and papers may be evidenced by a copy attested or identified by an officer or employee of the Internal Revenue Service or the Treasury Department, as the case may be.

(d) *Withdrawal of exhibits.* If any document, record, or other paper is introduced in evidence as an exhibit, the Administrative Law Judge may authorize the withdrawal of the exhibit subject to any conditions that he or she deems proper.

(e) *Objections.* Objections to evidence are to be made in short form, stating the grounds for the objection. Except as ordered by the Administrative Law Judge, argument on objections will not be recorded or transcribed. Rulings on objections are to be a part of the record, but no exception to a ruling is necessary to preserve the rights of the parties.

§ 10.73 Depositions.

(a) Depositions for use at a hearing may be taken, with the written approval of the Administrative Law Judge, by either the Director of Practice or the respondent or their duly authorized representatives. Depositions may be taken before any officer duly authorized to administer an oath for general purposes or before an officer or employee of the Internal Revenue Service who is authorized to administer an oath in internal revenue matters.

(b) The party taking the deposition must provide the deponent and the other party with 10 days written notice of the deposition, unless the deponent and the parties agree otherwise. The notice must specify the name of the deponent, the time and place where the deposition is to be taken, and whether the deposition will be taken by oral or written interrogatories. When a deposition is taken by written interrogatories, any cross-examination also will be by written interrogatories. Copies of the written interrogatories must be served on the other party with the notice of deposition, and copies of any written cross-interrogation must be mailed or delivered to the opposing party at least 5 days before the date that the deposition will be taken, unless the parties mutually agree otherwise. A party on whose behalf a deposition is taken must file the responses to the written interrogatories or a transcript of the oral deposition with the Administrative Law Judge and serve copies on the opposing party and the deponent. Expenses in the reporting of depositions will be borne by the party that requested the deposition.

§ 10.74 Transcript.

In cases where the hearing is stenographically reported by a Government contract reporter, copies of the transcript may be obtained from the reporter at rates not to exceed the maximum rates fixed by contract between the Government and the reporter. Where the hearing is stenographically reported by a regular employee of the Internal Revenue Service, a copy will be supplied to the respondent either without charge or upon the payment of a reasonable fee. Copies of exhibits introduced at the hearing or at the taking of depositions will be supplied to the parties upon the payment of a reasonable fee (Sec. 501, Public Law 82–137) (65 Stat. 290) (31 U.S.C. 483a).

§ 10.75 Proposed findings and conclusions.

Except in cases where the respondent has failed to answer the complaint or where a party has failed to appear at the hearing, the parties must be afforded a reasonable opportunity to submit proposed findings and conclusions and their supporting reasons to the Administrative Law Judge.

§ 10.76 Decision of Administrative Law Judge.

(a) As soon as practicable after the conclusion of a hearing and the receipt of any proposed findings and conclusions timely submitted by the parties, the Administrative Law Judge will enter a decision in the case. The decision must include a statement of findings and conclusions, as well as the reasons or basis for making such findings and conclusions, and an order of censure, suspension, disbarment, disqualification, or dismissal of the complaint. If the sanction is censure or a suspension of less than six month's duration, the Administrative Law Judge, in rendering findings and conclusions, will consider an allegation of fact to be proven if it is established by the party who is alleging the fact by a preponderance of evidence in the record. In the event that the sanction is disbarment or a suspension of a duration of six months or longer, an allegation of fact that is necessary for a finding against the practitioner must be proven by clear and convincing evidence in the record. An allegation of fact that is necessary for a finding of disqualification against an appraiser must be proven by clear and convincing evidence in the record. The Administrative Law Judge will provide the decision to the Director of Practice and a copy of the decision to the respondent or the respondent's authorized representative.

(b) In the absence of an appeal to the Secretary of the Treasury or his or her designee, or review of the decision on motion of the Secretary or his or her designee, the decision of the Administrative Law Judge will, without further proceedings, become the decision of the agency 30 days after the date of the Administrative Law Judge's decision.

§ 10.77 Appeal of decision of Administrative Law Judge.

Within 30 days from the date of the Administrative Law Judge's decision, either party may appeal to the Secretary of the Treasury, or his or her delegate. The respondent must file his or her appeal with the Director of Practice in duplicate and a notice of appeal must include exceptions to the decision of the Administrative Law Judge and supporting reasons for such exceptions. If the Director of Practice files an appeal, he or she must provide a copy to the respondent. Within 30 days after receipt of an appeal or copy thereof, the other party may file a reply brief in duplicate with the Director of Practice. If the reply brief is filed by the Director of Practice, he or she must provide a copy of it to the respondent. The Director of Practice must provide the entire record to the Secretary of the Treasury, or his or her delegate, after the appeal and any reply brief has been filed.

§ 10.78 Decision on appeal.

On appeal from or review of the decision of the Administrative Law Judge, the Secretary of the Treasury, or his or her delegate, will make the agency decision. The Secretary of the Treasury, or his or delegate, will provide a copy of the agency decision to the Director of Practice and the respondent or the respondent's authorized representative. The decision of the Administrative Law Judge will not be reversed unless the appellant establishes that the decision is clearly erroneous in light of the evidence in the record and applicable law. Issues that are exclusively matters of law will be reviewed *de novo*. In the event that the Secretary of the Treasury, or his or her delegate, determines that there are unresolved issues raised by the record, the case may be remanded to the Administrative Law Judge to elicit additional testimony or evidence. A copy of the agency decision or that of his or her delegate will be provided to the Director of Practice and the respondent contemporaneously.

§ 10.79 Effect of disbarment, suspension, or censure.

(a) *Disbarment.* When the final decision in a case is against the respondent (or the respondent has offered his or her consent and such consent has been accepted by the Director of Practice) and such decision is for disbarment, the respondent will not be permitted to practice before the Internal Revenue Service unless and until authorized to do so by the Director of Practice pursuant to § 10.81.

(b) *Suspension.* When the final decision in a case is against the respondent (or the respondent has offered his or her consent and such consent has been accepted by the Director of Practice) and such decision is for suspension, the respondent will not be permitted to practice before the Internal Revenue Service during the period of suspension. For periods after the suspension, the practitioner's future representations may be subject to conditions as authorized by paragraph (d) of this section.

(c) *Censure.* When the final decision in the case is against the respondent (or the respondent has offered his or her consent and such consent has been accepted by the Director of Practice) and such decision is for censure, the respondent will be permitted to practice before the Internal Revenue Service, but the respondent's future representations may be subject to conditions as authorized by paragraph (d) of this section.

(d) *Conditions.* After being subject to the sanction of either suspension or censure, the future representations of a practitioner so sanctioned shall be subject to conditions prescribed by the Director of Practice designed to promote high standards of conduct. These conditions can be imposed for a reasonable period in light of the gravity of the practitioner's violations. For example, where a practitioner is censured because he or she failed to advise his or her clients about a potential conflict of interest or failed to obtain the clients' written consents, the Director of Practice may require the practitioner to provide the Director of Practice or another Internal Revenue Service official with a copy of all consents obtained by the practitioner for an appropriate period following censure, whether or not such consents are specifically requested.

§ 10.80 Notice of disbarment, suspension, censure, or disqualification.

On the issuance of a final order censuring, suspending, or disbarring a practitioner or a final order disqualifying an appraiser, the Director of Practice may give notice of the censure, suspension, disbarment, or disqualification to appropriate officers and employees of the Internal Revenue Service and to interested departments and agencies of the Federal government. The Director of Practice may determine the manner of giving notice to the proper authorities of the State by which the censured, suspended, or disbarred person was licensed to practice.

§ 10.81 Petition for reinstatement.

The Director of Practice may entertain a petition for reinstatement from any person disbarred from practice before the Internal Revenue Service or any disqualified appraiser after the expiration of 5 years following such disbarment or disqualification. Reinstatement may not be granted unless the Director of Practice is satisfied that the petitioner, thereafter, is not likely to conduct himself contrary to the regulations in this part, and that granting such reinstatement would not be contrary to the public interest.

§ 10.82 Expedited suspension upon criminal conviction or loss of license for cause.

(a) *When applicable.* Whenever the Director of Practice determines that a practitioner is described in paragraph (b) of this section, the Director of Practice may institute a proceeding under this section to suspend the practitioner from practice before the Internal Revenue Service.

(b) *To whom applicable.* This section applies to any practitioner who, within 5 years of the date a complaint instituting a proceeding under this section is served:

(1) Has had his or her license to practice as an attorney, certified public accountant, or actuary suspended or revoked for cause (not including a failure to pay a professional licensing fee) by any authority or court, agency, body, or board described in § 10.51(i); or

(2) Has, irrespective of whether an appeal has been taken, been convicted of any crime under title 26 of the United States Code, any crime involving dishonesty or breach of trust, or any felony for which the conduct involved renders the practitioner unfit to practice before the Internal Revenue Service.

(3) Has violated conditions designed to promote high standards of conduct established pursuant to § 10.79(d).

(c) *Instituting a proceeding.* A proceeding under this section will be instituted by a complaint that names the respondent, is signed by the Director of Practice or a person representing the Director of Practice under § 10.69(a)(1), is filed in the Director of Practice's office, and is served according to the rules set forth in paragraph (a) of § 10.63. The complaint must give a plain and concise description of the allegations that constitute the basis for the proceeding. The complaint must notify the respondent—

(1) Of the place and due date for filing an answer;

(2) That a decision by default may be rendered if the respondent fails to file an answer as required;

(3) That the respondent may request a conference with the Director of Practice to address the merits of the complaint and that any such request must be made in the answer; and

(4) That the respondent may be suspended either immediately following the expiration of the period within which an answer must be filed or, if a conference is requested, immediately following the conference.

(d) *Answer.* The answer to a complaint described in this section must be filed no later than 30 calendar days following the date the complaint is served, unless the Director of Practice extends the time for filing. The answer must be filed in accordance with the rules set forth in § 10.64, except as otherwise provided in this section. A respondent is entitled to a conference with the Director of Practice only if the conference is requested in a timely filed answer. If a request for a conference is not made in the answer or the answer is not timely filed, the respondent will be deemed to have waived his or her right to a conference and the Director of Practice may suspend such respondent at any time following the date on which the answer was due.

(e) *Conference.* The Director of Practice or his or her designee will preside at a conference described in this section. The conference will be held at a place and time selected by the Director of Practice, but no sooner than 14 calendar days after the date by which the answer must be filed with the Director of Practice, unless the respondent agrees to an earlier date. An authorized representative may represent the respondent at the conference. Following the conference, upon a finding that the respondent is described in paragraph (b) of this section, or upon the respondent's failure to appear at the conference either personally or through an authorized representative, the Director of Practice may immediately suspend the respondent from practice before the Internal Revenue Service.

(f) *Duration of suspension.* A suspension under this section will commence on the date that written notice of the suspension is issued. A practitioner's suspension will remain effective until the earlier of the following—

(1) The Director of Practice lifts the suspension after determining that the practitioner is no longer described in paragraph (b) of this section or for any other reason; or

(2) The suspension is lifted by an Administrative Law Judge or the Secretary of the Treasury in a proceeding referred to in paragraph (g) of this section and instituted under § 10.60.

(g) *Proceeding instituted under § 10.60*. If the Director of Practice suspends a practitioner under this section, the practitioner may ask the Director of Practice to issue a complaint under § 10.60. The request must be made in writing within 2 years from the date on which the practitioner's suspension commences. The Director of Practice must issue a complaint requested under this paragraph within 30 calendar days of receiving the request.

Subpart E — General Provisions

§ 10.90 Records.

Availability. The Director of Practice will make available for public inspection at the Office of Director of Practice the roster of all persons enrolled to practice, the roster of all persons censured, suspended, or disbarred from practice before the Internal Revenue Service, and the roster of all disqualified appraisers. Other records of the Director of Practice may be disclosed upon specific request, in accordance with the applicable disclosure rules of the Internal Revenue Service and the Treasury Department.

§ 10.91 Saving clause.

Any proceeding instituted under regulations in effect prior to July 26, 2002, that is not final prior to July 26, 2002, will not be affected by this part and will apply the rules set forth at 31 CFR part 10 revised as of July 1, 2002. Any proceeding under this part based on conduct engaged in prior to July 26, 2002, which is instituted after that date, shall apply Subpart D and E of this part, but the conduct engaged in prior to July 26, 2002, shall be judged by the regulations in effect at the time the conduct occurred.

§ 10.92 Special orders.

The Secretary of the Treasury reserves the power to issue such special orders as he or she deems proper in any cases within the purview of this part.

§ 10.93 Effective date.

Subject to § 10.91, this part is applicable on July 26, 2002.

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved July 17, 2002.

David Aufhauser,
General Counsel, Office of the Secretary.

(Filed by the Office of the Federal Register on July 25, 2002, 8:45 a.m., and published in the issue of the Federal Register for July 26, 2002, 67 F.R. 48760)

Part III. Administrative, Procedural, and Miscellaneous

Weighted Average Interest Rate Update

Notice 2002–57

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

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

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

The rate of interest on 30-year Treasury Securities for July 2002 is 5.39 percent. Pursuant to Notice 2002–26, 2002–15 I.R.B. 743, the Service has determined this rate as the monthly average of the daily determination of yield on the 30-year Treasury bond maturing in February 2031.

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

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

Month	Year	Weighted Average	90% to 110% Permissible Range	90% to 120% Permissible Range
August	2002	5.65	5.09 to 6.22	5.09 to 6.78

Drafting Information

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

Part IV. Items of General Interest

Notice of Proposed Rulemaking and Notice of Public Hearing

Definition of Guaranteed Annuity and Lead Unitrust Interests

REG–115781–01

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations conforming the income, gift, and estate tax regulations to the Tax Court's decision in *Estate of Boeshore v. Commissioner*, 78 T.C. 523 (1982), *acq. in result*, 1987–2 C.B. 1, holding portions of § 20.2055–2(e)(2)(vi)(*e*) of the Estate Tax Regulations invalid.

DATES: Written or electronic comments and requests to speak at the public hearing scheduled for October 16, must be received by September 25, 2002.

ADDRESSES: Send submissions to: CC:ITA:RU (REG–115781–01), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submission of comments may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:ITA:RU (REG–115781–01), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet directly to the IRS Internet site at *www.irs.gov/regs*. The public hearing will be held in Room 4718, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Susan Hurwitz (202) 622–3090; concerning submissions of comments, Sonya Cruse (202) 622–7180.

SUPPLEMENTARY INFORMATION

Background

In general, if interests in the same property are transferred for both charitable and noncharitable purposes, the charitable interest will qualify for the charitable deduction for federal income, gift, and estate tax purposes only if the interest is in one of certain prescribed forms. If the charitable interest is not a remainder interest, sections 170(f), 2522(c)(2), and 2055(e)(2) of the Internal Revenue Code (Code) require that the charitable interest be in the form of either a guaranteed annuity or a fixed percentage of the annual net fair market value of the property (unitrust interest).

A guaranteed annuity is defined in the regulations under sections 170, 2522, and 2055 as an arrangement pursuant to which a specified sum is paid not less often than annually, for a specified term of years or for the life or lives of certain named individuals. A unitrust interest is defined as a right to receive not less often than annually a fixed percentage of the net fair market value, determined annually, of the property funding the unitrust interest, payable for a specified term of years or for the life of certain named individuals. The income, estate, and gift tax regulations also provide that if guaranteed annuity or unitrust interests are payable for private and charitable purposes from a trust and the private interest is payable before the expiration of the charitable interest, then in order for the charitable guaranteed annuity interest or unitrust interest to be deductible, among other requirements, the charitable interest must begin either before, or at the same time as, the private interest. See, for example, § 20.2055–2(e)(2)(vii)(*e*) regarding the estate tax provision applicable to unitrust interests. See also, Rev. Rul. 76–225, 1976–1 C.B. 281.

In *Estate of Boeshore v. Commissioner*, the decedent devised the residue of her estate to a charitable remainder unitrust described in section 664 of the Code. Under the terms of the trust, a 6 percent unitrust amount was to be paid annually from the trust. During the life of the decedent's surviving spouse, 70 percent of the distribution was to be paid to the surviving spouse and the remaining 30 percent to the decedent's daughter and two grandchildren. Upon the surviving spouse's death, 58 percent of the unitrust amount was to be paid to the decedent's daughter and two grandchildren for their lives, and the remaining 42 percent was to be paid to a qualifying charity. Upon the death of the last to die of the four individual beneficiaries, the remainder interest was to be paid to charity. The decedent's estate claimed an estate tax charitable deduction for the present values of the charitable remainder interest and the charitable unitrust interest that was to begin upon the spouse's death.

Under the authority of § 20.2055–2(e)(2)(vi)(*e*) (currently § 20.2055–2(e)(2)(vii)(*e*)), the IRS disallowed the deduction for the present value of the charitable unitrust interest, because it was preceded by a noncharitable unitrust interest.

The court noted that the rules contained in section 2055(e)(2) ensure that the value of the charitable interest is not subject to manipulation through trustee investment practices and that the actual benefit charity receives bears a reasonable relationship to the deduction allowed for the value of the charitable interest. Since all the nonremainder interests in the *Boeshore* trust, both charitable and noncharitable, were in the form of unitrust interests, any incentives to manipulate the income interest were removed. *Estate of Boeshore v. Commissioner*, 78 T.C. at 529. Under these circumstances, the court was unable to find any congressional intent to preclude a charitable deduction for an otherwise qualified charitable unitrust interest. Accordingly, the court held § 20.2055–2(e)(2)(vi)(*e*) invalid insofar as the regulation disallowed a deduction for the charitable unitrust interest under the facts presented.

Explanation of Provisions

The proposed regulations amend the existing regulations under sections 170, 2055, and 2522 governing charitable guaranteed annuity interests and unitrust interests to eliminate the requirement that the charitable interest can not be preceded in point of time by a noncharitable interest that is in the form of a guaranteed annuity or unitrust interest. The regulations will continue to require that any amounts payable for a private purpose before the expiration of the charitable annuity or unitrust interest either must be in the form of a guaranteed annuity or unitrust interest or must be payable from a separate group of assets devoted exclusively to private purposes.

Effective Date

The regulations are applicable as of the date these regulations are published in the **Federal Register** as final regulations.

Effect on Other Document

The following publication is revoked as of the date these regulations are published in the **Federal Register** as final regulations.

Rev. Rul. 76–225, 1976–1 C.B. 281

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 regulation does not impose a collection of information requirement on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 5) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies, if written) or electronic comments that are submitted timely (in the manner described in the ADDRESSES portion of this preamble) to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for October 16, 2002, at 10:00 a.m., Room 4718, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit comments and an outline of the topics to be discussed and the time to be devoted to each topic (preferably a signed original and eight (8) copies) by September 25, 2002.

A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

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

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Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.170A–6 is amended as follows:

1. Paragraph (c)(2)(i)(E) is revised and the example following paragraph (c)(2)(i)(E) is removed.

2. Paragraph (c)(2)(ii)(D) is revised.

The revision reads as follows:

§ 1.170A-6 Charitable contributions in trust.

* * * * *

(c) * * *

(2) * * *

(i) * * *

(E) Where a charitable interest in the form of a guaranteed annuity interest is transferred after May 21, 1972, the charitable interest generally is not a guaranteed annuity interest if any amount may be paid by the trust for a private purpose before the expiration of all the charitable annuity interests. There are two exceptions to this general rule. First, the charitable interest is a guaranteed annuity interest if the amount payable for a private purpose is in the form of a guaranteed annuity interest and the trust's governing instrument does not provide for any preference or priority in the payment of the private annuity as opposed to the charitable annuity. Second, the charitable interest is a guaranteed annuity interest if under the trust's governing instrument the amount that may be paid for a private purpose is payable only from a group of assets that are devoted exclusively to private purposes and to which section 4947(a)(2) is inapplicable by reason of section 4947(a)(2)(B). For purposes of this paragraph (c)(2)(i)(E), an amount is not paid for a private purpose if it is paid for an adequate and full consideration in money or money's worth. See § 53. 4947–1(c) of this chapter (Foundation and Similar Excise Tax Regulations) for rules relating to the inapplicability of section 4947(a)(2) to segregated amounts in a split-interest trust. * * *

* * * * *

(ii) * * *

(D) Where a charitable interest is in the form of a unitrust interest, the charitable interest generally is not a unitrust interest if any amount may be paid by the trust for a private purpose before the expiration of all the charitable unitrust interests. There are two exceptions to this general rule. First, the charitable interest is a unitrust interest if the amount payable for a private purpose is in the form of a unitrust interest and the trust's governing instrument does not provide for any preference or priority in the payment of the private unitrust interest as opposed to the charitable unitrust interest. Second, the charitable interest is a unitrust interest if under the trust's governing instrument the amount that may be paid for a private purpose is payable only from a group of assets that are devoted exclusively to private purposes and to which section 4947(a)(2) is inapplicable by reason of section 4947(a)(2)(B). For purposes of this paragraph (c)(2)(ii)(D), an amount is not paid for a private purpose if it is paid for an adequate and full consideration in money or money's worth. See § 53. 4947–1(c) of this chapter (Foundation and Similar Excise Tax Regulations) for rules relating to the inapplicability of section 4947(a)(2) to segregated amounts in a split-interest trust.

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PART 20—ESTATE TAX; ESTATES OF DECEDENTS DYING AFTER AUGUST 16, 1954

Par. 3. The authority citation for part 20 continues to read in part as follows:

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

Par. 4. Section 20.2055–2 is amended as follows:

1. Paragraph (e)(2)(vi)(*f*) is revised.
2. Paragraph (e)(2)(vii)(*e*) is revised.
3. In paragraph (f)(2)(iv) *Example (4)* is removed.

The revisions read as follows:

§ 20.2055–2 Transfers not exclusively for charitable purposes.

* * * * *

(e) * * *

(2) * * *

(vi) * * *

(*f*) Where a charitable interest in the form of a guaranteed annuity interest is in trust, the charitable interest generally is not a guaranteed annuity interest if any amount may be paid by the trust for a private purpose before the expiration of all the charitable annuity interests. There are two exceptions to this general rule. First, the charitable interest is a guaranteed annuity interest if the amount payable for a private purpose is in the form of a guaranteed annuity interest and the trust's governing instrument does not provide for any preference or priority in the payment of the private annuity as opposed to the charitable annuity. Second, the charitable interest is a guaranteed annuity interest if under the trust's governing instrument the amount that may be paid for a private purpose is payable only from a group of assets that are devoted exclusively to private purposes and to which section 4947(a)(2) is inapplicable by reason of section 4947(a)(2)(B). For purposes of this paragraph (e)(2)(vi)(*f*), an amount is not paid for a private purpose if it is paid for an adequate and full consideration in money or money's worth. See § 53. 4947–1(c) of this chapter (Foundation and Similar Excise Tax Regulations) for rules relating to the inapplicability of section 4947(a)(2) to segregated amounts in a split-interest trust.

* * * * *

(vii) * * *

(*e*) Where a charitable interest in the form of a unitrust interest is in trust, the charitable interest generally is not a unitrust interest if any amount may be paid by the trust for a private purpose before the expiration of all the charitable unitrust interests. There are two exceptions to this general rule. First, the charitable interest is a unitrust interest if the amount payable for a private purpose is in the form of a unitrust interest and the trust's governing instrument does not provide for any preference or priority in the payment of the private unitrust interest as opposed to the charitable unitrust interest. Second, the charitable interest is a unitrust interest if under the trust's governing instrument the amount that may be paid for a private purpose is payable only from a group of assets that are devoted exclusively to private purposes and to which section 4947(a)(2) is inapplicable by reason of section 4947(a)(2)(B). For purposes of this paragraph (e)(2)(vii)(*e*), an amount is not paid for a private purpose if it is paid for an adequate and full consideration in money or money's worth. See § 53. 4947–1(c) of this chapter (Foundation and Similar Excise Tax Regulations) for rules relating to the inapplicability of section 4947(a)(2) to segregated amounts in a split-interest trust.

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PART 25—GIFT TAX; GIFTS MADE AFTER DECEMBER 31, 1954

Par. 5. The authority for part 25 continues to read in part as follows:

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

Par. 6. Section 25.2522(c)–3 is amended as follows:

1. Paragraph (c)(2)(vi)(*f*) is revised.
2. Paragraph (c)(2)(vii)(*e*) is revised.
3. In paragraph (d)(2)(iv), *Example 4*, is removed.

The revisions read as follows:

§ 25.2522(c)–3 Transfers not exclusively for charitable, etc., purposes in the case of gifts made after July 31, 1969.

* * * * *

(c) * * *

(2) * * *

(vi) * * *

(*f*) Where a charitable interest in the form of a guaranteed annuity interest is in trust, and the gift of such interest is made after May 21, 1972, the charitable interest generally is not a guaranteed annuity interest if any amount may be paid by the trust for a private purpose before the expiration of all the charitable annuity interests. There are two exceptions to this general rule. First, the charitable interest is a guaranteed annuity interest if the amount payable for a private purpose is in the form of a guaranteed annuity interest and the trust's governing instrument does not provide for any preference or priority in the payment of the private annuity as opposed to the charitable annuity. Second, the charitable interest is a guaranteed annuity interest if under the trust's governing instrument the amount that may be paid for a private purpose is payable only from a group of assets that are devoted exclusively to private purposes and to which section 4947(a)(2) is inapplicable by reason of section 4947(a)(2)(B). For purposes of this paragraph (c)(2)(vi)(*f*), an amount is not paid for a private purpose if it is paid for an adequate and full consideration in money or money's worth. See § 53. 4947–1(c) of this chapter (Foundation and Similar Excise Tax Regulations) for rules relating to the inapplicability of section 4947(a)(2) to segregated amounts in a split-interest trust.

* * * * *

(vii) * * *

(*e*) Where a charitable interest in the form of a unitrust interest is in trust, the charitable interest generally is not a unitrust interest if any amount may be paid by the trust for a private purpose before the expiration of all the charitable unitrust interests. There are two exceptions to this general rule. First, the charitable interest is a unitrust interest if the amount payable for a private purpose is in the form of a unitrust interest and the trust's governing instrument does not provide for any preference or priority in the payment of the private unitrust interest as opposed to the charitable unitrust interest. Second, the charitable interest is a unitrust interest if under the trust's governing instrument the amount that may be paid for a private purpose is payable only from a group of assets that are devoted exclusively to private purposes and to which section 4947(a)(2) is inapplicable by reason of section 4947(a)(2)(B). For purposes of this paragraph (c)(2)(vii)(*e*), an amount is not paid for a private purpose if it is paid for an adequate and full consideration in money or money's worth. See § 53.4947–1(c) of this chapter (Foundation and Similar Excise Tax Regulations) for rules relating to the inapplicability of section 4947(a)(2) to segregated amounts in a split-interest trust.

* * * * *

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on July 22, 2002, 8:45 a.m., and published in the issue of the Federal Register for July 23, 2002, 67 F.R. 48070)

Notice of Proposed Rulemaking

Earnings Calculation for Returned or Recharacterized IRA Contributions

REG–124256–02

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: These proposed regulations provide a new method to be used for calculating the net income attributable to IRA contributions that are distributed as a returned contribution pursuant to section 408(d)(4) of the Internal Revenue Code or recharacterized pursuant to section 408A(d)(6). The regulations will affect IRA owners and IRA trustees, custodians and issuers.

DATES: Written or electronic comments must be received by October 21, 2002.

ADDRESSES: Send submissions to: CC:ITA:RU (REG–124256–02), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:ITA:RU (REG–124256–02), Courier's Desk Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically directly to the IRS Internet site at *www.irs.gov/regs*.

FOR FURTHER INFORMATION CONTACT: Cathy Vohs at (202) 622–6090.

SUPPLEMENTARY INFORMATION

Background

Section 408(d)(4) provides that an IRA contribution will not be included in the IRA owner's gross income when distributed as a returned contribution if: (1) it is received by the IRA owner on or before the day prescribed by law (including extensions) for filing the owner's Federal income tax return for the year of the contribution; (2) no deduction is allowed with respect to the contribution; and (3) the distribution is accompanied by the amount of net income attributable to the contribution.

Section 408A governs Roth IRAs and was added by section 302 of the Taxpayer Relief Act of 1997, Public Law 105–34 (111 Stat. 788). Section 408A(d)(6) provides that a contribution made to one type of IRA may be recharacterized as having been made to another type of IRA if: (1) the recharacterization transfer occurs on or before the date prescribed by law (including extensions) for filing the IRA owner's Federal income tax return for the year for which the contribution was made; (2) no deduction is allowed with respect to the contribution to the transferor IRA; and (3) the transfer is accompanied by any net income allocable to the contribution.

Section 1.408–4(c)(2)(ii) of the Income Tax Regulations prescribes the method (the old method) for calculating the amount of net income attributable to a contribution distributed pursuant to section 408(d)(4). The old method bases the calculation of the amount of net income attributable to a contribution on the income earned by the IRA during the period beginning on the first day of the taxable year in which the contribution is made and ending on the date of the distribution from the account. Under the old method, net income cannot be negative.

Section 1.408A–5, A-2(c), provides that if a contribution being recharacterized is in an IRA that at any time contained other contributions, the net income attributable to the contribution being recharacterized is calculated in the manner prescribed by § 1.408–4(c)(2)(ii) (the old method), except that net income can be negative. Section 1.408A–5, A–2(b), provides that if an IRA is established with a contribution and no other contributions or distributions are made, then the subsequent recharacterization transfer of the entire account balance of the IRA will satisfy the requirement that the transfer be accompanied by any net income allocable to the contribution.

In connection with issuing the regulations under section 408A governing Roth IRAs, it became apparent that the old method produced anomalous results for contributions made late in the year. This is because, under the old method, account activity in the part of the year that precedes the date the contribution is made is taken into account in the calculation of the net income attributable to the contribution.

In response to this concern, the IRS issued Notice 2000–39, 2000–2 C.B. 132, which provided a new method for calculating net income that generally bases the calculation of the amount of net income attributable to a contribution on the actual earnings and losses of the IRA during the time it held the contribution. Under this new method, net income can be negative. Notice 2000–39 provided that until further guidance is issued, either the old method or the new method may be used to calculate net income. Notice 2000–39 also requested comments regarding the new method.

The Service received comments on the new method which were generally favorable. However, commentators provided a number of suggestions for improving the method, including: (1) allowing a single computation period to be used in the case of multiple IRA contributions; (2) clarifying how transfers in or out of IRAs are treated under the new method; and (3) allowing net income to be determined on the basis of tracing specific assets, rather than dollar amounts. This last suggestion was focused primarily on the calculation of net income in the case of a recharacterization back to a traditional IRA following a conversion of an amount in a traditional IRA to a Roth IRA.

Explanation of Provisions

New Method for Net Income Calculation Under Section 408(d)(4)

These proposed regulations would incorporate, with certain modifications, the new method provided in Notice 2000–39. Under the proposed regulations, for purposes of returned contributions under section 408(d)(4), the net income attributable to a contribution is determined by allocating to the contribution a *pro-rata* portion of the net income on the assets in the IRA (whether positive or negative) during the period the IRA held the contribution. This new method is represented by the following formula:

$$\text{Net Income} = \text{Contribution} \times \frac{(\text{Adjusted Closing Balance} - \text{Adjusted Opening Balance})}{\text{Adjusted Opening Balance}}$$

Under this formula, the opening balance is the fair market value of the IRA immediately before the contribution being returned is made to the account and the closing balance is the fair market value of the account immediately before the contribution is removed. The opening balance then is adjusted to include the amount of any contributions or transfers made to the IRA during the computation period. In addition, the closing balance is adjusted to include the amount of any distributions or transfers made from the IRA during the computation period. In the case of an IRA that has received more than one regular contribution for a particular taxable year, the last regular contribution made to the IRA for the year is deemed to be the contribution that is distributed as a returned contribution under section 408(d)(4), up to the amount of the contribution identified by the IRA owner as the amount distributed as a returned contribution.

In response to comments received, the proposed regulations would clarify that a transfer made in or out of an IRA during the computation period is treated in the same manner as a contribution or distribution made to or from the IRA. The proposed regulations also provide that a single computation period is used if more than one contribution was made to the IRA as a regular contribution.

New Method for Net Income Calculation Under Section 408A(d)(6)

The proposed regulations would provide rules for calculating net income allocable to a contribution being recharacterized under section 408A(d)(6) that are substantially similar to the rules applicable to contributions being returned under section 408(d)(4). However, if more than one contribution is being recharacterized, different rules apply. In the case of multiple contributions for a particular year that are eligible for recharacterization, the IRA owner chooses (by date and dollar amount, not by specific assets acquired with those dollars) which contribution is to be recharacterized. In addition, if a series of regular contributions was made, and consecutive contributions in that series are being recharacterized, the computation period is determined using a single computation period, based on the first contribution in the series.

The proposed regulations would retain the rule that net income calculations must be based on the overall value of an IRA and the dollar amounts contributed, distributed or recharacterized to or from the IRA. Even in a recharacterization of an amount converted to a Roth IRA, the proposed regulations would not permit net income to be calculated on the basis of the return on specific assets. The dollars contributed to an IRA are invested in assets that generate gains and losses. Once contributions are commingled in an account, those dollars are no longer associated with particular assets. In the absence of maintaining separate accounts, tying particular assets to a particular contribution would create administrative problems for taxpayers, IRA providers and the IRS.

Proposed Effective Date

The regulations are proposed to be applicable for calculating income allocable to IRA contributions made on or after January 1, 2004. For purposes of determining net income applicable to IRA contributions made during 2002 and 2003, taxpayers may continue to apply the rules set forth in Notice 2000–39 or may rely on these proposed regulations. If, and to the extent, future guidance is more restrictive than these proposed regulations, the future guidance will be issued without retroactive effect.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. Because proposed § 1.408–11 and revised A–2(c) of § 1.408A–5 impose no new collection of information on small entities, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Request 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) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

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

Drafting Information

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

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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 entries in numerical order to read in part as follows:

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

§ 1.408–4 also issued under 26 U.S.C. 408.

§ 1.408–11 also issued under 26 U.S.C. 408. * * *

Par. 2. Section 1.408–4 is amended by adding the following text before the first sentence of (c)(1):

§ 1.408–4 Treatment of distributions from individual retirement arrangements.

* * * * *

(c) * * *(1)* * *

The rules in this paragraph (c) apply for purposes of determining net income attributable to IRA contributions made before January 1, 2004, and returned pursuant to section 408(d)(4). The rules in § 1.408–11 apply for purposes of determining net income attributable to IRA contributions made on or after January 1, 2004, and returned pursuant to section 408(d)(4).

* * * * *

Par. 3. Section 1.408–11 is added to read as follows:

§ 1.408–11 Net income calculation for returned or recharacterized IRA contributions.

(a) *Net income calculation for returned IRA contributions*—(1) *General rule.* For purposes of returned contributions under section 408(d)(4), the net income attributable to a contribution made to an IRA is determined by allocating to the contribution a *pro-rata* portion of the earnings on the assets in the IRA during the period the IRA held the contribution. This attributable net income is calculated by using the following formula:

$$\text{Net Income} = \text{Contribution x } \frac{\text{(Adjusted Closing Balance - Adjusted Opening Balance}}{\text{Adjusted Opening Balance}}$$

(2) *Special rule*. If an IRA is established with a contribution and no other contributions, distributions or transfers are made to or from that IRA, then the subsequent distribution of the entire account balance of the IRA pursuant to section 408(d)(4) will satisfy the requirement of that Code section that the return of a contribution be accompanied by the amount of net income attributable to the contribution.

(b) *Definitions.* For purposes of this section the following definitions apply—

(1) *Adjusted opening balance.* The term adjusted opening balance means the fair market value of the IRA at the beginning of the computation period plus the amount of any contributions or transfers (including the contribution that is distributed as a returned contribution pursuant to section 408(d)(4) and recharacterizations of contributions pursuant to section 408A(d)(6)) made to the IRA during the computation period.

(2) *Adjusted closing balance.* The term adjusted closing balance means the fair market value of the IRA at the end of the computation period plus the amount of any distributions or transfers (including recharacterizations of contributions pursuant to section 408A(d)(6)) made from the IRA during the computation period.

(3) *Computation period.* The term computation period means the period beginning immediately prior to the time that the contribution being returned was made to the IRA and ending immediately prior to the removal of the contribution. If more than one contribution was made as a regular contribution and is being returned from the IRA, the computation period begins immediately prior to the time the first contribution being returned was contributed.

(4) *Regular contribution.* The term regular contribution means an IRA contribution made by the IRA owner that is neither a trustee-to-trustee transfer from another IRA nor a rollover from another IRA or retirement plan.

(c) *Additional rules* —(1) When an IRA asset is not normally valued on a daily basis, the fair market value of the asset at the beginning of the computation period is deemed to be the most recent, regularly determined, fair market value of the asset, determined as of a date that coincides with or precedes the first day of the computation period. In addition, solely for purposes of this section, notwithstanding A–3 of § 1.408A–5, recharacterized contributions are taken into account for the period they are actually held in a particular IRA.

(2) In the case of an IRA that has received more than one regular contribution for a particular taxable year, the last regular contribution made to the IRA for the year is deemed to be the contribution that is distributed as a returned contribution under section 408(d)(4), up to the amount of the contribution identified by the IRA owner as the amount distributed as a returned contribution.

(3) In the case of an individual who owns multiple IRAs, the net income calculation is performed only on the IRA containing the contribution being returned, and that IRA is the IRA that must distribute the contribution.

(d) *Examples.* The following examples illustrate the net income calculation under section 408(d)(4) and this section:

Example 1. (i) On May 1, 2004, when her IRA is worth $4,800, Taxpayer A makes a $1,600 regular contribution to her IRA. Taxpayer A requests that $400 of the May 1, 2004, contribution be returned to her pursuant to section 408(d)(4). Pursuant to this request, on February 1, 2005, when the IRA is worth $7,600, the IRA trustee distributes to Taxpayer A the

$400 plus attributable net income. During this time, no other contributions have been made to the IRA and no distributions have been made.

(ii) The adjusted opening balance is $6,400 [$4,800 + $1,600] and the adjusted closing balance is $7,600. Thus, the net income attributable to the $400 May 1, 2004, contribution is $75 [$400 x ($7,600 - $6,400) ÷ $6,400]. Therefore, the total to be distributed on February 1, 2005, pursuant to § 408(d)(4) is $475.

Example 2. (i) Beginning in January 2004, Taxpayer B contributes $300 on the 15th of each month to an IRA for 2004, resulting in an excess regular contribution of $600 for that year. Taxpayer B requests that the $600 excess regular contribution be returned to her pursuant to section 408(d)(4). Pursuant to this request, on March 1, 2005, when the IRA is worth $16,000, the IRA trustee distributes to Taxpayer B the $600 plus attributable net income. The excess regular contributions to be returned are deemed to be the last two made in 2004: the $300 December 15 contribution and the $300 November 15 contribution. On November 15 the IRA was worth $11,000 immediately prior to the contribution. No distributions or transfers have been made from the IRA and no contributions or transfers, other than the monthly contributions (including $300 in January and February 2005), have been made.

(ii) As of the beginning of the computation period (November 15), the adjusted opening balance is $12,200 [$11,000 + $300 + $300 + $300 + $300] and the adjusted closing balance is $16,000. Thus, the net income attributable to the excess regular contributions is $187 [$600 x ($16,000 - $12,200) ÷ 12,200]. Therefore, the total to be distributed as returned contributions on March 1, 2005, to correct the excess regular contribution is $787 [$600 + $187].

Par. 4. In § 1.408A–5, A–2(c) is revised to read as follows:

§ 1.408A–5 Recharacterized contributions.

* * * * *

A-2. * * *

(c) (1) If paragraph (b) of this A–2 does not apply, then, for purposes of determining net income attributable to IRA contributions, the net income attributable to the amount of a contribution is determined by allocating to the contribution a *pro-rata* portion of the earnings on the assets in the IRA during the period the IRA held the contribution. This attributable net income is calculated by using the following formula:

$$\text{Net Income} = \text{Contribution x } \frac{\text{(Adjusted Closing Balance - Adjusted Opening Balance)}}{\text{Adjusted Opening Balance}}$$

(2) For purposes of this paragraph (c), the following definitions apply—

(i) The term adjusted opening balance means the fair market value of the IRA at the beginning of the computation period plus the amount of any contributions or transfers (including the contribution that is being recharacterized pursuant to section 408A(d)(6) and any other recharacterizations) made to the IRA during the computation period.

(ii) The term adjusted closing balance means the fair market value of the IRA at the end of the computation period plus the amount of any distributions or transfers (including contributions returned pursuant to section 408(d)(4) and recharacterizations of contributions pursuant to section 408A(d)(6)) made from the IRA during the computation period.

(iii) The term computation period means the period beginning immediately prior to the time the particular contribution being recharacterized is made to the IRA and ending immediately prior to the recharacterizing transfer of the contribution. If a series of regular contributions was made to the IRA, and consecutive contributions in that series are being recharacterized, the computation period begins immediately prior to the time the first of the regular contributions being recharacterized was made.

(3) When an IRA asset is not normally valued on a daily basis, the fair market value of the asset at the beginning of the computation period is deemed to be the most recent, regularly determined, fair market value of the asset, determined as of a date that coincides with or precedes the first day of the computation period. In addition, solely for purposes of this paragraph (c), notwithstanding A–3 of this section, recharacterized contributions are taken into account for the period they are actually held in a particular IRA.

(4) In the case of an individual with multiple IRAs, the net income calculation is performed only on the IRA containing the particular contribution to be recharacterized, and that IRA is the IRA from which the recharacterizing transfer must be made.

(5) In the case of multiple contributions made to an IRA for a particular year that are eligible for recharacterization, the IRA owner can choose (by date and by dollar amount, not by specific assets acquired with those dollars) which contribution, or portion thereof, is to be recharacterized.

(6) The following examples illustrate the net income calculation under section 408A(d)(6) and this paragraph:

Example 1. (i) On March 1, 2004, when her Roth IRA is worth $80,000, Taxpayer A makes a $160,000 conversion contribution to the Roth IRA. Subsequently, Taxpayer A discovers that she was ineligible to make a Roth conversion contribution in 2004 and so she requests that the $160,000 be recharacterized to a traditional IRA pursuant to section 408A(d)(6). Pursuant to this request, on March 1, 2005, when the IRA is worth $225,000, the Roth IRA trustee transfers to a traditional IRA the $160,000 plus allocable net income. No other contributions have been made to the Roth IRA and no distributions have been made.

(ii) The adjusted opening balance is $240,000 [$80,000 + $160,000] and the adjusted closing balance is $225,000. Thus the net income allocable to the $160,000 is -$10,000 [$160,000 x ($225,000 - $240,000) ÷ $240,000]. Therefore, in order to recharacterize the March 1, 2004, $160,000 conversion contribution on March 1, 2005, the Roth IRA trustee must transfer from Taxpayer A's Roth IRA to her traditional IRA $150,000 [$160,000 - $10,000].

Example 2. (i) On April 1, 2004, when her traditional IRA is worth $100,000, Taxpayer B converts the entire amount, consisting of 100 shares of stock in ABC Corp. and 100 shares of stock in XYZ Corp., by transferring the shares to a Roth IRA. At the time of the conversion, the 100 shares of stock in ABC Corp. are worth $50,000 and the 100 shares of stock in XYZ Corp. are also worth $50,000. Taxpayer B decides that she would like to recharacterize the ABC Corp. shares back to a traditional IRA. However, B may choose only by dollar amount the contribution or portion thereof that is to be recharacterized. On the date of transfer, November 1, 2004, the 100 shares of stock in ABC Corp. are worth $40,000 and the 100 shares of stock in XYZ Corp. are worth $70,000. No other contributions have been made to the Roth IRA and no distributions have been made.

(ii) If B requests that $50,000 (which was the value of the ABC Corp. shares at the time of conversion) be recharacterized, the net income allocable to the $50,000 is $5,000 [$50,000 x ($110,000 - $100,000) ÷ $100,000]. Therefore, in order to recharacterize $50,000 of the April 1, 2004, conversion contribution on November 1, 2004, the Roth

IRA trustee must transfer from Taxpayer B's Roth IRA to a traditional IRA assets with a value of $55,000 [$50,000 + $5,000].

(iii) If, on the other hand, B requests that $40,000 (which was the value of the ABC Corp. shares on November 1) be recharacterized, the net income allocable to the $40,000 is $4,000 [$40,000 x ($110,000 - $100,000) ÷ $100,000]. Therefore, in order to recharacterize $40,000 of the April 1, 2004, conversion contribution on November 1, 2004, the Roth IRA trustee must transfer from Taxpayer B's Roth IRA to a traditional IRA assets with a value of $44,000 [$40,000 + $4,000].

(iv) Regardless of the amount of the contribution recharacterized, the determination of that amount (or of the net income allocable thereto) is not affected by whether the recharacterization is accomplished by the transfer of shares of ABC Corp. or of shares of XYZ Corp.

(7) This paragraph (c) applies for purposes of determining net income attributable to IRA contributions, made on or after January 1, 2004. For purposes of determining net income attributable to IRA contributions made before January 1, 2004, see paragraph (c) of this A–2 of § 1.408A–5 (as it appeared in the April 1, 2003, edition of 26 CFR part 1).

* * * * *

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

(Filed by the Office of the Federal Register on July 22, 2002, 8:45 a.m., and published in the issue of the Federal Register for July 23, 2002, 67 F.R. 48067)

Supplement to Publication 590, *Individual Retirement Arrangements (IRAs)*

Announcement 2002–73

A supplement to Publication 590 is available from the Internal Revenue Service. This supplement contains new life expectancy and uniform lifetime tables. These tables are used in figuring required minimum distributions.

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New Revision of Publication 971, *Innocent Spouse Relief (And Separation of Liability and Equitable Relief)*

Announcement 2002–74

Publication 971, revised June 2002, is now available from the Internal Revenue Service. It replaces the April 2000 revision.

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Definition of Terms

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

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

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

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

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

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

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

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

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

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

Abbreviations

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

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

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[1] A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2002–1 through 2002–25 is in Internal Revenue Bulletin 2002–26, dated July 1, 2002.

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