Internal Revenue
bulletin

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HIGHLIGHTS OF THIS ISSUE

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

INCOME TAX

Rev. Rul. 2003–54, page 982.
Depreciation; gasoline pump canopies. This ruling determines the classification of typical "stand-alone" gasoline pump canopies and their supporting concrete footings for depreciation purposes by applying criteria set forth in *Whiteco Industries, Inc. v. Commissioner*, 65 T.C. 664 (1975). This ruling holds that the canopies are not inherently permanent structures and are classified as tangible personal property includible in asset class 57.0 of Rev. Proc. 87–56 for depreciation purposes. This ruling also holds that the supporting concrete footings are inherently permanent structures classified as land improvements includible in asset class 57.1 of Rev. Proc. 87–56 for depreciation purposes. Rev. Rul. 68–345 obsoleted. Rev. Proc. 2002–9 modified and amplified.

Rev. Rul. 2003–56, page 985.
Like kind exchanges. This ruling deals with the consequences under section 752 of the Code, and the minimum gain rules under section 1.704–2(d) of the regulations, of a section 1031 transaction that straddles two taxable years.

Rev. Rul. 2003–60, page 987.
Federal rates; adjusted federal rates; adjusted federal long-term rate and the long-term exempt rate. For purposes of sections 382, 1274, 1288, and other sections of the Code, tables set forth the rates for June 2003.

REG–113007–99, page 1004.
Proposed regulations under section 141 of the Code relate to the definition of private activity bond applicable to tax-exempt bonds issued by state and local governments. The proposed regulations affect issuers of tax-exempt bonds and provide needed guidance for applying the private activity bond restrictions to refunding issues. The proposed regulations adopt a general approach for applying the private activity bond restrictions to refunding issues based on the principles for measuring private activity contained in section 141 and the final regulations thereunder. A public hearing is scheduled for September 9, 2003.

REG–142605–02, page 1010.
Proposed regulations under sections 263A and 448 of the Code provide rules under which any adjustment under section 481(a) resulting from a change in method of accounting under the regulations will be taken into account over the same number of taxable years that is provided in general guidance. A public hearing is scheduled for August 13, 2003.

Notice 2003–33, page 990.
This notice provides guidance regarding the determination of the applicable date that terminates the election period under section 645 of the Code for trusts and estates of decedents dying before December 24, 2002.

(Continued on the next page)

Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

ESTATE TAX

Rev. Proc. 2003–42, page 993.
Sample QPRT. This procedure contains a sample declaration of trust that meets the requirements under section 2702(a)(3)(A) of the Code and section 25.2702–5(c) of the Gift Tax regulations for a qualified personal residence trust (QPRT) with one term holder.

GIFT TAX

Rev. Proc. 2003–42, page 993.
Sample QPRT. This procedure contains a sample declaration of trust that meets the requirements under section 2702(a)(3)(A) of the Code and section 25.2702–5(c) of the Gift Tax regulations for a qualified personal residence trust (QPRT) with one term holder.

ADMINISTRATIVE

Notice 2003–34, page 990.
This notice identifies arrangements involving an investment in a purported insurance company organized offshore which invests in hedge funds or investments in which hedge funds typically invest. This notice alerts taxpayers to the fact that some of the arrangements may not qualify as insurance, some of the entities may not qualify as insurance companies, and the stakeholders involved may be subject to sections 1291–1298 of the Code (the passive foreign investment company rules).

Notice 2003–35, page 992.
This notice reminds taxpayers that an entity must be an insurance company for federal income tax purposes in order to qualify as exempt from tax under section 501(c)(15) of the Code.

Notice 2003–36, page 992.
Uniform capitalization; simplified service cost and simplified production methods. The Service and Treasury intend to publish guidance to clarify the types of property that qualify as eligible property for purposes of the simplified service cost and simplified production methods under the regulations under section 263A. Comments are requested. Also, taxpayers are informed of changes in the procedures for requesting approval of a change in method of accounting to one of these methods. Rev. Proc. 2002–9 suspended in part.

Rev. Proc. 2003–43, page 998.
This procedure concerns relief for late S corporation elections, Electing Small Business Trust (ESBT) elections, Qualified Subchapter S Trust (QSST) elections, and Qualified Subchapter S Subsidiary (QSub) elections. Rev. Proc. 98–55 superseded.

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

Section 42.—Low-Income Housing Credit

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of June 2003. See Rev. Rul. 2003–60, page 987.

Section 167.—Depreciation

26 CFR 1.167(a)–2: Tangible 1245 property. (Also §§ 168, 1245, 1250, 1.1245–3.)

Depreciation; gasoline pump canopies. This ruling determines the classification of typical "stand-alone" gasoline pump canopies and their supporting concrete footings for depreciation purposes by applying criteria set forth in *Whiteco Industries, Inc. v. Commissioner*, 65 T.C. 664 (1975). This ruling holds that the canopies are not inherently permanent structures and are classified as tangible personal property includible in asset class 57.0 of Rev. Proc. 87–56 for depreciation purposes. This ruling also holds that the supporting concrete footings are inherently permanent structures classified as land improvements includible in asset class 57.1 of Rev. Proc. 87–56 for depreciation purposes. Rev. Rul. 68–345 obsoleted. Rev. Proc. 2002–9 modified and amplified.

Rev. Rul. 2003–54

ISSUE

How are gasoline pump canopies and their supporting concrete footings classified for depreciation purposes?

FACTS

Most retail motor fuel outlets feature gasoline pump canopies. These canopies protect customers and the gasoline pumps from weather conditions and also serve as advertising displays for the fuel outlet business. Generally, the canopies are not attached to buildings or other structures. The typical "stand-alone" gasoline pump canopies in use today are constructed in the manner described below.

Concrete footings are constructed by local contractors to specifications provided by a canopy manufacturer. Concrete is poured around a cage of rebar embedded in the ground at the fuel outlet site. Anchor bolts protrude from the footings. Footings are constructed for each vertical support column of the canopy. Each support column has a welded plate on the base with holes designed for the anchor bolts. Each column is bolted onto a footing, usually 1 to 2 feet below grade. Nuts on the anchor bolts are used for leveling the column. Electrical and fluid conduits are constructed in and around the columns. Earth or other material is graded over the footing. A concrete cap, 1 to 2 inches thick, may be poured over the footing.

The support columns also have welded plates at the top. Main support beams are laid parallel to each other across two column sets and bolted to each column's plate. For canopies with single row column designs, the main beams are bolted to each column. Secondary beams are bolted at right angles to the main support beams. Purlins are bolted across the secondary beams to support the decking. A steel outrigger frame is bolted along the perimeter of the structural steel skeleton to support the facia panels. Decking and facia panels, constructed of sheet metal and designed to be interlocking, are attached to the canopy structure by clamps.

Gasoline pump canopies constructed in the manner described above are sometimes dismantled and relocated for various reasons, including ground lease expiration or termination provisions, outlet expansions, and re-imaging. Because of the method of canopy construction, dismantling and removal can be accomplished by a small crew in a matter of hours or days. The dismantling process is the reverse of the construction process. Facia panels, light fixtures, and decking panels are removed and lowered to the ground. The steel support structure is disassembled by unbolting and removing the various components in sequence, starting with the outrigger framing, followed by the purlins, secondary beams, and main beams. The cement caps covering the concrete footings are broken and removed to expose the bases of the support columns. The columns are supported by heavy equipment while the base plates are unbolted from the footings and the columns removed. The footings remain embedded in the ground where they were poured.

The canopy structure and concrete footings sustain minimal damage during the dismantling and removal process. Most components of the canopy structure are reusable. The cost of dismantling, removing, and reinstalling a used canopy structure is significantly less than the cost of purchasing and installing a new canopy structure.

LAW AND ANALYSIS

Section 167(a) of the Internal Revenue Code provides that there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion and wear and tear of property used in a trade or business or held for the production of income.

The depreciation deduction provided by § 167(a) for tangible property placed in service after 1986 generally is determined under § 168, which prescribes two methods of accounting for determining depreciation allowances: (1) the general depreciation system in § 168(a); and (2) the alternative depreciation system in § 168(g). Under either depreciation system, the depreciation deduction is computed by using a prescribed depreciation method, recovery period, and convention.

The applicable recovery period for purposes of § 168(a) or § 168(g) is determined by reference to class life. Section 168(i)(1) provides that the term "class life" means the class life (if any) that would be applicable with respect to any property as of January 1, 1986, under former § 167(m) as if it were in effect and the taxpayer had elected under that section. Prior to its revocation, § 167(m) provided that if a taxpayer elected the asset depreciation range system of depreciation, the depreciation deduction would be computed based on the class life prescribed by the Secretary that reasonably reflected the anticipated useful life of that class of property to the industry or other group.

Section 1.167(a)–11(b)(4)(iii)(*b*) of the Income Tax Regulations provides rules for classifying property under former § 167(m) and, under these rules, property is included in the asset guideline class for the activity in which the property is primarily used.

Rev. Proc. 87–56, 1987–2 C.B. 674, sets forth the class lives of property that are necessary to compute the depreciation allowance under § 168. This revenue procedure establishes two broad categories of depreciable assets: (1) asset classes 00.11 through

00.4 that consist of specific assets used in all business activities; and (2) asset classes 01.1 through 80.0 that consist of assets used in specific business activities. The same item of depreciable property may be described in both an asset category (asset classes 00.11 through 00.4) and an activity category (asset classes 01.1 through 80.0), in which case the item is generally classified in the asset category. *See Norwest Corporation & Subsidiaries v. Commissioner*, 111 T.C. 105 (1998).

Asset class 57.0 of Rev. Proc. 87–56 includes assets used in wholesale and retail trade, personal and professional services, and section 1245 assets used in marketing petroleum and petroleum products. Assets in class 57.0 have a recovery period of 5 years for purposes of § 168(a) and 9 years for purposes of § 168(g). Asset class 57.1 includes (i) section 1250 assets, including service station buildings and (ii) depreciable land improvements, whether section 1245 property or section 1250 property, used in the marketing of petroleum and petroleum products, but not including any facilities related to petroleum and natural gas trunk pipelines. Assets in class 57.1 have a recovery period of 15 years for purposes of § 168(a) and 20 years for purposes of § 168(g). Accordingly, with the exception of assets included in the asset categories for specific assets used in all business activities (classes 00.11 through 00.4), all assets used in the business activity of petroleum marketing are included in asset class 57.0 or asset class 57.1. Gas station canopies and their supporting concrete footings are not listed among the assets described in asset classes 00.11 through 00.4.

Section 1245(a)(3) provides that section 1245 property includes any property that is of a character subject to the allowance for depreciation under § 167 and is either personal property or certain other property described within § 1245(a)(3)(B) through (F). Section 1.1245–3(b) provides that "personal property" includes tangible personal property as defined in § 1.48–1(c) (relating to the definition of "section 38 property" for purposes of the investment tax credit) and intangible personal property. Section 1.48–1(c) provides that "tangible personal property" means any tangible property except land and improvements thereto, such as buildings or other inherently permanent structures (including items that are structural components of such buildings or structures). Therefore, section 1245 property used in petroleum marketing that is tangible personal property is included in asset class 57.0. Asset class 57.1 includes buildings used in petroleum marketing, which are section 1250 property, and other inherently permanent structures used in petroleum marketing, regardless of whether the structures are section 1245 property or section 1250 property.

The question of whether a particular structure is inherently permanent was initially addressed by the Service in the context of the investment tax credit provisions. Rev. Rul. 75–178, 1975–1 C.B. 9, provides that the classification of property as "personal" or "inherently permanent" should be made on the basis of the manner of attachment to the land or the structure and how permanently the property is designed to remain in place.

In *Whiteco Industries, Inc. v. Commissioner*, 65 T.C. 664 (1975), *acq.*, 1980–1 C.B. 1, the Tax Court concluded that outdoor advertising displays were tangible personal property that qualified for the investment tax credit rather than inherently permanent structures. The court set forth the following questions to be considered in deciding whether property (other than items in the nature of machinery) is to be classified as tangible personal property: (1) Is the property capable of being moved, and has it in fact been moved? (2) Is the property designed or constructed to remain permanently in place? (3) Are there circumstances that tend to show the expected or intended length of affixation, that is, are there circumstances that show the property may or will have to be moved? (4) How substantial a job is removal of the property, and how time-consuming is it? (5) How much damage will the property sustain upon its removal? (6) What is the manner of affixation of the property to the land?

In Rev. Rul. 80–151, 1980–1 C.B. 7, the Service announced that it would apply the criteria set forth by the court in *Whiteco* in determining whether outdoor advertising displays are tangible personal property. The revenue ruling also provides that outdoor advertising displays will not be categorically treated as being either tangible personal property or inherently permanent structures. Rather, the *Whiteco* criteria will be applied on a case-by-case basis to determine whether a particular outdoor advertising display should be treated as tangible personal property.

In *JFM, Inc. and Subsidiaries v. Commissioner*, T.C.M. 1994–239, the Tax Court concluded, based on the application of the *Whiteco* criteria, that certain gasoline pump canopies were not inherently permanent structures for depreciation purposes. Stating that no one factor is necessarily decisive and that each, to some extent, is probative, the court found that the canopies were capable of being moved, noted that some had been moved, were subject to lease agreements that could require canopy removal, were constructed in such a way as to be easily dismantled in a few days with most components being reusable, and were affixed to the land by being bolted to concrete footings. The court noted that the concrete footings are residual structures that remain on the land after the canopy structure is unbolted.

The depreciation classification of the gasoline pump canopies and the supporting concrete footings described in this revenue ruling depends upon whether the canopies and footings are inherently permanent structures. This determination is made by application of the *Whiteco* criteria. As noted by the court in *JFM*, no one factor is decisive.

Application of the *Whiteco* factors to the stand-alone gasoline pump canopies described above indicates that these canopies are not inherently permanent structures. The canopies are capable of being moved and, on occasion, have been relocated to other fuel outlet sites. The canopies' construction facilitates easy, cost effective removal in a short period of time and minimal damage is sustained by the canopies during the dismantling and removal process. In some factual settings ground lease provisions and re-imaging histories may provide additional indications of affixation length. With regard to the concrete footings, however, application of the *Whiteco* factors indicates that these footings are inherently permanent structures. The footings are not constructed in a manner that enables them to be removed with the canopy structure. If a canopy is moved the footings remain embedded in the ground. The footings are directly attached to the land and permanently affixed thereto.

HOLDING

The gasoline pump canopies described in this revenue ruling are not inherently per-

manent structures and are classified as tangible personal property includible in asset class 57.0 of Rev. Proc. 87–56 for depreciation purposes. The supporting concrete footings are inherently permanent structures classified as land improvements includible in asset class 57.1 of Rev. Proc. 87–56 for depreciation purposes.

CHANGE IN METHOD OF ACCOUNTING

Any change in a taxpayer's treatment of the cost of gasoline pump canopies or the cost of the supporting concrete footings to conform with this revenue ruling is a change in method of accounting to which the provisions of §§ 446 and 481 and the regulations thereunder apply.

A taxpayer wanting to change the method of accounting for the cost of gasoline pump canopies or supporting concrete footings owned by the taxpayer at the beginning of the year of change (and for which the taxpayer has used another method of computing depreciation in at least two taxable years immediately preceding the year of change) to conform with this revenue ruling must follow the automatic change in method of accounting provisions in Rev. Proc. 2002–9, 2002–1 C.B. 327 (as modified and amplified by Rev. Proc. 2002–19, 2002–1 C.B. 696, modified and clarified by Announcement 2002–17, 2002–1 C.B. 561, and amplified, clarified, and modified by Rev. Proc. 2002–54, 2002–35 I.R.B. 432) (or its successor), with the following modifications:

(1) The scope limitations in section 4.02 of Rev. Proc. 2002–9 do not apply to a taxpayer that wants to change its method of accounting for the cost of gasoline pump canopies or supporting concrete footings to conform with this revenue ruling for either its first or second taxable year ending after December 31, 2001, provided the taxpayer's method of accounting for the cost of gasoline pump canopies or supporting concrete footings is not an issue under consideration, within the meaning of section 3.09 of Rev. Proc. 2002–9, for taxable years under examination, before an appeals office, or before a federal court at the time the Form 3115 is filed with the national office; and

(2) To assist the Internal Revenue Service in processing changes in method of accounting under this revenue ruling, and to ensure proper handling, section 6.02(4)(a) of Rev. Proc. 2002–9 is modified to require that a Form 3115 filed under this revenue ruling include the statement "Automatic Change Filed Under Rev. Rul. 2003–54." This statement should be legibly printed or typed on the appropriate line on the Form 3115.

AUDIT PROTECTION

If a taxpayer is currently treating the cost of gasoline pump canopies or supporting concrete footings in conformance with this revenue ruling, the treatment of such canopies or footings will not be raised as an issue by the Service in a taxable year that ends before May 8, 2003, or any subsequent taxable year. Additionally, if a taxpayer is currently treating the cost of gasoline pump canopies or supporting concrete footings in conformance with this revenue ruling, and its use of that method is an issue under consideration (within the meaning of section 3.09 of Rev. Proc. 2002–9) in examination, in appeals, or before the U.S. Tax Court in a taxable year that ends before May 8, 2003, that issue will not be further pursued by the Service.

A taxpayer may continue to use its present method of treating the cost of gasoline pump canopies placed in service during any taxable year beginning before May 8, 2003, as land improvements includible in asset class 57.1 of Rev. Proc. 87–56 for depreciation purposes.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 68–345, 1968–2 C.B. 30, is obsoleted. Rev. Proc. 2002–9 is modified and amplified to include this change in method of accounting in section 2 of the APPENDIX.

DRAFTING INFORMATION

The principal author of this revenue ruling is Winston H. Douglas of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling, contact Mr. Douglas at (202) 622–3110 (not a toll-free call).

Section 168.—Accelerated Cost Recovery System

This ruling determines the classification of typical "stand-alone" gasoline pumps canopies and their supporting concrete footings for depreciation purposes and provides the applicable recovery periods for the gasoline pumps canopies and their footings under section 168 of the Internal Revenue Code. See Rev. Rul. 2003–54, page 982.

Section 263A.—Capitalization and Inclusion in Inventory Costs of Certain Expenses

Proposed regulations under section 448 of the Code provide rules under which any adjustment under section 481(a) resulting from a change in method of accounting under the regulations will be taken into account over the same number of taxable years that is provided in general guidance. See REG–142605–02, page 1010.

Section 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of June 2003. See Rev. Rul. 2003–60, page 987.

Section 382.—Limitation on Net Operating Loss Carryforwards and Certain Built-In Losses Following Ownership Change

The adjusted applicable federal long-term rate is set forth for the month of June 2003. See Rev. Rul. 2003–60, page 987.

Section 412.—Minimum Funding Standards

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of June 2003. See Rev. Rul. 2003–60, page 987.

Section 448.—Limitation on Use of Cash Method of Accounting

26 CFR 1.448–1: Limitation on the use of the cash receipts and disbursements method of accounting.

Proposed regulations under section 448 of the Code provide rules under which any adjustment under section 481(a) resulting from a change in method of accounting under the regulations will be taken into account over the same number of taxable years that is provided in general guidance.

See REG–142605–02, page 1010.

Section 467.—Certain Payments for the Use of Property or Services

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of June 2003. See Rev. Rul. 2003–60, page 987.

Section 468.—Special Rules for Mining and Solid Waste Reclamation and Closing Costs

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of June 2003. See Rev. Rul. 2003–60, page 987.

Section 481.—Adjustments Required by Changes in Method of Accounting

Proposed regulations under sections 263A and 448 of the Code provide rules under which any adjustment under section 481(a) resulting from a change in method of accounting under the regulations will be taken into account over the same number of taxable years that is provided in general guidance. See REG–142605–02, page 1010.

Section 482.—Allocation of Income and Deductions Among Taxpayers

Federal short-term, mid-term, and long-term rates are set forth for the month of June 2003. See Rev. Rul. 2003–60, page 987.

Section 483.—Interest on Certain Deferred Payments

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of June 2003. See Rev. Rul. 2003–60, page 987.

Section 642.—Special Rules for Credits and Deductions

Federal short-term, mid-term, and long-term rates are set forth for the month of June 2003. See Rev. Rul. 2003–60, page 987.

Section 704.—Partner's Distributive Share

26 CFR 1.704–2: Allocations attributable to nonrecourse liabilities.

If a partnership enters into an exchange that qualifies as a deferred like kind exchange under section 1031 of the Internal Revenue Code in which property subject to a liability is transferred in one taxable year of the partnership and property subject to a liability is received in the following taxable year of the partnership, and the relinquished liability and the replacement liability are nonrecourse liabilities, then under section 1.704–2(d), is the partnership minimum gain on the last day of the first taxable year of the partnership computed by using the replacement property and the replacement nonrecourse liability? See Rev. Rul. 2003–56 on this page.

Section 731.—Extent of Recognition of Gain or Loss on Distribution

26 CFR 1.731–1: Extent of recognition of gain or loss on distribution.

If a partnership enters into an exchange that qualifies as a deferred like kind exchange under section 1031 of the Internal Revenue Code in which property subject to a liability is transferred in one taxable year of the partnership and property subject to a liability is received in the following taxable year of the partnership, and the liabilities netted for purposes of section 752, and if so, when is any net change in a partner's share of partnership liability taken into account? See Rev. Rul. 2003–56 on this page.

Section 752.—Treatment of Certain Liabilities

26 CFR 1.752–1: Treatment of certain liabilities. (Also §§ 1031; 1.704–2, 1.731–1, 1.1031(b)–1, 1.1031(k)–1.)

Like kind exchanges. This ruling deals with the consequences under section 752 of the Code, and the minimum gain rules under section 1.704–2(d) of the regulations, of a section 1031 transaction that straddles two taxable years.

Rev. Rul. 2003–56

ISSUE

If a partnership enters into an exchange that qualifies as a deferred like kind exchange under § 1031 of the Internal Revenue Code in which property subject to a liability is transferred in one taxable year of the partnership and property subject to a liability is received in the following taxable year of the partnership, are the liabilities netted for purposes of § 752, and if so, when is any net change in a partner's share of partnership liability taken into account?

FACTS

Situation 1. *P* is a general partnership with two equal partners that reports on the calendar year. *P* owns Property 1, which has a fair market value of $300*x* and is subject to a liability of $100*x*. *P* has an adjusted basis of $80*x* in Property 1. *P* enters into an agreement for a deferred like kind exchange of properties that qualifies under § 1031(a)(1). Pursuant to the agreement, *P* transfers Property 1 on October 16, Year 1, subject to the liability. On January 17, Year 2, *P* receives Property 2, which has a fair market value of $260*x*, subject to a liability of $60*x*. Thus, *P* has a net decrease in liability of $40*x*.

Situation 2. Situation 2 is the same as Situation 1 except that Property 2 has a fair market value of $340*x* and is subject to a liability of $140*x*. Thus, *P* has a net increase in liability of $40*x*.

LAW

Section 752(a) provides that any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by the partner of partnership liabilities, shall be considered as a contribution of money by the partner to the partnership.

Section 752(b) provides that any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of the individual liabilities, shall be considered as a distribution of money to the partner by the partnership.

Section 1031(a)(1) provides that no gain or loss is recognized on the exchange of property held for productive use in a trade

or business or for investment if the property is exchanged solely for property of like kind that is to be held either for productive use in a trade or business or for investment.

Section 1031(a)(3) provides that any property received by a taxpayer will be treated as property which is not like kind property if (A) the property is not identified as property to be received in the exchange on or before the day which is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange, or (B) the property is received after the earlier of (i) the day which is 180 days after the date on which the taxpayer transfers the property relinquished in the exchange, or (ii) the due date (including extensions) for the taxpayer's federal income tax return for the taxable year in which the transfer of the relinquished property occurs.

Section 1031(b) provides that if an exchange would be within the provisions of § 1031(a) if it were not for the fact that the property received in exchange consists not only of property permitted by the provisions to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of the money and the fair market value of the other property.

Section 1.1031(b)–1(c) of the Income Tax Regulations provides that consideration in the form of an assumption of liabilities (or a transfer subject to a liability) is to be treated as "other property or money" for the purposes of § 1031(b). Where, in an exchange described in § 1031(b), each party either assumes a liability of the other party or acquires property subject to a liability, then, in determining the amount of other property or money, consideration given in the form of an assumption of liabilities (or the receipt of property subject to a liability) is offset against consideration received in the form of an assumption of liability (or transfer subject to a liability).

Example (5) of § 1.1031(k)–1(j)(3), describes the following situation: *B* has an adjusted basis in real property *X* of $40,000. On May 17, 1991, *B* transfers real property *X*, which is encumbered by a mortgage of $30,000 and has a fair market value of $100,000, to *C* with *C* assuming the $30,000 mortgage on real property *X*. On July 5, 1991, *C* transfers real property *V*, which is encumbered by a $20,000 mortgage and has a fair market value of $90,000, to *B* with *B* assuming the mortgage. The consideration received by *B* in the form of the liability assumed by *C* ($30,000) is offset by the consideration given by *B* in the form of the liability assumed by *B* ($20,000), and the net amount, $10,000, is treated as "money or other property." Thus, *B* recognizes gain under § 1031(b) in the amount of $10,000.

Rev. Rul. 94–4, 1994–1 C.B. 196, holds that a deemed distribution of money under § 752(b) resulting from a decrease in a partner's share of the liabilities of a partnership is treated as an advance or drawing of money under § 1.731–1(a)(1)(ii) to the extent of the partner's distributive share of income for the partnership taxable year. An amount treated as an advance or drawing of money is taken into account at the end of the partnership taxable year.

Section 1.704–2(d)(1) provides that the amount of partnership minimum gain is determined by first computing for each partnership nonrecourse liability any gain the partnership would realize if it disposed of the property subject to that liability for no consideration other than full satisfaction of the liability, and then aggregating the separately computed gains. For any partnership taxable year, the net increase or decrease in partnership minimum gain is determined by comparing the partnership minimum gain on the last day of the immediately preceding taxable year with the partnership minimum gain on the last day of the current taxable year.

ANALYSIS

If a partnership enters into a § 1031 exchange, consideration given in the form of the receipt of the replacement property subject to a liability (replacement liability) is offset against consideration received in the form of the transfer of the relinquished property subject to a liability (relinquished liability) in determining the amount of money or other property for purposes of § 1031(b) (hereinafter referred to simply as "money or other property") received in the exchange that is used to calculate gain recognized under § 1031(b). Section 1.1031(b)–1(c). If the exchange straddles two taxable years of the partnership, the amount of the relinquished liability that exceeds the amount of the replacement liability is treated as money or other property received in the first taxable year of the partnership, since the excess is attributable to the transfer of the relinquished property subject to the relinquished liability in that year. In addition, any gain resulting from the receipt of money or other property in the first taxable year of the partnership must be recognized and reported in that year.

The liability offsetting rule of § 1.1031(b)–1(c) also is taken into account for purposes of determining the amount of any decrease in a partner's share of partnership liability under § 752(b), which is treated as a deemed distribution of money to the partner. Accordingly, if a partnership enters into a § 1031 exchange that straddles two taxable years of the partnership, each partner's share of the relinquished liability is offset with each partner's share of the replacement liability for purposes of determining any decrease in a partner's share of partnership liability under § 752(b). Any net decrease is taken into account in the first taxable year of the partnership since it is attributable to the transfer of the relinquished property subject to the relinquished liability in that year.

Any deemed distribution of money to the partners under § 752(b) in the first taxable year of the partnership is treated as an advance or drawing of money to the extent of each partner's distributive share of partnership income for that year. Rev. Rul. 94–4. For this purpose, any gain recognized by the partnership under § 1031(b) from the net decrease in liability resulting from the exchange is included in the partners' distributive share of partnership income for the first taxable year of the partnership. An amount treated as an advance or drawing of money is taken into account by the partners at the end of that year.

In addition, if a partner's share of the replacement liability exceeds the partner's share of the relinquished liability, only the net increase in liability is taken into account for purposes of determining the increase in the partner's share of partnership liability under § 752(a). The net increase is taken into account in the second taxable year of the partnership since it is attributable to the receipt of the replacement property subject to the replacement liability in that year.

Furthermore, if the relinquished liability and the replacement liability are non-

recourse liabilities, then under § 1.704–2(d), the partnership minimum gain on the last day of the first taxable year of the partnership is computed by using the replacement property and the replacement nonrecourse liability.

In *Situation 1*, *P*'s amount realized is $300*x* (the fair market value of the replacement property ($260*x*), increased by the relinquished liability ($100*x*), and decreased by the replacement liability ($60*x*)), and *P*'s adjusted basis in the relinquished property is $80*x*, resulting in a realized gain of $220*x*. Under § 1031(b), *P* recognizes gain only to the extent of money or other property received in the exchange. The relinquished liability of $100*x* is offset by the replacement liability of $60*x* in determining the amount of money or other property that *P* is treated as receiving. Therefore, under § 1031(b), *P* is treated as receiving $40*x* of money or other property and therefore recognizes a gain of $40*x* in Year 1. That gain is allocated $20*x* to each partner of *P* as part of each partner's distributive share of *P*'s Year 1 income. Furthermore, under § 752(b), each partner is treated as receiving a deemed distribution from the partnership of $20*x* in Year 1. Under Rev. Rul. 94–4, each partner's § 752(b) deemed distribution of $20*x* is treated as an advance or drawing of money to the extent of each partner's distributive share of *P*'s income for Year 1.

In *Situation 2*, *P*'s amount realized is $300*x* (the fair market value of the replacement property ($340*x*), increased by the relinquished liability ($100*x*), and decreased by the replacement liability ($140*x*)), and *P*'s adjusted basis in the relinquished property is $80*x*, resulting in a realized gain of $220*x*. Under § 1031(b), *P* recognizes gain only to the extent of money or other property received in the exchange. The relinquished liability of $100*x* is offset by the replacement liability of $140*x* in determining the amount of money or other property that *P* is treated as receiving. Therefore, under § 1031(b), *P* is not treated as having received money or other property. Accordingly, *P* recognizes no gain in Year 1. Furthermore, under § 752(a), each partner is treated as having made a contribution to the partnership of $20*x* in Year 2.

HOLDING

If a partnership enters into an exchange that qualifies as a deferred like kind exchange under § 1031 in which property subject to a liability is transferred in one taxable year of the partnership and property subject to a liability is received in the following taxable year of the partnership, the liabilities are netted for purposes of § 752. Any net decrease in a partner's share of partnership liability is taken into account for purposes of § 752(b) in the first taxable year of the partnership, and any net increase in a partner's share of partnership liability is taken into account for purposes of § 752(a) in the second taxable year of the partnership.

DRAFTING INFORMATION

The principal author of this revenue ruling is Pietro Canestrelli of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For more information regarding this revenue ruling, contact Mr. Canestrelli at (202) 622–3060 (not a toll-free call).

Section 807.—Rules for Certain Reserves

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of June 2003. See Rev. Rul. 2003–60, on this page.

Section 846.—Discounted Unpaid Losses Defined

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of June 2003. See Rev. Rul. 2003–60, on this page.

Section 1031.—Exchange of Property Held for Productive Use or Investment

26 CFR 1.1031(b)–1: Receipt of other property or money in tax-free exchange.
26 CFR 1.1031(k)–1: Treatment of deferred exchanges.

If a partnership enters into an exchange that qualifies as a deferred like kind exchange under § 1031 of the Internal Revenue Code in which property subject to a liability is transferred in one taxable year of the partnership and property subject to a liability is received in the following taxable year of the partnership, are the liabilities netted for purposes of § 752, and if so, when is any net change in a partner's share of partnership liability taken into account? See Rev. Rul. 2003–56, page 985.

Section 1245.—Gain From Dispositions of Certain Depreciable Property

26 CFR 1.1245–3: Definition of section 1245 property.

This ruling classifies typical "stand-alone" gasoline pump canopies as tangible personal property includible in asset class 57.0 of Revenue Procedure 87–56 for depreciation purposes by determining that section 1245 property used in petroleum marketing that is tangible personal property, as listed in section 1.1245–3(b) of the Income Tax Regulations, is includible in the asset class 57.0. See Rev. Rul. 2003–54, page 982.

Section 1250.—Gain From Dispositions of Certain Depreciable Realty

This ruling classifies supporting concrete footings for typical "stand-alone" gasoline pump canopies as inherently permanent structures (that is, land improvements) includible in asset class 57.1 of Revenue Procedure 87–56 for depreciation purposes by determining that other inherently permanent structures used in petroleum marketing, regardless of whether the structures are section 1245 property or section 1250 property are includible in the asset class 57.1. See Rev. Rul. 2003–54, page 982.

Section 1274.—Determination of Issue Price in the Case of Certain Debt Instruments Issued for Property

(Also Sections 42, 280G, 382, 412, 467, 468, 482, 483, 642, 807, 846, 1288, 7520, 7872.)

Federal rates; adjusted federal rates; adjusted federal long-term rate and the long-term exempt rate. For purposes of sections 382, 1274, 1288, and other sections of the Code, tables set forth the rates for June 2003.

Rev. Rul. 2003–60

This revenue ruling provides various prescribed rates for federal income tax purposes for June 2003 (the current month). Table 1 contains the short-term, mid-term, and long-term applicable federal rates

(AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Finally, Table 5 contains the federal rate for determining the present value of annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520.

REV. RUL. 2003–60 TABLE 1

Applicable Federal Rates (AFR) for June 2003

Period for Compounding

	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	1.49%	1.48%	1.48%	1.48%
110% AFR	1.64%	1.63%	1.63%	1.62%
120% AFR	1.79%	1.78%	1.78%	1.77%
130% AFR	1.93%	1.92%	1.92%	1.91%
Mid-Term				
AFR	3.06%	3.04%	3.03%	3.02%
110% AFR	3.37%	3.34%	3.33%	3.32%
120% AFR	3.68%	3.65%	3.63%	3.62%
130% AFR	3.99%	3.95%	3.93%	3.92%
150% AFR	4.61%	4.56%	4.53%	4.52%
175% AFR	5.39%	5.32%	5.29%	5.26%
Long-Term				
AFR	4.65%	4.60%	4.57%	4.56%
110% AFR	5.12%	5.06%	5.03%	5.01%
120% AFR	5.60%	5.52%	5.48%	5.46%
130% AFR	6.07%	5.98%	5.94%	5.91%

REV. RUL. 2003–60 TABLE 2

Adjusted AFR for June 2003

Period for Compounding

	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	1.29%	1.29%	1.29%	1.29%
Mid-term adjusted AFR	2.61%	2.59%	2.58%	2.58%
Long-term adjusted AFR	4.35%	4.30%	4.28%	4.26%

REV. RUL. 2003–60 TABLE 3 Rates Under Section 382 for June 2003	
Adjusted federal long-term rate for the current month	4.35%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months.)	4.45%

REV. RUL. 2003–60 TABLE 4 Appropriate Percentages Under Section 42(b)(2) for June 2003	
Appropriate percentage for the 70% present value low-income housing credit	7.89%
Appropriate percentage for the 30% present value low-income housing credit	3.38%

REV. RUL. 2003–60 TABLE 5 Rate Under Section 7520 for June 2003	
Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest	3.6%

Section 1288.—Treatment of Original Issue Discounts on Tax-Exempt Obligations

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of June 2003. See Rev. Rul. 2003–60, page 987.

Section 1361.—S Corporation Defined

Can a taxpayer get relief for late S corporation elections, Electing Small Business Trust (ESBT) elections, Qualified Subchapter S Trust (QSST) elections, and Qualified Subchapter S Subsidiary (QSub) elections if the request for relief is filed within 24 months of the due date of the election and other requirements are met? See Rev. Proc. 2003–43, page 998.

Section 1362.—Election; Revocation; Termination

Can a taxpayer get relief for late S corporation elections, Electing Small Business Trust (ESBT) elections, Qualified Subchapter S Trust (QSST) elections, and Qualified Subchapter S Subsidiary (QSub) elections if the request for relief is filed within 24 months of the due date of the election and other requirements are met? See Rev. Proc. 2003–43, page 998.

Section 7520.—Valuation Tables

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of June 2003. See Rev. Rul. 2003–60, page 987.

Section 7872.—Treatment of Loans With Below-Market Interest Rates

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of June 2003. See Rev. Rul. 2003–60, page 987.

Part III. Administrative, Procedural, and Miscellaneous

Applicable Date Under § 645 With Respect to Trusts and Estates of Decedents Dying Before December 24, 2002

Notice 2003–33

This notice provides guidance regarding the determination of the applicable date that terminates the election period under § 645 of the Internal Revenue Code for trusts and estates of decedents dying before December 24, 2002.

Section 645 provides that a qualified revocable trust may elect to be treated and taxed for purposes of subtitle A of the Code as part of an estate (and not as a separate trust) for all taxable years of the estate ending after the date of the decedent's death and before the applicable date. Section 1.645–1(f)(1) of the Income Tax Regulations provides that the § 645 election period begins on the date of the decedent's death and terminates on the earlier of the day on which both the electing trust and related estate, if any, have distributed all their assets, or the day before the applicable date.

Section 645(b)(2) provides that the "applicable date" is — (A) if no federal estate tax return is required to be filed, the date which is 2 years after the date of the decedent's death, and (B) if a federal estate tax return is required to be filed, the date that is 6 months after the date of final determination of liability for the estate tax.

Under proposed regulations for § 645 published on December 18, 2000 (REG–106542–98, 2001–5 I.R.B. 473 [79015]), the applicable date, if a federal estate tax return is required to be filed, is the day that is 6 months after the date of final determination of liability for estate tax. The date of final determination of liability is the day on which the first of a series of events occurs. One of those events is the issuance of an estate tax closing letter, unless a claim for refund with respect to the estate tax is filed within 6 months after the issuance of the letter. Thus, under the proposed regulations, if the closing letter determines the date of final determination of liability, the applicable date is the date that is 6 months after the date that the closing letter is issued.

When the regulations were issued as final regulations on December 24, 2002, (T.D. 9032, 2003–7 I.R.B. 471 [78371]), the applicable date was changed for those situations in which a federal estate tax return is required to be filed. Section 1.645–1(f)(2)(ii) provides that the applicable date is the later of the day that is 2 years after the date of the decedent's death or the day that is 6 months after the date of final determination of liability for estate tax.

Further, under the final regulations, if the issuance of the closing letter triggers the date of final determination of liability, the date of final determination is the date that is 6 months after the date the closing letter is issued, rather than the date the closing letter is issued as provided in the proposed regulations. Thus, under the final regulations, if the closing letter triggers the date of final determination of liability, the applicable date (that is, 6 months after the date of final determination of liability) is the date that is 12 months after the date that the closing letter is issued.

Section 1.645–1(j) of the final regulations provides that §1.645–1(f)(2)(ii) is effective for trusts and estates of decedents dying on or after December 24, 2002. The preamble to the final regulations provides that trusts and estates of decedents dying before December 24, 2002, may follow certain provisions of the final regulations, but § 1.645–1(f)(2)(ii) is not included in those provisions.

The Internal Revenue Service has received several requests that trusts and estates of decedents dying before December 24, 2002, be permitted to rely on § 1.645–1(f)(2)(ii) of the final regulations to determine the applicable date that terminates the election period. Accordingly, provided that a Form 1041, *U.S. Income Tax Return for Estates and Trusts*, has not been filed treating the § 645 election period as terminated, trusts and estates of decedents dying before December 24, 2002, may rely on § 1.645–1(f)(2)(ii) of the final regulations to determine the applicable date.

The principal author of this notice is Faith Colson of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice, contact Faith Colson at (202) 622–3060 (not a toll-free call).

Offshore Entities Investing in Hedge Funds

Notice 2003–34

I. PURPOSE

Treasury and the Internal Revenue Service have become aware of arrangements, described below, that are being used by taxpayers to defer recognition of ordinary income or to characterize ordinary income as a capital gain. The arrangements involve an investment in a purported insurance company that is organized offshore which invests in hedge funds or investments in which hedge funds typically invest. This notice alerts taxpayers and their representatives that these arrangements often do not generate the claimed federal tax benefits.

II. BACKGROUND

The typical arrangement involves a Stakeholder, subject to U.S. income taxation, investing (directly or indirectly) in the equity of an enterprise ("FC"), usually a corporation organized outside the United States. FC is organized as an insurance company and complies with the applicable local laws regulating insurance companies.

FC issues "insurance or annuity contracts" or contracts to "reinsure" risks underwritten by insurance companies. Some of the contracts do not cover insurance risks. Other contracts significantly limit the risks assumed by FC through the use of retrospective rating arrangements, unrealistically low policy limits, finite risk transactions, or other similar devices.

FC's actual insurance activities, if any, are relatively small compared to its investment activities. FC invests its capital and the amounts it receives as consideration for its "insurance" contracts in, among other things, hedge funds or investments in which hedge funds typically invest. As a result, FC's portfolio generates investment returns that substantially exceed the needs of FC's "insurance" business. FC generally does not currently distribute these earnings to Stakeholder.

Stakeholder takes the position that FC is an insurance company engaged in the active conduct of an insurance business and

is not a passive foreign investment company. Therefore, when Stakeholder disposes of its interest in FC, it will recognize gain as a capital gain, rather than as ordinary income.

III. DISCUSSION

The business of an insurance company necessarily includes substantial investment activities. Both life and nonlife insurance companies routinely invest their capital and the amounts they receive as premiums. The investment earnings are then used to pay claims, support writing more business or to fund distributions to the company's owners. The presence of investment earnings does not, in itself, suggest that an entity does not qualify as an insurance company.

Treasury and the Internal Revenue Service are concerned that in some cases FC and its Stakeholders are inappropriately claiming that FC is an insurance company for federal income tax purposes to avoid tax that otherwise would be due. The Service will challenge the claimed tax treatment in appropriate cases, as outlined below.

A. Definition of Insurance

For FC to qualify as an insurance company, FC must issue insurance contracts. Neither the Code nor the regulations define the terms "insurance" or "insurance contract." The United States Supreme Court, however, has explained that for an arrangement to constitute insurance for federal income tax purposes, both risk shifting and risk distribution must be present. *Helvering v. LeGierse*, 312 U.S. 531 (1941). The risk shifted and distributed must be an insurance risk. *See, e.g., Allied Fidelity Corp. v. Commissioner*, 572 F.2d 1190 (7th Cir. 1978), *cert. denied*, 439 U.S. 835 (1978); Rev. Rul. 89–96, 1989–2 C.B. 114.

Risk shifting occurs if a person facing the possibility of an economic loss resulting from the occurrence of an insurance risk transfers some or all of the financial consequences of the potential loss to the insurer. The effect of such a transfer is that a loss by the insured will not affect the insured because the loss is offset by the insurance payment. Risk distribution incorporates the "law of large numbers" to allow the insurer to reduce the possibility that a single costly claim will exceed the amount available to the insurer for the payment of such a claim. *Clougherty Packing Co. v. Commissioner*, 811 F.2d 1297, 1300 (9th Cir. 1987). Risk distribution necessarily entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks. *See Humana, Inc. v. Commissioner*, 881 F.2d 247, 257 (6th Cir. 1989).

Treasury and the Service are concerned that any risks assumed under the contracts issued by FC may not be insurance risks. Treasury and the Service are also concerned that the terms of the contracts may significantly limit the risks assumed by FC.

B. Status as an Insurance Company

A corporation that is an insurance company for federal income tax purposes is subject to tax under subchapter L of the Internal Revenue Code. For this purpose, an insurance company is a company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. While a taxpayer's name, charter powers, and state regulation help to indicate the activities in which it may properly engage, whether the taxpayer qualifies as an insurance company for tax purposes depends on its actual activities during the year. § 1.801–3(a) of the Income Tax Regulations; § 816(a) (which provides that a company will be treated as an insurance company only if "more than half of the business" of that company is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies).

To qualify as an insurance company, a taxpayer "must use its capital and efforts primarily in earning income from the issuance of contracts of insurance." *Indus. Life Ins. Co. v. United States*, 344 F. Supp. 870, 877 (D. S.C. 1972), *aff'd per curiam*, 481 F.2d 609 (4th Cir. 1973), *cert. denied*, 414 U.S. 1143 (1974). To determine whether FC qualifies as an insurance company, all of the relevant facts will be considered, including but not limited to, the size and activities of its staff, whether it engages in other trades or businesses, and its sources of income. *See generally Bowers v. Lawyers Mortgage Co.*, 285 U.S. 182 (1932); *Indus. Life Ins. Co.*, at 875–77; *Cardinal Life Ins. Co. v. United States*, 300 F. Supp. 387, 391–92 (N.D. Tex. 1969), *rev'd on other grounds*, 425 F. 2d 1328 (5th Cir. 1970); *Serv. Life Ins. Co. v. United States*, 189 F. Supp. 282, 285–86 (D. Neb. 1960), *aff'd on other grounds*, 293 F.2d 72 (8th Cir. 1961); *Inter-Am. Life Ins. Co. v. Commissioner*, 56 T.C. 497, 506–08 (1971), *aff'd per curiam*, 469 F.2d 697 (9th Cir. 1971); *Nat'l. Capital Ins. Co. of the Dist. of Columbia v. Commissioner*, 28 B.T.A. 1079, 1085–86 (1933).

In *Inter-Am. Life Ins. Co.*, 56 T.C. at 506–08, the Tax Court applied the standard of § 1.801–3(a), and held that the taxpayer was not an insurance company because it was not using its capital and efforts primarily in earning income from the issuance of insurance. The court in particular noted the disproportion between investment income and earned premiums. The court also noted the absence of an active sales staff soliciting or selling insurance policies.

Even if the contracts qualify as insurance contracts as explained above, the character of all of the business actually done by FC may indicate that FC uses its capital and efforts primarily in investing rather than primarily in the insurance business.

C. Possible Tax Treatment of Stakeholder's Interest in FC

Sections 1291–1298 provide special rules for taxing an investment in a foreign corporation that is a passive foreign investment company (as defined in § 1297). These rules impose current U.S. taxation (or similar treatment) on U.S. persons that earn passive income through a foreign corporation. A foreign corporation is a passive foreign investment company if (1) 75 percent or more of the gross income of such corporation for the taxable year is passive income, or (2) the average percentage of assets (as determined in accordance with § 1297(e)) held by such corporation during the taxable year which produce passive income or which are held for the production of passive income is at least 50 percent. Section 1297(a). For these purposes, passive income generally means any income which is of a kind which would be foreign personal holding company income as defined in § 954(c). Foreign personal holding company income includes dividends, interest, royalties, rents, annuities, and gains from the sale or exchange of property giving rise to such types of income. Section 954(c)(1).

Section 1297(b)(2)(B) provides an exception to passive income for any income derived in the active conduct of an insurance business by a corporation which is predominantly engaged in an insurance business and which would be subject to tax under subchapter L if it were a domestic corporation (the insurance income exception). If FC would not be subject to tax under subchapter L if it were a domestic corporation (for the reasons discussed above), then the insurance income exception to passive income will not apply, and FC will be subject to the general income and assets tests described above. Additionally, even if FC would be subject to tax under subchapter L if it were a domestic corporation, the insurance income exception may not apply to FC because this exception is applicable only to income derived in the *active* conduct of an insurance business.

The Service will scrutinize these arrangements and will apply the PFIC rules where it determines that FC is not an insurance company for federal tax purposes.

IV. DRAFTING INFORMATION

The principal authors of this notice are John Glover of the Office of Associate Chief Counsel (Financial Institutions & Products) and Theodore Setzer of the Office of Associate Chief Counsel (International). For further information regarding this notice, contact Mr. Glover at (202) 622–3970 or Mr. Setzer at (202) 622–3870 (not a toll-free call).

Organizations Exempt Under Section 501(c)(15)

Notice 2003–35

The purpose of this notice is to remind taxpayers that an entity must be an insurance company for federal income tax purposes in order to qualify as exempt from federal income tax as an organization described in § 501(c)(15) of the Internal Revenue Code.

Section 501(a) provides that an organization described in § 501(c) shall be exempt from federal income tax. Section 501(c)(15) provides that an insurance company (other than a life insurance company) is tax-exempt if its net written premiums (or, if greater, direct written premiums) for the taxable year do not exceed $350,000. For purposes of this annual test, the company is treated as receiving during the taxable year premiums received during the same year by all other companies within the same controlled group, as defined in § 831(b)(2)(B)(ii).

For an entity to qualify as an insurance company, it must issue insurance contracts or reinsure risks underwritten by insurance companies as its primary and predominant business activity during the taxable year. For a discussion of the analysis applicable to evaluating whether an entity qualifies as an insurance company, see Notice 2003–34, 2003–23 I.R.B. 990 (June 9, 2003) and Notice 2002–70, 2002–44 I.R.B. 765 (November 4, 2002).

The Service is scrutinizing the tax-exempt status of entities claiming to be described in § 501(c)(15) and will challenge the exemption of any entity that does not qualify as an insurance company. The Service will challenge the exemption of the entity, regardless of whether the exemption is claimed pursuant to an existing determination letter or on a return filed with the Service.

Taxpayers claiming exemption pursuant to § 501(c)(15) should also consider whether they are engaged in arrangements described in Notice 2002–70 or substantially similar thereto.

DRAFTING INFORMATION

The principal author of this notice is Lee T. Phaup. TE/GE Division, Exempt Organizations. For further information concerning this notice, contact Ms. Phaup at (202) 283–8935 (not a toll-free call).

Simplified Service Cost Method; Simplified Production Method

Notice 2003–36

PURPOSE

The Treasury Department and the Internal Revenue Service have become aware that uncertainty exists as to what types of property constitute "eligible property" under §§ 1.263A–1(h)(2)(i)(D) and 1.263A–2(b)(2)(i)(D) of the Income Tax Regulations for purposes of qualifying taxpayers to use the simplified service cost and the simplified production methods. These sections provide that self-constructed assets produced by the taxpayer on a routine and repetitive basis in the ordinary course of the taxpayer's trade or business are "eligible property." There is uncertainty about the proper interpretation and application of the term "routine and repetitive." Accordingly, the Treasury Department and the Service plan to publish guidance that will clarify the types of property that qualify as eligible property under §§ 1.263A–1(h)(2)(i)(D) and 1.263A–2(b)(2)(i)(D) and, in particular, that will address the interpretation and application of the term "routine and repetitive." This notice requests comments in connection with the guidance and informs taxpayers of the procedures that the Service will follow in the interim with respect to applications for consent to change to the simplified service cost or simplified production methods for self-constructed assets under §§ 1.263A–1(h)(2)(i)(D) and 1.263A–1(b)(2)(i)(D).

BACKGROUND

Rev. Proc. 2002–9, 2002–1 C.B. 327, as modified and clarified by Announcement 2002–17, 2002–1 C.B. 561, modified and amplified by Rev. Proc. 2002–19, 2002–1 C.B. 696, and amplified, clarified, and modified by Rev. Proc. 2002–54, 2002–35 I.R.B. 432, provides procedures by which taxpayers may obtain automatic consent to change to the methods of accounting described in the Appendix of the revenue procedure. Section 4.01(1)(a)(vi) of the Appendix of Rev. Proc. 2002–9 permits certain resellers to use the automatic consent procedures to change from a non-UNICAP method to a UNICAP method specifically described in the regulations. Section 4.02 of the Appendix of Rev. Proc. 2002–9 permits producers of real or tangible personal property to use the automatic consent procedures to change to a UNICAP method specifically described in the regulations. For this purpose, the simplified production method and the simplified service cost method are UNICAP methods specifically described in the regulations. *See* sections 4.01(2)(g) and 4.02(3) of the Appendix of Rev. Proc. 2002–9.

INTERIM PROCEDURES FOR ACCOUNTING METHOD CHANGE APPLICATIONS

Pending the issuance of further guidance, the following procedures will apply

to Forms 3115, *Application for Change in Accounting Method*, filed under either the automatic consent procedures of Rev. Proc. 2002–9 or the advance consent procedures of Rev. Proc. 97–27, 1997–1 C.B. 680, as modified and amplified by Rev. Proc. 2002–19, that request consent to change to either the simplified service cost method or the simplified production method, for self-constructed assets under §§ 1.263A–1(h)(2)(i)(D) and 1.263A–2(b)(2)(i)(D).

A. *Pending Applications*. The national office will continue to process pending applications. However, due to the uncertainty surrounding the types of property that qualify as eligible property under §§ 1.263A–1(h)(2)(i)(D) and 1.263A–2(b)(2)(i)(D), the national office expects that it will require additional time to process applications filed under the advance consent procedures, and that resolution of these applications will be delayed. Further, the national office may review copies of applications filed with the national office under Rev. Proc. 2002–9 (the automatic consent procedures that are generally effective for taxable years ending on or after December 31, 2001) on or before May 8, 2003, to determine whether the taxpayer's proposed change to the simplified service cost method or the simplified production method is appropriate. If an application filed under the automatic consent procedures is reviewed by the national office, the taxpayer will be notified by the national office of the outcome of the review.

B. *Future Applications*. After May 8, 2003, the Service will not accept applications filed under the automatic consent procedures of Rev. Proc. 2002–9 that request consent to change to either the simplified service cost method or the simplified production method for self-constructed assets under §§ 1.263A–1(h)(2)(i)(D) and 1.263A–2(b)(2)(i)(D). Instead, taxpayers will be required to file applications to make these changes under the advanced consent procedures of Rev. Proc. 97–27. Notwithstanding section 6.02(3) of Rev. Proc. 2002–9, if the taxpayer has filed a copy of the Form 3115 with the national office on or before May 8, 2003, but has not yet attached the original of the Form 3115 to its timely filed (including extensions) federal income tax return, for purposes of this notice the taxpayer will be deemed to have a pending application provided, however, that pursuant to section 6.02(3) of Rev. Proc. 2002–9, the taxpayer files the original Form 3115 with its timely filed (including extensions) federal income tax return.

EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2002–9 is suspended in part.

REQUEST FOR COMMENTS

The Service requests comments on issues relating to the qualifications for eligible property under §§ 1.263A–1(h)(2)(i)(D) and 1.263A–2(b)(2)(i)(D). In addition, the Service requests comments on the simplified service cost method in general. For example, the Service requests comments on the ability of small taxpayers to use the simplified service cost method given that small taxpayers may not have costs separated into departments or functions. Comments should be submitted by July 7, 2003, to:

Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044
Attn: CC:PA:T:CRU(ITA)
Room 5529

or electronically via the Service internet site at: *Notice.Comments@irscounsel.treas.gov* (the Service comments e-mail address). All comments will be available for public inspection and copying.

DRAFTING INFORMATION

The principal author of this notice is Scott Rabinowitz of the Office of the Associate Chief Counsel (Income Tax and Accounting). For further information regarding this notice, contact Mr. Rabinowitz at (202) 622–4970 (not a toll-free call).

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26 CFR 601.201: Rulings and determination letters.
(Also Part I, § 2702; 25.2702–5.)

Rev. Proc. 2003–42

SECTION 1. PURPOSE

This revenue procedure contains an annotated sample declaration of trust and alternate provisions that meet the requirements under § 2702(a)(3)(A) of the Internal Revenue Code and § 25.2702–5(c) of the Gift Tax Regulations for a qualified personal residence trust (QPRT) with one term holder.

SECTION 2. BACKGROUND

Section 2702(a) provides special rules for the valuation for gift tax purposes of a transfer of an interest in a trust to or for the benefit of a member of the transferor's family if the transferor (or an applicable family member) retains an interest in the trust. Under § 2702(a)(2)(A), the value of any retained interest that is not a qualified interest (as defined in § 2702(b)) is treated as zero unless the transfer is described in § 2702(a)(3). Section 2702(a)(3)(A) and § 25.2702–5(a)(1) provide that § 2702(a) does not apply to a transfer to a personal residence trust; that is, a transfer of an interest in trust all the property of which consists of a residence to be used as a personal residence by persons holding term interests in the trust. Although there are differences between a personal residence trust created under the statute and a QPRT created under the regulations, under § 25.2702–5(a), a trust meeting the requirements of a QPRT will be treated as a personal residence trust. Section 25.2702–5(c) contains the requirements that must be met by a trust in order to qualify as a QPRT. This revenue procedure provides a sample declaration of trust, as well as additional guidance in the form of annotations and alternative provisions.

SECTION 3. SCOPE AND OBJECTIVE

Section 4 of this revenue procedure provides a sample declaration of trust for a QPRT with one transferor for a term equal to the lesser of the life of the term holder or a term of years. Section 5 provides annotations to the provisions in the sample trust. Section 6 provides samples of certain alternate provisions concerning: (.01) additions to the trust to purchase a personal residence, and (.02) disposition of trust assets on cessation of its qualification as a QPRT.

The Internal Revenue Service will recognize a trust as a QPRT meeting all of the requirements of § 2702(a)(3)(A) and § 25.2702–5(c) if (i) the trust instrument is substantially similar to the sample in section 4 of this revenue procedure or if the trust agreement properly integrates one or more alternate provisions from section 6 of this revenue procedure into a document sub-

stantially similar to the sample in section 4, and (ii) the trust operates in a manner consistent with the terms of the trust instrument and is a valid trust under applicable local law. A trust instrument that contains substantive provisions in addition to those provided in section 4 of this revenue procedure (other than properly integrated alternate provisions from section 6 of this revenue procedure or provisions necessary to establish a valid trust under applicable local law), or that omits any of the provisions of section 4 of this revenue procedure (unless an alternative provision from section 6 of this revenue procedure is properly integrated), will not necessarily be disqualified, but will not be assured of qualification under the provisions of this revenue procedure. The Service generally will not issue a letter ruling on whether a trust with one term holder qualifies as a QPRT. The Service, however, will generally issue a letter ruling on the effect of substantive trust provisions, other than those contained in sections 4 and 6 of this revenue procedure, on the qualification of a trust as a QPRT.

SECTION 4. SAMPLE QUALIFIED PERSONAL RESIDENCE TRUST — ONE TERM HOLDER

This trust agreement is made this _____ day of _____, 20 ___, by and between, _____, (hereinafter "the Transferor"), and _____ as the trustee (hereinafter "the Trustee"), hereby creating the _____ Trust.

ARTICLE I. RETAINED INTEREST AND IRREVOCABILITY

A. *Retained Interest*. The Transferor intends to establish a qualified personal residence trust within the meaning of Rev. Proc. 2003–42, § 2702(a)(3)(A) of the Internal Revenue Code (hereinafter "the Code"), and § 25.2702–5(c) of the Gift Tax Regulations (hereinafter "the regulations"). Accordingly, the Transferor retains no right, title, or interest in any trust asset except as specifically provided in this trust instrument.

B. *Irrevocable*. This trust is irrevocable and therefore may not be modified, amended, or revoked by the Transferor or any other person. Notwithstanding the preceding sentence, however, the Trustee shall have the power, acting alone, to amend the trust to the extent provided in § 25.2702–5(a)(2) of the regulations (or any subsequent regulation or statute) in any manner required for the sole purpose of ensuring that the trust qualifies as a qualified personal residence trust for purposes of § 2702(a)(3)(A) of the Code and § 25.2702–5(c) of the regulations (including with respect to the grantor retained annuity trust ("GRAT") administered under Article III, the qualification of the annuity interest under § 2702(b)(1) of the Code and § 25.2702–3 of the regulations).

ARTICLE II. QUALIFIED PERSONAL RESIDENCE TRUST

A. *Funding of the Qualified Personal Residence Trust ("QPRT").*

(1) *Residence*. The Transferor transfers and assigns to the Trustee all of the Transferor's interests in and rights to certain real property, including all improvements thereon and appurtenances thereto, known as _____*[legal description and/or address]*_____, _____*[city]*_____, _____*[state]*_____. This property, or any property acquired as a replacement, will hereinafter be referred to as the "Residence." The Trustee accepts the Residence and agrees to hold, manage, and distribute the Residence and any other trust property under the terms set forth in this instrument.

(2) *Assets of Trust*. Except as provided in Paragraphs A(3), B(6), and D of this Article II, the Trustee is prohibited from holding, at any time during the term of the QPRT, any property other than (a) an interest in one (and only one) Residence that meets the requirements of a personal residence of the Transferor as set forth in § 25.2702–5(c)(2) of the regulations, and (b) policies of insurance on the Residence.

(3) *Additions to QPRT*. From time to time, the Trustee may accept an addition of cash to the QPRT in an amount which, when added to any cash already held, does not exceed the amount reasonably required for: (a) the payment of QPRT expenses (including without limitation mortgage payments) already incurred or reasonably expected to be paid by the trust within 6 months after the date the addition is made; (b) the cost of improvements to the Residence to be paid by the trust within 6 months after the date the addition is made; and (c) the purchase by the trust of a replacement Residence within 3 months after the date the addition is made, provided that no addition may be made, or held by the Trustee, for the purchase of a replacement Residence unless the Trustee has, prior to receipt of the addition, entered into a contract to purchase that Residence. The Trustee shall hold the additions of cash received in accordance with this paragraph in a separate account.

B. *Administration of Trust*.

(1) *Use and Management of Residence*. The Trustee shall hold and maintain the Residence as a personal residence of the Transferor during the period beginning on the date of creation of the trust and continuing through the date of termination of the trust (hereinafter "the term of the QPRT"). During the term of the QPRT, the Transferor shall have the exclusive rent-free use, possession, and enjoyment of the Residence.

(2) *Payment of Expenses*. The Transferor shall be responsible for the payment of all costs associated with the Residence, including but not limited to mortgage payments, property taxes, utilities, repairs, maintenance, and insurance. The Trustee's responsibility for the maintenance of the Residence and for other costs associated with the Residence is limited to the extent of any trust income and additions of cash for that purpose received by the Trustee in accordance with this Article II. If the Trustee has insufficient funds to pay these costs and expenses, the Trustee shall notify the Transferor, who shall be responsible for the unpaid balance of these costs and expenses. In addition, the Trustee from time to time may make improvements to the Residence, but the Trustee's authority and responsibility to do so is limited to the extent of any trust income, insurance proceeds, and additions of cash for that purpose received by the Trustee in accordance with this Article II.

(3) *Distributions of Cash to Transferor*. Any net income of the QPRT shall be distributed to the Transferor, not less frequently than annually. In addition, the Trustee shall determine, not less frequently than quarterly, whether the cash held by the QPRT exceeds the amount permitted to be held by the Trustee and shall immediately distribute the excess, if any, to the Transferor. Within 30 days of the date of the ter-

mination of the QPRT, the Trustee shall distribute outright to the Transferor (or to the estate of the Transferor, as the case may be), any amounts held by the QPRT pursuant to Paragraph A(3) of this Article II that are not used to pay QPRT expenses due and payable on the date of termination (including expenses directly related to the termination of the QPRT).

(4) *Reinvestment of Trust Assets*. Except as provided in Paragraph B(5) of this Article II, the Trustee may sell the Residence from time to time upon terms and conditions the Trustee deems appropriate. The Trustee may disburse from time to time any part or all of the amounts described in Paragraph A(1) and A(3) above and Paragraph B(6) below, including all income and capital gains thereon, as the Trustee deems appropriate for the purchase or construction of a replacement Residence to be owned by the trust or for the reconstruction or repair of the Residence. These disbursements shall be made, and any reconstruction and repairs shall be completed, within the time periods necessary to allow this trust to continue to qualify as a QPRT, but the Trustee shall not be held liable for any failure in this regard unless the Trustee has acted (or failed to act) through willful default or gross negligence.

(5) *Prohibition on Sale of Residence to Transferor or Related Parties*. The Trustee is prohibited from selling or transferring (as defined in § 25.2702–5(c)(9) of the regulations) the Residence, directly or indirectly, to the Transferor, the Transferor's spouse, or an entity controlled by the Transferor or the Transferor's spouse during the retained term interest of the QPRT, or at any time after the termination of the retained term interest in the QPRT while the trust is treated as owned in whole or in part by the Transferor or the Transferor's spouse under §§ 671 through 678 of the Code.

(6) *Receipt of Proceeds With Respect to Residence*. If the Residence is sold, the Trustee shall hold the proceeds of the sale (along with any income accrued thereon) in a separate account. If the Residence is damaged, destroyed, or involuntarily converted within the meaning of § 1033 of the Code, the Trustee shall hold any proceeds payable as a result thereof (consisting either of insurance proceeds in the case of damage or destruction to the Residence or the proceeds payable upon involuntary conversion) in a separate account. The proceeds (and any interest thereon) so received shall be held, administered, and distributed by the Trustee as provided in this Article II.

(7) *Commutation of Interests*. The Transferor's interest in the QPRT may not be sold, commuted, or prepaid by any person.

(8) *Prohibited Distributions*. Except to the extent provided in Paragraph D below, the Trustee may not make any distribution of income or principal from the QPRT to or for the benefit of any person other than the Transferor prior to the termination of the QPRT.

C. *Termination of Trust*. The trust's date of termination shall be the earlier of *[date]*, or the date of the Transferor's death. Except as otherwise provided in Paragraph D below, the Trustee shall distribute the trust property at the end of the term of the QPRT as provided in this Paragraph C. If the date of termination is *[date]*, the Trustee shall distribute all of the property of the trust (other than any amounts due the Transferor pursuant to this trust instrument) to [*designate transferees — if more than one, specify shares*]. If the date of termination is the earlier death of the Transferor, the Trustee shall distribute all trust property (other than any amounts due the Transferor's estate pursuant to this trust instrument) to [*designate transferees — if more than one, specify shares*].

D. Cessation of Qualification as a Personal Residence Trust.

(1) *Cessation Date*.

(a) The trust shall cease to be a QPRT on the date on which the Residence ceases to be used or held for use as a personal residence of the Transferor within the meaning of § 25.2702–5(c)(7) of the regulations (other than for reasons described in Paragraphs D(1)(b) or D(1)(c) below).

(b) In the event of a sale of the Residence, the trust shall cease to be a QPRT on the first to occur of the following: (i) the date which is 2 years after the date of sale; (ii) the date of termination as determined in Paragraph C above; or (iii) the date on which a replacement Residence is acquired by the Trustee. If the first to occur is the acquisition of a replacement Residence by the Trustee, then the QPRT shall continue with respect to that replacement Residence, and the trust shall cease to be a QPRT only to the extent of any sale proceeds then held by the Trustee and not used for the purchase of the replacement Residence.

(c) If the Residence is damaged or destroyed, thus making it unusable as a personal residence, the trust shall cease to be a QPRT on the first to occur of the following dates: (i) the date that is 2 years after the date of damage or destruction; (ii) the date of termination as determined in Paragraph C above; or (iii) replacement of or repairs to the Residence are completed or a new Residence is acquired by the Trustee. If the first to occur is the completion of the replacement or repair (or the acquisition of a new Residence), then the QPRT shall continue with respect to the repaired Residence or the new Residence, and the trust shall cease to be a QPRT only to the extent of any insurance proceeds then held by the Trustee and not used for the replacement or repair of the Residence (or the purchase of the new Residence).

(2) *Distribution on Cessation*. Within 30 days after the date on which the trust ceases to be a QPRT with respect to any of its assets, and after satisfying the provisions of Paragraph B(3) of this Article II, the Trustee shall distribute the trust assets with respect to which the trust has ceased to qualify as a QPRT to a separate share of this trust to be referred to and administered as a GRAT in accordance with Article III below. That GRAT shall continue until the date of termination as defined in Paragraph C above.

(3) *Multiple GRATs*. Because it may be possible to have more than one cessation of qualification during the term of the QPRT, the Trustee shall create and fund a separate GRAT for each cessation and each GRAT shall be administered as a separate share of the trust in accordance with Article III below.

ARTICLE III. GRANTOR RETAINED ANNUITY TRUST

Each GRAT administered as a separate share under this Article III (each of which is referred to as "the GRAT" with regard to that separate share) is intended to provide for the payment of a qualified annuity interest as defined in § 25.2702–3 of the regulations for the benefit of the Transferor. No amount shall be paid before the termination of this trust other than to or for the Transferor's benefit.

A. *Right to Receive Annuity*. In each taxable year of the GRAT, beginning with the

year beginning on the cessation date (as defined below), the Trustee shall pay to the Transferor an annuity, the amount of which shall be determined in accordance with Paragraph D of this Article III. The right of the Transferor to receive the annuity amount begins on the cessation date.

B. *Cessation Date*. The cessation date is the date on which the Residence ceases to be used or held for use as a personal residence of the Transferor, the date of sale of the Residence, or the date of damage to or destruction of the Residence that renders the Residence unusable as a residence, as the case may be.

C. *Payment of Annuity*. The annuity amount shall be paid in equal [*insert monthly, quarterly, semi-annual or annual*] installments. The annuity amount shall be paid first from the net income of the GRAT and, to the extent net income is not sufficient, from principal. The Trustee may defer payment of any annuity amount otherwise payable after the cessation date until the date that is 30 days after the date that the assets are converted to a GRAT as provided in this trust instrument. Any deferred payment of the annuity amount shall bear interest for the period of deferral, compounded annually, at a rate not less than the rate prescribed in § 7520 of the Code in effect on the cessation date. The Trustee shall reduce the aggregate deferred annuity payments by the amount of income actually distributed to the Transferor during the deferral period.

D. *Computation of Annuity Amount*.

The amount of the annuity payable to the Transferor shall be determined as follows.

(1) If, on the date that any property of the trust is converted from the QPRT to a GRAT (hereinafter the "conversion date"), the assets of the trust do not include a Residence used or held for use as a personal residence of the Transferor, the annuity shall be the amount determined by dividing the lesser of (a) the value of the interest retained by the Transferor (as of the date of the original transfer) or (b) the value of all the trust assets (as of the conversion date) by the annuity factor determined (i) for the original term of the Transferor's interest and (ii) at the rate used in valuing the retained interest at the time of the original transfer to the QPRT.

(2) If, on the conversion date, the assets of the trust include a Residence used or held for use as a personal residence of the Transferor, the annuity shall be the amount determined under subparagraph (1) of this Paragraph D multiplied by a fraction. The numerator of the fraction is the excess of the fair market value of the assets of the trust on the conversion date over the fair market value of the assets as to which the trust continues as a QPRT, and the denominator of the fraction is the fair market value of the trust assets on the conversion date.

(3) In computing the annuity amount for any second or subsequent GRAT to be administered under this Article III, the Trustee shall make appropriate adjustments to the formulas above in this paragraph D that are consistent with the applicable provisions of the Code and the regulations thereunder and with the Transferor's intent to maintain qualification of each of the trust shares hereunder as a QPRT or a GRAT.

(4) If there is an error in the determination of the annuity amount, then, within a reasonable period after the error is discovered, the difference between the annuity amount payable and the amounts actually paid shall be paid to or for the use of the Transferor by the Trustee in the event of an underpayment, or shall be repaid by the Transferor to the Trustee in the event of an overpayment.

E. *Proration*. Notwithstanding the preceding paragraphs of this Article III, in determining the annuity amount for a short taxable year, the Trustee shall prorate the annuity amount on a daily basis. In determining the annuity amount for the taxable year of the termination of the GRAT, the Trustee shall prorate the annuity amount for the final period of the annuity interest on a daily basis.

F. *Additional Contributions Prohibited*. No additional contributions shall be made to the GRAT after its creation.

G. *Termination of GRAT*. The GRAT shall continue through the date of termination of the QPRT, as defined in Paragraph C of Article II, and shall then terminate. Upon termination of the GRAT, the Trustee shall distribute all of the trust property in the manner described in Paragraph C of Article II as if the GRAT property had been part of the QPRT disposed of under that provision.

H. *No Commutation*. The Transferor's interest in the annuity amount may not be sold, commuted, or prepaid by any person.

ARTICLE IV. GENERAL PROVISIONS

A. *Taxable Year*. The taxable year of the trust shall be the calendar year.

B. *Governing Law*. The operation of the trust shall be governed by the laws of the state of *[state]*. The Trustee, however, shall not have or exercise any power or discretion granted under applicable law that would prevent: (1) the QPRT administered under Article II above from meeting the requirements for a qualified personal residence trust under § 2702(a)(3)(A) of the Code and § 25.2702–5(c) of the regulations; or (2) the Transferor's interest in any GRAT administered under Article III above from meeting the requirements for a qualified annuity interest under § 25.2702–3 of the regulations.

SECTION 5. ANNOTATIONS REGARDING SAMPLE QUALIFIED PERSONAL RESIDENCE TRUST

.01 *Annotations for Introductory Paragraph and Article I, Retained Interest and Irrevocability*.

(1) *Qualification as a QPRT*. In order to qualify as a QPRT, the governing instrument must contain all the provisions required under the regulations, and these provisions must by their terms continue in effect during the existence of any term interest in the trust. Section 25.2702–5(c)(1).

(2) *Appointment of Trustee*. Alternative or successor trustees may be designated in the trust instrument.

(3) *Limited Power of Amendment*. A QPRT must be irrevocable. However, modification of a trust by judicial reformation (or nonjudicial reformation if effective under state law) to comply with the requirements of § 25.2702–5(c) will be effective for purposes of § 2702, provided the reformation is commenced within 90 days after the due date (including extension) for the filing of the gift tax return reporting the transfer of the residence under § 6075 and is completed within a reasonable time after commencement. Section 25.2702–5(a)(2).

.02 *Annotations for Article II, Qualified Personal Residence Trust.*

(1) *Requirement that QPRT Must be Funded With a Personal Residence (Article II, Paragraph A(1))*. The QPRT must be funded with a residence that qualifies as a personal residence of the term holder during the term of the QPRT. A personal residence of a term holder is: (A) the principal

residence of the term holder (as that term is defined in § 25.2702–5(c)(2)(i)(A)); (B) one other residence of the term holder (within the meaning of § 25.2702–5(c)(2)(i)(B)); or (C) an undivided fractional interest in a residence described in either (A) or (B). Section 25.2702–5(c)(2)(i). A personal residence may include appurtenant structures used by the term holder for residential purposes and adjacent land not in excess of that which is reasonably appropriate for residential purposes, taking into account the residence's size and location. The fact that a residence is subject to a mortgage does not affect its status as a personal residence. The term "personal residence" does not include any personal property, for example, household furnishings. Section 25.2702–5(c)(2)(ii). A residence is a personal residence only if its primary use is as a residence of the term holder when occupied by the term holder. The principal residence of the term holder will not fail to meet the requirements of the preceding sentence merely because a portion of the residence is used in an activity meeting the requirements of § 280A(c)(1) or (4) (relating to deductibility of expenses related to certain uses), provided that such use is secondary to use of the residence as a residence. A residence is not used primarily as a residence if it is used to provide transient lodging and substantial services are provided in connection with the provision of lodging, for example, a hotel or a bed and breakfast. A residence is not a personal residence if, during any period not occupied by the term holder, its primary use is other than as a residence. Section 25.2702–5(c)(2)(iii).

(2) *Assets other than personal residence (Article II, Paragraph A(3))*. This is an optional provision that, if included in the trust instrument, permits the trustee to accept additions of cash to the trust for the purposes set forth in Paragraph A(3) of Article II. A provision in the trust instrument that permits these additions is not required in order to qualify the trust as a QPRT. Section 25.2702–5(c)(5)(ii)(A). In addition, the trust instrument may permit improvements to the residence to be added to the trust and may permit the trust to hold such improvements, provided the residence, as improved, meets the requirements of a personal residence. Section 25.2702–5(c)(5)(ii)(B).

(3) *Authority to Sell or Repair Residence (Article II, Paragraph B(4))*. The provisions of Paragraph B(4) are optional. If the trustee is given the authority to sell the personal residence but not to reinvest the proceeds in a replacement personal residence, the trust ceases to be a QPRT upon the sale of the residence.

(4) *Prohibition on Sale of Residence to Transferor or Related Person (Article II, Paragraph B(5))*. The governing instrument must prohibit the trust from selling or transferring the residence directly or indirectly to the transferor, the transferor's spouse, or an entity controlled by the transferor or the transferor's spouse during the retained term interest in the trust or at any time after the expiration of that interest when the trust is a grantor trust. For these purposes: (A) a sale or transfer to another grantor trust of the transferor or the transferor's spouse is considered a sale or transfer to the transferor or the transferor's spouse; and (B) a "grantor trust" is a trust that is treated as owned in whole or in part by the transferor or the transferor's spouse pursuant to §§ 671 through 678, and "control" is as defined in § 25.2701–2(b)(5)(ii) and (iii).

This prohibition, however, does not apply to a distribution for no consideration either to: (i) another grantor trust of the transferor or the transferor's spouse, if the distributee-grantor trust includes the same prohibition against a sale or transfer; (ii) the transferor's spouse after the term of the QPRT; or (iii) any person pursuant to the trust instrument or the exercise of the transferor's retained power of appointment, if any, if the transferor dies prior to the expiration of the retained term interest. Section 25.2702–5(c)(9).

(5) *Termination of Trust (Article II, Paragraph C)*.

(a) *Termination on Death of Transferor*. If the trust terminates by reason of the death of the transferor, and therefore terminates prior to the end of the term interest, the trust property will be includible in the transferor's gross estate for federal estate tax purposes because the transferor will have retained an interest in the trust for a period that did not in fact end before the transferor's death. Section 2036(a)(1). Therefore, consideration should be given to designing the dispositive provisions to take advantage of marital or charitable deductions that may be available for estate tax purposes.

(b) *Generation-Skipping Transfer Tax*. Consideration also should be given to potential generation-skipping transfer (GST) tax consequences under § 2601 upon termination of the trust by reason of the death of the transferor during the QPRT term. The transferor may prefer to design the dispositive provisions to avoid any generation-skipping transfer in the event of the transferor's death during the term because, pursuant to § 2642(f), no allocation of GST exemption can be made until the end of the term of the QPRT (the transferor's death).

(6) *Cessation of Use As a Personal Residence (Article II, Paragraph D)*.

The governing instrument must provide that a trust ceases to be a QPRT if the residence ceases to be used or held for use as a personal residence of the term holder. Under § 25.2702–5(c)(7)(i), a residence is held for use as a personal residence of the term holder so long as the residence is not occupied by any other person (other than the spouse or a dependent of the term holder) and is available at all times for use by the term holder as a personal residence.

.03 *Annotation for Article III, Grantor Retained Annuity Trust (GRAT)*.

(1) *Payment of Annuity (Article III, Paragraph C)*. Allowing deferral of the annuity payment is an optional provision and is not required in order to qualify as a QPRT. If the trustee is given the power to defer payment of any annuity amount, then the trust may (but is not required to) provide that the aggregate deferred annuity payments must be reduced by the amount of income actually distributed to the transferor during the deferral period. Section 25.2702–5(c)(8)(ii)(B).

(2) *Computation of Annuity Amount (Article III, Paragraph D)*. The annuity amount may be greater than the amount identified in the sample trust, but may not be less than that amount. See *Example 6* in § 25.2702–5(d) for a numerical example of how the annuity formulas operate.

.04 *Annotation for Article IV, General Provisions*.

Trustee Powers. The trust instrument may contain administrative provisions relating to the trustee's duties and powers, as long as the provisions do not conflict with the rules governing QPRTs under § 2702(a)(3)(A) and § 25.2702–5(c), or the rules governing qualified annuity interests under § 25.2702–3. A clause may be included that provides: "Except to the ex-

tent provided otherwise in Article II and Article III, the Trustee has the following powers . . .."

SECTION 6. ALTERNATIVE OR OPTIONAL PROVISIONS FOR SAMPLE QUALIFIED PERSONAL RESIDENCE TRUST

.01 *Contribution(s) of Cash to Purchase Personal Residence*.

(1) *Explanation*. If the transferor does not currently own the personal residence that will constitute the trust corpus, cash may be transferred to the QPRT for the purchase of the initial residence. However, the purchase must take place within 3 months of the date the trust is created. Except for a nominal amount that may be required under state law to create the trust, before any contribution, the trustee must have previously entered into a contract to purchase that residence. Section 25.2702–5(c)(5)(ii)(A)(iii).

(2) *Instructions for use*. Replace Paragraphs A(1) and A(3) of Article II with the following paragraphs:

A(1) *Cash for Purchase of Residence*. The Transferor transfers $_____ to the Trustee and confirms that the Transferor intends to transfer to the Trustee additional cash in an amount sufficient to allow the Trustee to purchase a residence to be used as a personal residence of the Transferor. The Trustee accepts that amount, agrees to hold it in a separate account, and agrees to use it and any additional cash contributed under Paragraph A(3)(d) of this Article to purchase, within 3 months after the date on which this trust is created, such a residence (hereinafter referred to as "the Residence"). The Trustee agrees to hold, manage, and distribute the Residence and any other trust property under the terms set forth in this instrument.

A(3) *Additions to QPRT*. From time to time, the Trustee may accept an addition of cash to the QPRT in an amount which, when added to any cash already held, does not exceed the amount reasonably required for: (a) the payment of QPRT expenses (including without limitation mortgage payments) already incurred or reasonably expected to be paid by the trust within 6 months after the date the addition is made; (b) the cost of improvements to the Residence to be paid by the trust within 6 months after the date the addition is made; (c) the purchase by the trust of a replacement Residence within 3 months after the date the addition is made, provided that no addition may be made, or held by the Trustee, for this purpose unless the Trustee has, prior to receipt of the addition, entered into a contract to purchase that Residence; and (d) the purchase by the trust of the initial Residence within 3 months of the date the trust is created, provided that no addition may be made, or held by the Trustee, for the purchase of the initial Residence unless the Trustee has, prior to receipt of the addition, entered into a contract to purchase that Residence. The Trustee shall hold the additions of cash received in accordance with this paragraph in a separate account.

.02 *Disposition of Trust Assets on Cessation as QPRT*.

(1) *Explanation*. The sample trust provides that, if the trust ceases to qualify as a QPRT, the assets are to be held as a separate share in a GRAT pursuant to which a qualified annuity interest is to be paid to the transferor until the QPRT's date of termination. Alternatively, the trust instrument may direct that the assets be returned to the transferor, or may give to a trustee, who is independent of the transferor, the discretion either to elect to return the assets to the transferor or to hold the assets in a GRAT. Section 25.2702–5(c)(8).

(2) *Instructions for use if outright distribution*. If the assets are to be distributed outright to the term holder, delete all of Article III, delete the reference to GRAT at the end of Paragraph B of Article I and Paragraph B of Article IV, delete Paragraph D(3) of Article II, and replace Paragraph D(2) of Article II with the following paragraph:

D(2) *Distribution on Cessation*. Within 30 days after the date on which the trust ceases to be a QPRT with respect to any assets, the Trustee shall distribute those assets outright to the Transferor.

(3) *Instructions for use if trustee's discretion*. If the trustee is to be given the discretion to either distribute the assets outright or establish a GRAT, replace Paragraph D(2) of Article II with the following paragraph:

D(2) *Distribution on Cessation*. Within 30 days after the date on which the trust ceases to be a QPRT with respect to any of its assets, and after satisfying the provisions of Paragraph B(3) of this Article II, the Trustee shall distribute any trust assets with respect to which the trust has ceased to qualify as a QPRT in one of two ways, as the Trustee may select in the Trustee's sole discretion. Specifically, the Trustee shall distribute the assets with respect to which the trust no longer qualifies as a QPRT either: (i) to the Transferor, outright; or (ii) to a separate share of this trust to be referred to and administered as a GRAT in accordance with Article III below. That GRAT shall continue until the date of termination as defined in Paragraph C above.

DRAFTING INFORMATION

The principal author of this revenue procedure is Mary Berman of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue procedure, contact Mary Berman at (202) 622–3090 (not a toll-free call).

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26 CFR 601.105: Examination of returns and claims for refund, credit or abatement; determination of correct tax liability.
(Also Part I, §§ 1361, 1362; 1.1361–1, 1.1361–3, 1.1362–4, 1.1362–6, 301.9100–1, 301.9100–3.)

Rev. Proc. 2003–43

SECTION 1. PURPOSE

This revenue procedure provides a simplified method for taxpayers to request relief for late S corporation elections, Electing Small Business Trust (ESBT) elections, Qualified Subchapter S Trust (QSST) elections and Qualified Subchapter S Subsidiary (QSub) elections. Generally, this revenue procedure provides that certain eligible entities may be granted relief for failing to file these elections in a timely manner if the request for relief is filed within 24 months of the due date of the election. Accompanying this document is a flowchart designed to aid taxpayers in applying this revenue procedure.

SECTION 2. BACKGROUND

.01 *S Corporation Elections*.

(1) *In General*. Section 1361(a)(1) of the Internal Revenue Code defines an "S corporation," with respect to any taxable year, as a small business corporation for which an S corporation election is in effect for that year.

Section 1362(b)(1) provides that a corporation may make an election to be treated

as an S corporation (A) at any time during the preceding taxable year, or (B) at any time during the taxable year and on or before the 15th day of the 3rd month of the taxable year. Section 1.1362–6(a)(2) of the Income Tax Regulations provides that a corporation makes an election to be an S corporation by filing a completed Form 2553, *Election by a Small Business Corporation*.

Under § 1362(b)(3), if an S corporation election is made for a taxable year after the 15th day of the 3rd month of that taxable year and on or before the 15th day of the 3rd month of the following taxable year, then the S corporation election is treated as made for the following taxable year.

(2) *Late S Corporation Elections*. Section 1362(b)(5) provides that if (A) an election under § 1362(a) is made for any taxable year (determined without regard to § 1362(b)(3)) after the date prescribed by § 1362(b) for making the election for the taxable year or no election is made for any taxable year, and (B) the Secretary determines that there was reasonable cause for the failure to timely make the election, the Secretary may treat the election as timely made for the taxable year (and § 1362(b)(3) shall not apply).

.02 *QSub Elections*.

(1) *In General*. Section 1361 generally provides that an S corporation may elect to treat certain wholly owned subsidiaries as QSubs (as defined in § 1361(b)(3)(B)).

Section 1.1361–3 describes the time and manner for a corporation to make a QSub election. Section 1.1361–3(a)(2) provides that an S corporation may make a QSub election by filing the election form with the applicable service center. Form 8869, *Qualified Subchapter S Subsidiary Election*, is used to make a QSub election. The election to treat a subsidiary as a QSub may be filed at any time during the taxable year under § 1.1361–3(a)(3). Section 1.1361–3(a)(4) provides that the effective date is the date specified on the form (provided the date specified is not earlier than two months and 15 days before the date of the filing and the date specified is not more than 12 months after the date of the filing) or, on the date the election form is filed if no date is specified. If an election form specifies an effective date more than two months and 15 days prior to the date on which the election form is filed, it will be effective two months and 15 days prior to the date it is filed. If an election form specifies an effective date more than 12 months after the date on which the election is filed, it will be effective 12 months after the date it is filed.

(2) *Late QSub Elections*. Under § 301.9100–1(c) of the Procedure and Administration Regulations, the Commissioner may grant a reasonable extension of time under the rules set forth in § 301.9100–2 and § 301.9100–3 to make a regulatory election, or certain statutory elections under all subtitles of the Code except subtitles E, G, H, and I. Section 301.9100–1(b) defines the term "regulatory election" as an election whose due date is prescribed by a regulation published in the Federal Register, or a revenue ruling, revenue procedure, notice, or announcement published in the Internal Revenue Bulletin. Because a QSub election is a regulatory election, the Commissioner may permit a late QSub election under the rules set forth in § 301.9100–3.

.03 *ESBT and QSST Elections*.

(1) *In General*. Section 1361(b)(1)(B) limits the permitted shareholders of an S corporation to domestic individuals, estates, certain trusts, and certain exempt organizations.

Section 1361(d)(1)(A) provides that a QSST (as defined in § 1361(d)(3)(A)) is a permitted S corporation shareholder if the beneficiary of the QSST makes an election under § 1361(d)(2). Pursuant to § 1361(d)(2)(A) and § 1.1361–1(j)(6)(i), the election by a current income beneficiary of a QSST may be made by the beneficiary's guardian or legal representative (or a natural or an adoptive parent of the current income beneficiary if a legal representative has not been appointed) if the current income beneficiary is a minor. A QSST election is made by signing and filing an election statement with the applicable service center. Section 1.1361–1(j)(6)(iii) provides that the QSST election must be made within the 16-day-and-2-month period beginning on the day that the S corporation stock is transferred to the trust.

Section 1361(c)(2)(A)(v) provides that an ESBT (as defined in § 1361(e)) is a permitted S corporation shareholder. To qualify as an ESBT, the trustee of the trust must make an ESBT election by signing and filing an election statement with the applicable service center. Section 1.1361–1(m)(2)(iii) provides that the ESBT election must be filed within the time requirements prescribed in § 1.1361–1(j)(6)(iii) for filing a QSST election (described above).

(2) *Late ESBT and QSST Elections*. Failure to properly make an election to be treated as an ESBT or a QSST may result in a shareholder who is not an eligible S corporation shareholder under § 1361(b)(1)(B) holding stock of the corporation. As a result, the failure to properly file an ESBT or QSST election may result in an inadvertent invalid S corporation election, or in an inadvertent termination of an S corporation election.

Section 1362(f) grants the Secretary (or his delegate) authority to provide relief if a corporation's S corporation election was not effective for the taxable year for which it was made by reason of a failure to meet the requirements of § 1361(b) or to acquire the required shareholder consents. Under § 1362(f), the Secretary may also grant relief if the corporation's S corporation election terminated under § 1362(d)(2) or (3). A corporation is eligible for relief under this provision if (1) the Secretary determines that the circumstances resulting in the ineffectiveness or termination were inadvertent, (2) no later than a reasonable period of time after discovery of the circumstances resulting in the ineffectiveness or termination, steps were taken so that the S corporation is a small business corporation, or to acquire the required shareholder consents, and (3) the corporation, and each person who was a shareholder of the corporation at any time during the period specified pursuant to § 1362(f), agrees to make any adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to the period. If a corporation is eligible for relief under this provision, then, notwithstanding the circumstances resulting in the ineffectiveness or termination, the corporation will be treated as an S corporation during the period specified by the Secretary.

Section 1.1362–4 sets forth additional guidance regarding inadvertent termination relief. Section 1.1362–4(b) provides that the corporation has the burden of establishing that under the relevant facts and circumstances the Commissioner should determine that the termination was inadvertent. The fact that the terminating event

was not reasonably within the control of the corporation and was not part of a plan to terminate the election, or the fact that the event took place without the knowledge of the corporation, notwithstanding its due diligence to safeguard against such an event, tends to establish that the termination was inadvertent.

Section 1.1362–4(c) provides that a corporation may request inadvertent termination relief by submitting a request for a letter ruling. Section 1.1362–4(d) provides that the Commissioner may condition the granting of a ruling request on any adjustments that are appropriate. Section 1.1362–4(e) requires the corporation and all persons who were shareholders of the corporation at any time during the time specified by the Commissioner to consent to any adjustments that the Commissioner may require.

The Service will grant relief for both the late QSST and ESBT election and the inadvertent termination of the S corporation election (or inadvertent invalid S corporation election) if the standard described in section 1362(f) for an inadvertent termination of an S corporation election or an inadvertent invalid S corporation election is satisfied.

SECTION 3. SCOPE

.01 *In General*. This revenue procedure supersedes Rev. Proc. 98–55, 1998–2 C.B. 643, and provides relief for a late Election Under Subchapter S (as defined in section 4.01(1) of this revenue procedure.)

Section 4.01 of this revenue procedure provides a glossary of certain terms as they are used in this revenue procedure. Section 4.02 of this revenue procedure provides the situations in which an entity is eligible for relief. Section 4.03 of this revenue procedure provides the procedural requirements for relief.

This revenue procedure provides procedures in lieu of the letter ruling process ordinarily used to obtain relief for a late Election Under Subchapter S filed pursuant to § 1362(b)(5), § 1362(f), or § 301.9100–1 and § 301.9100–3. Accordingly, user fees do not apply to corrective actions under this revenue procedure.

.02 *Entities That Fail to Qualify for Relief Under This Revenue Procedure*.

(1) *Letter Rulings*. A corporation or trust that does not meet the requirements for relief or is denied relief under this revenue procedure may request inadvertent termination, inadvertent invalid election, or late election relief (as appropriate) by requesting a letter ruling. The Service will not ordinarily issue a letter ruling if the period of limitations on assessment under § 6501(a) has lapsed for any taxable year for which an election should have been made or any taxable year that would have been affected by the election had it been timely made. The procedural requirements for requesting a letter ruling are described in Rev. Proc. 2003–1, 2003–1 I.R.B. 1 (or its successor).

(2) *Rev. Proc. 97–48*. Certain corporations may be eligible for automatic late S corporation election relief pursuant to Rev. Proc. 97–48, 1997–2 C.B. 521. Rev. Proc. 97–48 provides special procedures to obtain automatic relief for certain late S corporation elections. Generally, relief is available in situations in which a corporation intends to be an S corporation, the corporation and its shareholders reported their income consistent with S corporation status for the taxable year the S corporation election should have been made and for every subsequent year, and the corporation did not receive notification from the Service regarding any problem with the S corporation status within 6 months of the date on which the Form 1120S for the first year was timely filed. Rev. Proc. 97–48 does not provide relief for late ESBT, QSST or QSub elections.

SECTION 4. RELIEF FOR LATE S CORPORATION, ESBT, QSST AND QSUB ELECTIONS UNDER THIS REVENUE PROCEDURE

.01 *Definitions*.

(1) *Election Under Subchapter S*: For purposes of this revenue procedure, Election Under Subchapter S refers to the filing of a Form 2553 by a corporation to be treated as a subchapter S corporation under § 1362, an election by a trustee to treat a trust as an ESBT under § 1361(e), an election by a trust beneficiary to treat a trust as a QSST under § 1361(d), or the filing of a Form 8869 by a parent S corporation to treat a subsidiary as a QSub under § 1361(b)(3).

(2) *Due Date of Election Under Subchapter S*: The Due Date of the Election Under Subchapter S will vary depending on the type of election sought. For a corporation that requests to be treated as a subchapter S corporation, the Due Date of the Election Under Subchapter S is specified by § 1362(b). For ESBT or QSST elections, the Due Date of the Election Under Subchapter S is specified by § 1.1361–1(m)(2)(iii) or § 1.1361–1(j)(6)(iii), respectively. The Due Date of the Election Under Subchapter S for a parent S corporation to make an election to treat a subsidiary as a QSub on a specific date is specified by § 1.1361–3(a)(3).

.02 *Eligibility for Relief*. Relief is available under section 4.04 of this revenue procedure if the following requirements are met:

(1) The entity fails to qualify for its intended status as an S corporation, ESBT, QSST, or QSub on the first day that status was desired solely because of the failure to file the appropriate Election Under Subchapter S timely with the applicable service center;

(2) Less than 24 months have passed since the original Due Date of the Election Under Subchapter S;

(3) Either,

(a) the entity is seeking relief for a late S corporation or QSub election and the entity has reasonable cause for its failure to make the timely Election Under Subchapter S, or

(b) the S corporation and the entity are seeking relief for an inadvertent invalid S corporation election or an inadvertent termination of an S corporation election due to the failure to make the timely ESBT or QSST election and the failure to file the timely Election Under Subchapter S was inadvertent; and

(4) Either,

(a) all of the following requirements are met: (i) the entity seeking to make the election has not filed a tax return (in the case of QSubs, the parent has not filed a tax return) for the first year in which the election was intended, (ii) the application for relief is filed under this revenue procedure no later than 6 months after the due date of the tax return (excluding extensions) of the entity seeking to make the election (in the case of QSubs, the due date of the tax return of the parent) for the first year in which the election was intended, and, (iii) no taxpayer whose tax liability or tax return would be affected by the Election Under Subchapter S (including all shareholders of the S corporation) has reported inconsistently with the S corporation election (as well as any ESBT, QSST

or QSub elections), on any affected return for the year the Election Under Subchapter S was intended; or

(b) all of the following requirements are met: (i) the entity seeking to make the election has filed a tax return (in the case of QSubs, the parent has filed a tax return) for the first year in which the election was intended within 6 months of the due date of the tax return (excluding extensions), and (ii) all taxpayers whose tax liability or tax returns would be affected by the Election Under Subchapter S (including all shareholders of the S corporation) have reported consistently with the S corporation election (as well as any ESBT, QSST or QSub elections), on all affected returns for the year the Election Under Subchapter S was intended, as well as for any subsequent years.

.03 *Procedural Requirements for Relief.*

(1) *Procedural Requirements When a Tax Return Has Not Been Filed for the First Year of the Intended Election Under Subchapter S.* If the entity seeking the election has not filed a tax return for the first taxable year of the intended Election Under Subchapter S, the entity may request relief for the late Election Under Subchapter S by filing with the applicable service center the properly completed election form(s). The election form(s) must be filed within 18 months of the original Due Date of the intended Election Under Subchapter S (but in no event later than 6 months after the due date of the tax return (excluding extensions) of the entity (in the case of QSubs, the due date of the tax return of the parent) for the first year in which the election was intended) and must state at the top of the document "FILED PURSUANT TO REV. PROC. 2003–43." Attached to the election form must be a statement establishing either reasonable cause for the failure to file the Election Under Subchapter S timely (in the case of S corporation or QSub elections), or a statement establishing that the failure to file the Election Under Subchapter S timely was inadvertent (in the case of ESBT or QSST elections.)

(2) *Procedural Requirements When a Tax Return Has Been Filed for the First Year of the Intended Election Under Subchapter S.* If the entity seeking the election has filed a tax return for the first taxable year of the intended Election Under Subchapter S within 6 months of the due date of that tax return (excluding extensions), then the entity may request relief for the late Election Under Subchapter S by filing with the applicable service center the properly completed election form(s) and the supporting documents described below. The election form(s) must be filed within 24 months of the original Due Date for the Election Under Subchapter S and must state at the top of the document "FILED PURSUANT TO REV. PROC. 2003–43." Attached to the election form must be a statement establishing either reasonable cause for the failure to file the Election Under Subchapter S timely (in the case of S corporation or QSub elections), or a statement establishing that the failure to file the Election Under Subchapter S timely was inadvertent (in the case of ESBT or QSST elections.) The following additional documents must be attached to the election form (if applicable):

(a) *S Corporations*. An entity seeking relief for a late S corporation election must file a completed Form 2553, signed by an officer of the corporation authorized to sign and all persons who were shareholders at any time during the period that began on the first day of the taxable year for which the election is to be effective and ends on the day the election is made. The completed election form must include the following material:

(i) Statements from all shareholders during the period between the date the S corporation election was to have become effective and the date the completed election was filed that they have reported their income (on all affected returns) consistent with the S corporation election for the year the election should have been made and for all subsequent years; and

(ii) A dated declaration signed by an officer of the corporation authorized to sign which states: "Under penalties of perjury, I declare that, to the best of my knowledge and belief, the facts presented in support of this election are true, correct, and complete."

(b) *ESBTs and QSSTs*. The trustee of an ESBT or the current income beneficiary of a QSST must sign and file the appropriate election with the applicable service center. The completed election form must include the following material:

(i) A statement from the trustee of the ESBT or the current income beneficiary of the QSST that includes the information required by § 1.1361–1(m)(2)(ii) (in the case of ESBT elections) or § 1.1361–1(j)(6)(ii) (in the case of QSST elections);

(ii) In the case of a QSST, a statement from the trustee that the trust satisfies the QSST requirements of § 1361(d)(3) and that the income distribution requirements have been and will continue to be met;

(iii) In the case of an ESBT, a statement from the trustee that all potential current beneficiaries meet the shareholder requirements of § 1361(b)(1) and that the trust satisfies the requirements of an ESBT under § 1361(e)(1) other than the requirement to make an ESBT election;

(iv) A statement from the trustee of the ESBT or the current income beneficiary of the QSST that the beneficiary or trustee acted diligently to correct the mistake upon its discovery;

(v) Statements from all shareholders during the period between the date the S corporation election terminated or was to have become effective and the date the completed election was filed that they have reported their income (on all affected returns) consistent with the S corporation election for the year the election should have been made and for all subsequent years; and

(vi) A dated declaration, signed by the trustee of the ESBT or the current income beneficiary of the QSST which states: "Under penalties of perjury, I declare that, to the best of my knowledge and belief, the facts presented in support of this election are true, correct, and complete."

(c) *QSubs*. An S corporation seeking relief for a late QSub election for a subsidiary must file a completed Form 8869. The completed election form must include the following material:

(i) A statement that the corporation satisfies the QSub requirements of § 1361(b)(3)(B), and that all assets, liabilities, and items of income, deduction, and credit of the QSub have been treated as assets, liabilities, and items of income, deduction, and credit of the S corporation (on all affected returns) consistent with the QSub election for the year the election was intended and for all subsequent years;

(ii) A dated declaration signed by an officer of the S corporation authorized to sign which states: "Under penalties of perjury, I declare that, to the best of my knowledge and belief, the facts presented in support of this election are true, correct, and complete."

.04 *Relief for Late Election Under Subchapter S*. Upon receipt of a completed application requesting relief under section 4.03 of this revenue procedure, the Service will determine whether the requirements for granting additional time to file the Election Under Subchapter S have been satisfied and will notify the entity of the result of this determination.

SECTION 5. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 98–55 is superseded.

SECTION 6. EFFECTIVE DATE

.01 *In general*. This revenue procedure is effective June 9, 2003. Any entity that meets the requirements of this revenue procedure as of June 9, 2003, may seek relief under this revenue procedure. This revenue procedure applies to requests pending with the service center pursuant to Rev. Proc. 98–55 on June 9, 2003, and to requests received thereafter. It also applies to all letter ruling requests pending in the national office on June 9, 2003, and all future requests for relief.

.02 *Transition rule for pending letter ruling requests*. If an entity has filed a request for a letter ruling seeking relief for a late Election Under Subchapter S and that letter ruling request is pending in the national office on June 9, 2003, the entity may withdraw that letter ruling request and receive a refund of its user fee. However, the national office will process letter ruling requests pending on June 9, 2003, unless, prior to the earlier of July 24, 2003, or the issuance of the letter ruling, the entity notifies the national office that it will withdraw its letter ruling request.

SECTION 7. PAPERWORK REDUCTION ACT

The collection of information contained in this revenue procedure has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1548.

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

The collections of information in this revenue procedure are in section 4.03. This information is required to be submitted to the applicable service center in order to obtain relief for a late Election Under Subchapter S. This information will be used to determine whether the eligibility requirements for obtaining relief have been met. The collection of information is required to obtain a benefit. The likely respondents are business or other for-profit institutions.

The estimated total annual reporting burden is 25,000 hours.

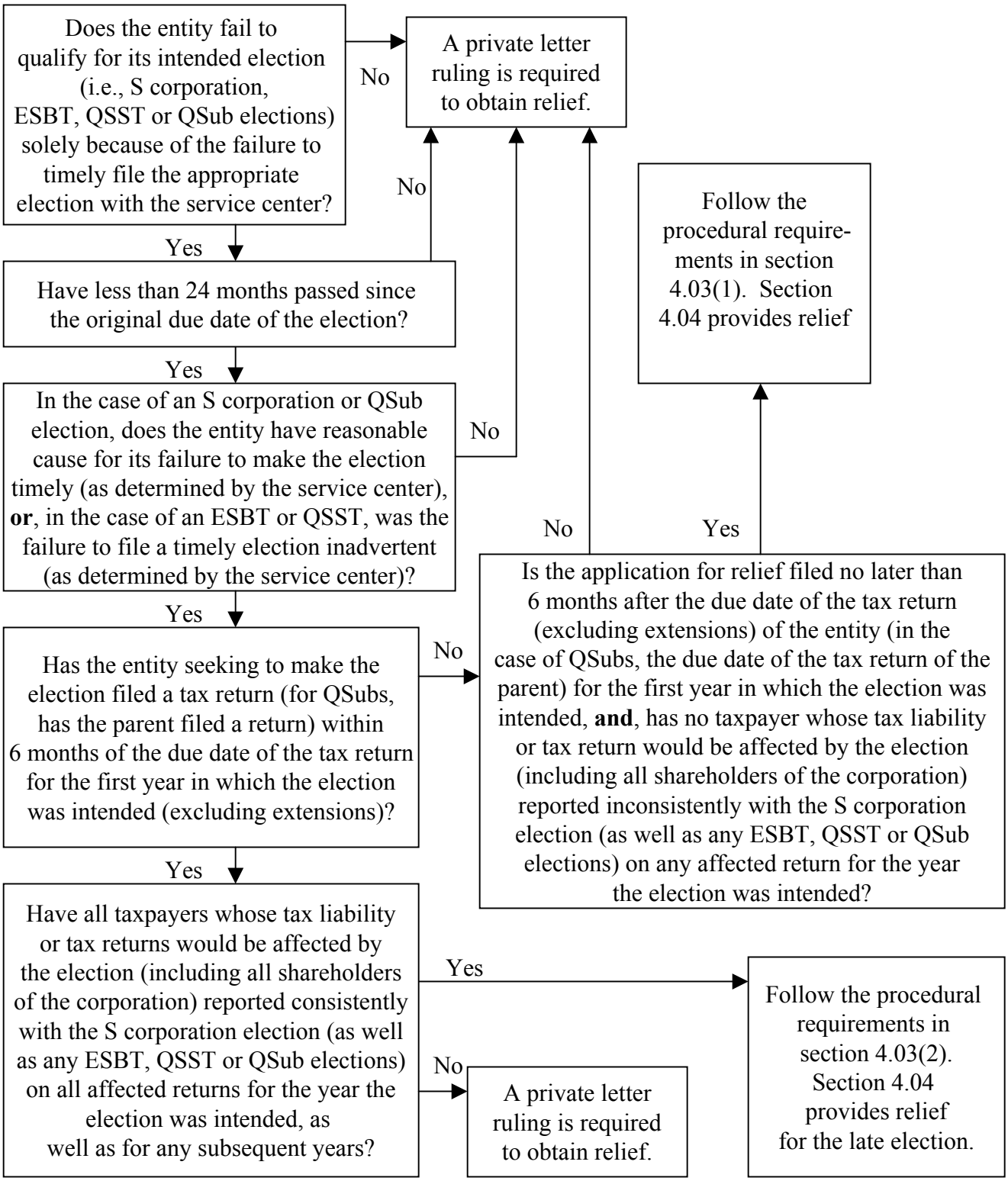
The estimated annual burden per respondent varies from .5 hours to 7 hours, depending on individual circumstances, with an estimated average burden of 1 hour to complete the statement. The estimated number of respondents is 25,000.

The estimated annual frequency of responses is on occasion.

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

SECTION 8. DRAFTING INFORMATION

The principal author of this revenue procedure is Jason T. Smyczek of the Office of the Associate Chief Counsel (Passthroughs and Special Industries.) For further information regarding this revenue procedure, contact Mr. Smyczek at (202) 622–3050 (not a toll-free call).


Does the entity fail to qualify for its intended election (i.e., S corporation, ESBT, QSST or QSub elections) solely because of the failure to timely file the appropriate election with the service center?
No
A private letter ruling is required to obtain relief.
Yes
Have less than 24 months passed since the original due date of the election?
No
Yes
In the case of an S corporation or QSub election, does the entity have reasonable cause for its failure to make the election timely (as determined by the service center), **or**, in the case of an ESBT or QSST, was the failure to file a timely election inadvertent (as determined by the service center)?
No
Yes
Has the entity seeking to make the election filed a tax return (for QSubs, has the parent filed a return) within 6 months of the due date of the tax return for the first year in which the election was intended (excluding extensions)?
No
Yes
Is the application for relief filed no later than 6 months after the due date of the tax return (excluding extensions) of the entity (in the case of QSubs, the due date of the tax return of the parent) for the first year in which the election was intended, **and**, has no taxpayer whose tax liability or tax return would be affected by the election (including all shareholders of the corporation) reported inconsistently with the S corporation election (as well as any ESBT, QSST or QSub elections) on any affected return for the year the election was intended?
No
Yes
Follow the procedural requirements in section 4.03(1). Section 4.04 provides relief
Have all taxpayers whose tax liability or tax returns would be affected by the election (including all shareholders of the corporation) reported consistently with the S corporation election (as well as any ESBT, QSST or QSub elections) on all affected returns for the year the election was intended, as well as for any subsequent years?
Yes
Follow the procedural requirements in section 4.03(2). Section 4.04 provides relief for the late election.
No
A private letter ruling is required to obtain relief.

Part IV. Items of General Interest

Notice of Proposed Rulemaking and Notice of Public Hearing

Obligations of States and Political Subdivisions

REG–113007–99

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations on the definition of private activity bond applicable to tax-exempt bonds issued by state and local governments. These regulations affect issuers of tax-exempt bonds and provide needed guidance for applying the private activity bond restrictions to refunding issues. This document also contains a notice of public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by August 19, 2003. Outlines of topics to be discussed at the public hearing scheduled for September 9, 2003, at 10 a.m., must be received by August 19, 2003.

ADDRESSES: Send submissions to CC:PA:RU (REG–113007–99), 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 4 p.m. to CC:PA:RU (REG–113007–99), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically to the IRS Internet site at *www.irs.gov/regs*. The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Gary W. Bornholdt, (202) 622–3980; concerning submissions and the hearing, Treena Garrett, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

In general, under section 103 of the Internal Revenue Code (Code), gross income does not include the interest on any state or local bond. However, this exclusion does not apply to private activity bonds (other than certain qualified bonds). Section 141(a) defines a private activity bond as any bond issued as part of an issue that meets either (1) the private business use test in section 141(b)(1) and the private security or payment test in section 141(b)(2) (the private business tests) or (2) the private loan financing test in section 141(c) (the private business tests and the private loan financing test are referred to collectively as the "private activity bond tests").

The private business use test is met if more than 10 percent of the proceeds of an issue are to be used for any private business use. Section 141(b)(6) defines private business use as use directly or indirectly in a trade or business that is carried on by any person other than a governmental unit.

The private security or payment test is met if the payment of the principal of, or the interest on, more than 10 percent of the proceeds of an issue is directly or indirectly (1) secured by an interest in property used or to be used for a private business use, (2) secured by an interest in payments in respect of such property, or (3) to be derived from payments, whether or not to the issuer, in respect of property, or borrowed money, used or to be used for a private business use.

The private loan financing test is satisfied if more than the lesser of $5 million or 5 percent of the proceeds of an issue are to be used to make or finance loans to persons other than governmental units.

In 1994, proposed regulations (FI–72–88, 1995–1 C.B. 859 [59 FR 67658]) were published in the **Federal Register** (the 1994 Proposed Regulations) to provide guidance under the Code with respect to the application of the private activity bond tests. Generally, the 1994 Proposed Regulations provide that the private business use of a facility is equal to the greatest percentage of private business use of that facility for any one year period during the term of the bonds. The amount of private security or private payments is determined by comparing the present value of the private security or private payments to the present value of the debt service to be paid over the term of the issue, using the bond yield as the discount rate.

With respect to refunding issues, the 1994 Proposed Regulations provide that the determination of whether a refunding issue satisfies either the private business tests or the private loan financing test is made without regard to whether the prior issue satisfied those tests. In general, under the 1994 Proposed Regulations, the private business tests and the private loan financing test are applied to a refunding issue by treating the proceeds of the refunding issue as used for the same purposes as the proceeds of the prior issue, but disregarding any use of the property financed with the prior issue that occurred before the issue date of the refunding issue. In addition, in applying the private business tests to a refunding issue under the 1994 Proposed Regulations, an issuer may treat the refunding issue as a continuation of the prior issue.

On January 16, 1997, final regulations (T.D. 8712, 1997–1 C.B. 15 [62 FR 2275]) relating to the definition of private activity bond and related rules under sections 103, 141, 142, 144, 145, 147, 148, and 150 were published in the **Federal Register** (the Final Regulations). Under the Final Regulations, the amount of private business use of property financed by an issue is equal to the average percentage of private business use of that property during a defined measurement period. The measurement period begins on the later of the issue date of the issue or the date that the property is placed in service and ends on the earlier of the last date of the reasonably expected economic life of the property or the latest maturity date of any bond of the issue financing the property (determined without regard to any optional redemption dates). The Final Regulations retain the basic approach in the 1994 Proposed Regulations relating to the measurement of private security and private payments.

The Final Regulations reserve §1.141–13 for rules regarding the application of the private business tests and the private loan fi-

nancing test to refunding issues. This document amends the Income Tax Regulations (26 CFR part 1) under section 141 by proposing rules on the application of the private business tests and the private loan financing test to refunding issues. This document also amends the Income Tax Regulations under sections 145, 149, and 150 by proposing rules on certain related matters. These regulations are published as proposed regulations (the proposed regulations) to provide an opportunity for public review and comment.

Explanation of Provisions

A. *Application of Private Activity Bond Tests to Refunding Issues*

1. *In general*

The proposed regulations provide that, in general, a refunding issue and a prior issue are tested separately under section 141. Thus, the determination of whether a refunding issue consists of private activity bonds generally does not depend on whether the prior issue consists of private activity bonds.

The proposed regulations apply to determine whether a refunding issue satisfies the private business tests or the private loan financing test, but do not impact the methodology used to determine whether the prior issue satisfies those tests. For example, following a refunding, the private business use test continues to apply to a prior issue based on the measurement period for the prior issue.

2. *Allocation of proceeds*

The proposed regulations provide that, in applying the private business tests and the private loan financing test to a refunding issue, the proceeds of the refunding issue are allocated to the same purpose investments (including any private loan under section 141(c)) and expenditures as the proceeds of the prior issue.

3. *Measurement of private business use*

The proposed regulations generally provide that the amount of private business use of a refunding issue is determined based on the separate measurement period for the refunding issue under §1.141–3(g) (for example, without regard to any private business use that occurred before the issue date of the refunding issue). Thus, for instance, if an issuer refunds a taxable bond or an exempt facility bond, any private business use of the refinanced facilities before the issue date of the refunding issue is disregarded in applying the private business use test to the refunding issue.

In the case of a refunding issue that refunds a prior issue of governmental bonds, however, the amount of private business use is generally determined based on a combined measurement period. For purposes of the proposed regulations, a governmental bond is any bond that, when issued, purported to be either a governmental bond, as defined in §1.150–1(b), or a qualified 501(c)(3) bond, as defined in section 145(a). The combined measurement period is the period that begins on the first day of the measurement period (as defined in §1.141–3(g)) for the prior issue (or the first issue of governmental bonds in the case of a series of refundings of governmental bonds) and ends on the last day of the measurement period for the refunding issue.

As an alternative to the combined measurement period approach, the proposed regulations permit issuers to measure private business use based on the separate measurement period of the refunding issue, but only if the prior issue of governmental bonds does not satisfy the private business use test during a shortened measurement period. The shortened measurement period begins on the first day of the measurement period of the prior issue (or the first issue of governmental bonds in the case of a series of refundings of governmental bonds) and ends on the issue date of the refunding issue. Whether a prior issue satisfies the private business use test during the shortened measurement period is determined based on the actual use of proceeds, without regard to the reasonable expectations test of §1.141–2(d).

4. *Measurement of private security and private payments*

If the amount of private business use is determined based on the separate measurement period for the refunding issue, then the amount of private security and private payments allocable to the refunding issue is determined under §1.141–4 by treating the refunding issue as a separate issue. On the other hand, if the amount of private business use is determined based on a combined measurement period, then the amount of private security and private payments allocable to the refunding issue is determined under §1.141–4 by treating the refunding issue and all earlier issues taken into account in determining the combined measurement period as a combined issue. The proposed regulations contain specific rules for determining the present value of the debt service on, and the private security and private payments allocable to, a combined issue.

The proposed regulations also permit an issuer to use the yield on a prior issue of governmental bonds to determine the present value of private security or private payments under arrangements that were not entered into in contemplation of the refunding issue. For this purpose, any arrangement that was entered into more than one year before the issue date of the refunding issue will be treated as not entered into in contemplation of the refunding issue.

5. *Multipurpose issue allocations*

Section 1.148–9(h) permits an issuer to treat the portion of a multipurpose issue allocable to a separate purpose as a separate issue for certain of the arbitrage provisions of section 148. The proposed regulations allow an issuer to apply §1.148–9(h) to a multipurpose issue for certain purposes under section 141. An allocation will not be reasonable for this purpose if it achieves more favorable results under section 141 than could be achieved with actual separate issues. In addition, allocations under the proposed regulations and §1.148–9(h) must be consistent for purposes of sections 141 and 148. The proposed regulations do not permit allocations for purposes of section 141(c)(1) (relating to the private loan financing test) or section 141(d)(1) (relating to certain restrictions on acquiring nongovernmental output property).

6. *Application of reasonable expectations test to certain refunding bonds*

Section 1.141–2(d) of the Final Regulations provides that an issue consists of private activity bonds if the issuer (1) reasonably expects, as of the issue date, that the issue will meet either the private business tests or the private loan financing test, or (2) takes a deliberate action, subsequent to the issue date, that causes the conditions of either the private business tests or the private loan financing test to be sat-

isfied. In general, a deliberate action is any action taken by the issuer that is within its control.

The proposed regulations provide that an action that would otherwise cause a refunding issue to satisfy the private business tests or the private loan financing test is not taken into account under the reasonable expectations test of §1.141–2(d) if (1) the action is not a deliberate action within the meaning of §1.141–2(d)(3), and (2) the weighted average maturity of the refunding bonds is not greater than the remaining weighted average maturity of the prior bonds.

B. *Treatment of Issuance Costs Financed by Prior Issue of Qualified 501(c)(3) Bonds*

Under the Final Regulations, the use of proceeds of an issue of qualified 501(c)(3) bonds to pay issuance costs of the issue is treated as a private business use. The proposed regulations provide that, solely for purposes of applying the private business use test to a refunding issue, the use of proceeds of the prior issue (or any earlier issue in a series of refundings) to pay issuance costs of the prior issue (or the earlier issue) is treated as a government use.

C. *Limitation on Advance Refundings of Private Activity Bonds*

Under section 149(d)(2), interest on a bond is not excluded from gross income if any portion of the issue of which the bond is a part is issued to advance refund a private activity bond (other than a qualified 501(c)(3) bond). The proposed regulations provide that, for purposes of section 149(d)(2), the term private activity bond includes a qualified bond described in section 141(e) (other than a qualified 501(c)(3) bond), regardless of whether the refunding issue consists of private activity bonds under the proposed regulations. The proposed regulations also provide that, for purposes of section 149(d)(2), the term private activity bond does not include a taxable bond.

Proposed Effective Date

The proposed regulations will apply to bonds that are (1) sold on or after the date of publication of final regulations under §1.141–13 in the **Federal Register** and (2) subject to the Final Regulations.

Special Analyses

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

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments that are submitted timely (preferably a signed original and eight (8) copies) to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for September 9, 2003, at 10 a.m. in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Because of access restrictions, visitors will not be admitted beyond the lobby more than 30 minutes before the hearing starts.

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

Persons who wish to present oral comments at the hearing must submit written comments by August 19, 2003, and submit an outline of the topics to be discussed and the amount of time to be devoted to each topic by August 19, 2003.

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.

Comments are requested on all aspects of the proposed regulations. In addition, comments are specifically requested on the application of the private loan financing test to refunding issues.

Drafting Information

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

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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 1.141–0 is amended by adding entries to the table in numerical order for §§1.141–13 and 1.141–15(j) to read as follows:

§1.141–0 Table of contents.

* * * * *

§1.141–13 Refunding Issues.

(a) In general.
(b) Application of private business use test and private loan financing test.
(1) Allocation of proceeds.
(2) Determination of amount of private business use.
(c) Application of private security or payment test.
(1) Separate issue treatment.
(2) Combined issue treatment.
(3) Special rule for arrangements not entered into in contemplation of the refunding issue.
(d) Multipurpose issue allocations.
(1) In general.
(2) Exceptions.
(e) Application of reasonable expectations test to certain refunding bonds.
(f) Examples.

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§1.141–15 Effective dates.

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(j) Effective dates for certain regulations relating to refundings.

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Par. 3. In §1.141–1, paragraph (b) is amended by revising the definition of governmental bond to read as follows:

§1.141–1 Definitions and rules of general application.

* * * * *

Governmental bond has the same meaning as in §1.150–1(b), except that, for purposes of §1.141–13, governmental bond is defined in §1.141–13(b)(2)(iv).

* * * * *

Par. 4. Section 1.141–13 is added to read as follows:

§1.141–13 Refunding Issues.

(a) *In general*. Except as provided in this section, a refunding issue and a prior issue are tested separately under section 141. Thus, the determination of whether a refunding issue consists of private activity bonds generally does not depend on whether the prior issue consists of private activity bonds.

(b) *Application of private business use test and private loan financing test*—(1) *Allocation of proceeds*. In applying the private business use test and the private loan financing test to a refunding issue, the proceeds of the refunding issue are allocated to the same expenditures and purpose investments as the proceeds of the prior issue.

(2) *Determination of amount of private business use*—(i) *In general*. Except as provided in paragraph (b)(2)(ii) of this section, the amount of private business use of a refunding issue is determined under §1.141–3(g), based on the measurement period for that issue (for example, without regard to any private business use that occurred prior to the issue date of the refunding issue).

(ii) *Refundings of governmental bonds*. In applying the private business use test to a refunding issue that refunds a prior issue of governmental bonds, the amount of private business use of the refunding issue is the amount of private business use—

(A) During the combined measurement period; or

(B) At the option of the issuer, during the period described in paragraph (b)(2)(i) of this section, but only if, without regard to the reasonable expectations test of §1.141–2(d), the prior issue does not satisfy the private business use test, based on a measurement period that begins on the first day of the combined measurement period and ends on the issue date of the refunding issue.

(iii) *Combined measurement period*. For purposes of this section, the *combined measurement period* is the period that begins on the first day of the measurement period (as defined in §1.141–3(g)) for the prior issue (or, in the case of a series of refundings of governmental bonds, the first issue of governmental bonds in the series) and ends on the last day of the measurement period for the refunding issue.

(iv) *Governmental bond*. For purposes of this section, the term *governmental bond* means any bond that, when issued, purported to be a governmental bond, as defined in §1.150–1(b), or a qualified 501(c)(3) bond, as defined in section 145(a).

(v) *Special rule for refundings of qualified 501(c)(3) bonds with governmental bonds*. For purposes of applying this paragraph (b)(2) to a refunding issue that refunds a qualified 501(c)(3) bond, any use of the property refinanced by the refunding issue before the issue date of the refunding issue by a 501(c)(3) organization with respect to its activities that do not constitute an unrelated trade or business under section 513(a) is treated as government use.

(c) *Application of private security or payment test*—(1) *Separate issue treatment*. If the amount of private business use of a refunding issue is determined based on the measurement period for that issue in accordance with paragraph (b)(2)(i) or (b)(2)(ii)(B) of this section, then the amount of private security and private payments allocable to the refunding issue is determined under §1.141–4 by treating the refunding issue as a separate issue.

(2) *Combined issue treatment*. If the amount of private business use of a refunding issue is determined based on the combined measurement period for that issue in accordance with paragraph (b)(2)(ii)(A) of this section, then the amount of private security and private payments allocable to the refunding issue is determined under §1.141–4 by treating the refunding issue and all earlier issues taken into account in determining the combined measurement period as a combined issue. For this purpose, the present value of the private security and private payments is compared to the present value of the debt service on the combined issue (other than debt service paid with proceeds of any refunding bond). Present values are computed as of the issue date of the earliest issue taken into account in determining the combined measurement period (the earliest issue). Except as provided in paragraph (c)(3) of this section, present values are determined by using the yield on the combined issue as the discount rate. The yield on the combined issue is determined by taking into account payments on the refunding issue and all earlier issues taken into account in determining the combined measurement period (other than payments made with proceeds of any refunding bond), and based on the issue price of the earliest issue. In the case of a partial refunding, the unrefunded debt service is not taken into account in determining the yield on the combined issue.

(3) *Special rule for arrangements not entered into in contemplation of the refunding issue*. In applying the private security or payment test to a refunding issue that refunds a prior issue of governmental bonds, the issuer may use the yield on the prior issue to determine the present value of private security and private payments under arrangements that were not entered into in contemplation of the refunding issue. For this purpose, any arrangement that was entered into more than 1 year before the issue date of the refunding issue is treated as not entered into in contemplation of the refunding issue.

(d) *Multipurpose issue allocations*—(1) *In general*. For purposes of section 141, unless the context clearly requires otherwise, §1.148–9(h) applies to allocations of multipurpose issues (as defined in §1.148–1(b)), including allocations involving the refunding purposes of the issue. An allocation is not reasonable under this paragraph (d) if it achieves more favorable results under section 141 than could be achieved with actual separate issues. Allocations made under this paragraph (d) and §1.148–9(h) must be consistent for purposes of section 141 and section 148.

(2) *Exceptions*. This paragraph (d) does not apply for purposes of sections 141(c)(1) and 141(d)(1).

(e) *Application of reasonable expectations test to certain refunding bonds*. An action that would otherwise cause a refunding issue to satisfy the private business tests or the private loan financing test is not taken

into account under the reasonable expectations test of §1.141–2(d) if—

(1) The action is not a deliberate action within the meaning of §1.141–2(d)(3); and

(2) The weighted average maturity of the refunding bonds is not greater than the remaining weighted average maturity of the prior bonds.

(f) Examples. The following examples illustrate the application of this section.

Example 1. Measuring private business use. In 2002, Authority A issues tax-exempt bonds that mature in 2032 to acquire an office building. The measurement period for the 2002 bonds under §1.141–3(g) is 30 years. At the time A acquires the building, it enters into a 10-year lease with a nongovernmental person under which the nongovernmental person will use 5 percent of the building in its trade or business during each year of the lease term. In 2007, A issues bonds to refund the 2002 bonds. The 2007 bonds mature on the same date as the 2002 bonds and have a measurement period of 25 years under §1.141–3(g). Under paragraph (b)(2)(ii)(A) of this section, the amount of private business use of the proceeds of the 2007 bonds is 1.67 percent, which equals the amount of private business use during the combined measurement period (5 percent of 1/3rd of the 30-year combined measurement period). In addition, the 2002 bonds do not satisfy the private business use test, based on a measurement period beginning on the first day of the measurement period for the 2002 bonds and ending on the issue date of the 2007 bonds, because only 5 percent of the proceeds of the 2002 bonds are used for a private business use during that period. Thus, under paragraph (b)(2)(ii)(B) of this section, A may treat the amount of private business use of the 2007 bonds as 1 percent (5 percent of 1/5th of the 25-year measurement period for the 2007 bonds). The 2007 bonds do not satisfy the private business use test.

Example 2. Combined issue yield computation. (i) On January 1, 2000, County B issues 20-year bonds with an interest rate of 8% and an issue price of $100 million. The debt service payments on the 2000 bonds are as follows:

Date	Debt Service
1/1/01	$10,306,800
1/1/02	10,306,800
1/1/03	10,306,800
1/1/04	10,306,800
1/1/05	10,306,800
1/1/06	10,306,800
1/1/07	10,306,800
1/1/08	10,306,800
1/1/09	10,306,800
1/1/10	10,306,800
1/1/11	10,306,800
1/1/12	10,306,800
1/1/13	10,306,800
1/1/14	10,306,800
1/1/15	10,306,800
1/1/16	10,306,800
1/1/17	10,306,800
1/1/18	10,306,800
1/1/19	10,306,800
1/1/20	10,306,800
	$206,136,000

(ii) On January 1, 2005, B issues 15-year bonds to refund all of the outstanding 2000 bonds. The 2005 bonds have an interest rate of 6% and an issue price of $93,250,000. The debt service payments on the 2005 bonds are as follows:

Date	Debt Service
1/1/06	$9,657,800
1/1/07	9,657,800
1/1/08	9,657,800
1/1/09	9,657,800
1/1/10	9,657,800
1/1/11	9,657,800
1/1/12	9,657,800
1/1/13	9,657,800
1/1/14	9,657,800
1/1/15	9,657,800
1/1/16	9,657,800
1/1/17	9,657,800
1/1/18	9,657,800
1/1/19	9,657,800
1/1/20	9,657,800
	$144,867,000

(iii) For purposes of determining the amount of private security and private payments with respect to the 2005 bonds, the 2005 bonds and the 2000 bonds are treated as a combined issue under paragraph (c)(2) of this section. The yield on the combined issue is 7.5036 percent per year compounded semiannually, computed as follows:

Date	Unrefunded New Money Debt Service	Refunding Debt Service	Total Debt Service	Present Value on 1/1/00
1/1/00				($100,000,000.00)
1/1/01	$10,306,800		$10,306,800	9,574,857.71
1/1/02	10,306,800		10,306,800	8,894,894.64
1/1/03	10,306,800		10,306,800	8,263,219.48
1/1/04	10,306,800		10,306,800	7,676,403.02
1/1/05	10,306,800		10,306,800	7,131,259.62
1/1/06		$9,657,800	9,657,800	6,207,676.64
1/1/07		9,657,800	9,657,800	5,766,835.53
1/1/08		9,657,800	9,657,800	5,357,300.97
1/1/09		9,657,800	9,657,800	4,976,849.70
1/1/10		9,657,800	9,657,800	4,623,416.36
1/1/11		9,657,800	9,657,800	4,295,082.25
1/1/12		9,657,800	9,657,800	3,990,064.95
1/1/13		9,657,800	9,657,800	3,706,708.59
1/1/14		9,657,800	9,657,800	3,443,474.92
1/1/15		9,657,800	9,657,800	3,198,934.91
1/1/16		9,657,800	9,657,800	2,971,761.03
1/1/17		9,657,800	9,657,800	2,760,720.01
1/1/18		9,657,800	9,657,800	2,564,666.17
1/1/19		9,657,800	9,657,800	2,382,535.18
1/1/20		9,657,800	9,657,800	2,213,338.32
	$51,534,000	$144,867,000	$196,401,000	0.00

Example 3. Refunding taxable bonds and qualified bonds. (i) In 1999, City C issues taxable bonds to finance the construction of a facility for the furnishing of water. The bonds are secured by revenues from the facility. The facility is managed pursuant to a management contract with a nongovernmental person that gives rise to private business use. In 2007, C terminates the management contract and takes over the operation of the facility. In 2009, C issues bonds to refund the 1999 bonds. On the issue date of the 2009 bonds, C reasonably expects that the facility will not be used for a private business use during the term of the 2009 bonds. In addition, during the term of the 2009 bonds, the facility is not used for a private business use. Under paragraph (b)(2)(i) of this section, the 2009 bonds do not satisfy the private business use test because the amount of private business use is based on the measurement period for those bonds and therefore does not take into account any private business use that occurred pursuant to the management contract.

(ii) The facts are the same as in paragraph (i) of this *Example 3*, except that the 1999 bonds are issued as exempt facility bonds under section 142(a)(4). The 2009 bonds do not satisfy the private business use test.

Example 4. Multipurpose issue. In 2001, State D issues bonds to finance the construction of two office buildings, Building 1 and Building 2. D expends an equal amount of the proceeds on each building. D enters into arrangements that result in 8 percent of Building 1 and 12 percent of Building 2 being used for a private business use during the measurement period under §1.141–3(g). These arrangements result in a total of 10 percent of the proceeds of the 2001 bonds being used for a private business use. In 2006, D purports to allocate, under paragraph (d) of this section, an equal amount of the outstanding 2001 bonds to Building 1 and Building 2. D also enters into another private business use arrangement with respect to Building 1 that results in 10 percent of Building 1 being used for a private business use during the measurement period. An allocation is not reasonable under paragraph (d) of this section if it achieves more favorable results under section 141 than could be achieved with actual separate issues. D's allocation is unreasonable because, if permitted, would result in more that 10 percent of the proceeds of the 2001 bonds being used for a private business use.

Par. 5. Section 1.141–15 is amended by revising paragraphs (b)(1), (c), (d), and (h) and adding paragraph (j) to read as follows:

§1.141–15 Effective dates.

* * * * *

(b) *Effective dates*—(1) *In general*. Except as otherwise provided in this section, §§1.141–0 through 1.141–6(a), 1.141–9 through 1.141–12, 1.141–14, 1.145–1 through 1.145–2(c), and the definition of bond documents contained in §1.150–1(b) (the 1997 regulations contained in 26 CFR Part 1 revised April 1, 2003) apply to bonds issued on or after May 16, 1997, that are subject to section 1301 of the Tax Reform Act of 1986 (100 Stat. 2602).

* * * * *

(c) *Refunding bonds*. Except as otherwise provided in this section, the 1997 regulations contained in 26 CFR Part 1 revised April 1, 2003, do not apply to any bonds issued on or after May 16, 1997, to refund a bond to which those regulations do not apply unless—

(1) The refunding bonds are subject to section 1301 of the Tax Reform Act of 1986 (100 Stat. 2602); and

(2)(i) The weighted average maturity of the refunding bonds is longer than—

(A) The weighted average maturity of the refunded bonds; or

(B) In the case of a short-term obligation that the issuer reasonably expects to refund with a long-term financing (such as a bond anticipation note), 120 percent of the weighted average reasonably expected economic life of the facilities financed; or

(ii) A principal purpose for the issuance of the refunding bonds is to make one or more new conduit loans.

(d) *Permissive application of regulations*. Except as provided in paragraph (e) of this section, the 1997 regulations contained in 26 CFR Part 1 revised April 1, 2003, may be applied in whole, but not in part, to actions taken before February 23, 1998, with respect to—

(1) Bonds that are outstanding on May 16, 1997, and subject to section 141; or

(2) Refunding bonds issued on or after May 16, 1997, that are subject to 141.

* * * * *

(h) *Permissive retroactive application*. Except as provided in paragraphs (d), (e) or (i) of this section, §§1.141–1 through 1.141–6(a), 1.141–7 through 1.141–14, 1.145–1 through 1.145–2, 1.149(d)–1(g), 1.150–1(a)(3), the definition of bond documents contained in §1.150–1(b) and §1.150–1(c)(3)(ii) may be applied by issuers in whole, but not in part, to—

(1) Outstanding bonds that are sold before the date of publication of final regulations in the **Federal Register**, and subject to section 141; or

(2) Refunding bonds that are sold on or after the date of publication of final regulations in the **Federal Register**, and subject to section 141.

* * * * *

(j) *Effective dates for certain regulations relating to refundings*. Except as otherwise provided in this section, §§1.141–13, 1.145–2(d), 1.149(d)–1(g), 1.150–1(a)(3) and 1.150–1(c)(3)(ii) apply to bonds that are sold on or after the date of publication of final regulations in the **Federal Register** and that are subject to the 1997 regulations contained in 26 CFR Part 1 revised April 1, 2003.

Par. 6. Section 1.145–0 is amended by adding an entry to the table in numerical order for §1.145–2(d) to read as follows:

§1.145–0 Table of contents.

* * * * *

§1.145–2 Application of private activity bond regulations.

* * * * *

(d) Issuance costs financed by prior issue.

* * * * *

Par. 7. In §1.145–2, paragraph (d) is added to read as follows:

§1.145–2 Application of private activity bond regulations.

* * * * *

(d) *Issuance costs financed by prior issue*. Solely for purposes of applying the private business use test to a refunding issue under §1.141–13, the use of proceeds of the prior issue (or any earlier issue in a series of refundings) to pay issuance costs of the prior issue (or the earlier issue) is treated as a government use.

Par. 8. Section 1.149(d)–1 is amended by revising paragraph (g) and adding paragraph (h) to read as follows:

§1.149(d)–1 Limitations on advance refundings.

* * * * *

(g) *Limitation on advance refundings of private activity bonds*. Under section 149(d)(2) and this section, interest on a bond is not excluded from gross income if any portion of the issue of which the bond is a part is issued to advance refund a private activity bond (other than a qualified 501(c)(3) bond). For this purpose, the term private activity bond—

(1) Includes a qualified bond described in section 141(e) (other than a qualified 501(c)(3) bond), regardless of whether the refunding issue consists of private activity bonds under §1.141–13; and

(2) Does not include a taxable bond.

(h) *Effective dates*—(1) *In general*. Except as provided in this paragraph (h), this section applies to bonds issued after June 30, 1993, to which §§1.148–1 through 1.148–11 apply, including conduit loans that are treated as issued after June 30, 1993, under paragraph (b)(4) of this section. In addition, this section applies to any issue to which the election described in §1.148–11(b)(1) is made.

(2) *Special effective date for paragraph (b)(3)*. Paragraph (b)(3) of this section applies to any advance refunding issue issued after May 28, 1991.

(3) *Special effective date for paragraph (f)(3)*. Paragraph (f)(3) of this section applies to bonds sold on or after July 8, 1997, and to any issue to which the election described in §1.148–11(b)(1) is made. See §1.148–11A(i) for rules relating to certain bonds sold before July 8, 1997.

(4) *Special effective date for paragraph (g)*. See §1.141–15 for the applicability date of paragraph (g) of this section.

Par. 9. Section 1.150–1 is amended by revising paragraphs (a)(3) and (c)(3)(ii) to read as follows:

§1.150–1 Definitions.

(a) * * *

(3) *Exceptions to general effective date*. See §1.141–15 for the applicability date of the definition of bond documents contained in paragraph (b) of this section and the effective date of paragraph (c)(3)(ii) of this section.

* * * * *

(c) * * *

(3) * * *

(ii) *Exceptions*. This paragraph (c)(3) does not apply for purposes of sections 141, 144(a), 148, 149(d) and 149(g).

* * * * *

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

(Filed by the Office of the Federal Register on May 9, 2003, 11:31 a.m., and published in the issue of the Federal Register for May 14, 2003, 68 F.R. 25845)

Notice of Proposed Rulemaking and Notice of Public Hearing

Administration Simplification of Section 481(a) Adjustment Periods in Various Regulations

REG–142605–02

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of Proposed Rulemaking and Notice of Public Hearing.

SUMMARY: This document contains proposed amendments to regulations under sections 263A and 448 of the Internal Revenue Code. The amendments apply to taxpayers changing a method of accounting under the regulations and are necessary to conform the rules governing those changes to the rules provided in general guidance issued by the IRS for changing a method of accounting. Specifically, the amendments will allow taxpayers changing their method of accounting under the regulations to take any adjustment under section 481(a) resulting from the change into account over the same number of taxable years that is provided in the general guidance.

DATES: Written or electronic comments must be received by July 11, 2003. Re-

quests to speak (with outlines of oral comments to be discussed) at the public hearing scheduled for August 13, 2003, at 10 a.m. must be received by July 23, 2003.

ADDRESSES: Send submissions to: CC:PA:RU (REG–142605–02), room 5226, Internal Revenue Service, POB 7604 Ben Franklin Station, Washington, DC 20044.

Submissions of comments may also be hand-delivered Monday through Friday between the hours of 8:00 a.m. and 5:00 p.m. to: CC:PA:RU (REG–142605–02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet direct to the IRS Internet site at *http://www.irs.gov/regs*. The public hearing will be held in the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC .

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Christian Wood, 202–622–4930. Concerning the hearing, contact Sonya Cruse, 202–622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to 26 CFR part 1 under sections 263A and 448. These amendments pertain to the period for taking into account the adjustment required under section 481 to prevent duplications or omissions of amounts resulting from a change in method of accounting under section 263A or 448.

Section 263A (the uniform capitalization rules) generally requires the capitalization of direct costs and indirect costs properly allocable to real property and tangible personal property produced by a taxpayer. Section 263A also requires the capitalization of direct costs and indirect costs properly allocable to real property and personal property acquired by a taxpayer for resale.

Section 448(a) generally prohibits the use of the cash receipts and disbursements method of accounting by C corporations, partnerships with a C corporation partner, and tax shelters. Section 448(b), however, provides exceptions to this general rule in the case of farming businesses, qualified personal service corporations, and entities with gross receipts of not more than $5,000,000.

Section 446(e) generally provides that a taxpayer that changes the method of accounting on the basis of which it regularly computes its income in keeping its books must, before computing its taxable income under the new method, secure the consent of the Secretary.

Section 481(a) generally provides that a taxpayer must take into account those adjustments that are determined to be necessary solely by reason of a change in method of accounting in order to prevent amounts from being duplicated or omitted. Section 481(c) and §§1.446–1(e)(3)(ii) and 1.481–4 provide that the adjustment required by section 481(a) shall be taken into account in determining taxable income in the manner and subject to the conditions agreed to by the Commissioner and the taxpayer.

Rev. Proc. 97–27, 1997–1 C.B. 680 (as modified and amplified by Rev. Proc. 2002–19, 2002–1 C.B. 696, and modified by Rev. Proc. 2002–54, 2002–35 I.R.B. 432), provides procedures under which taxpayers may apply for the advance consent of the Commissioner to change a method of accounting. Rev. Proc. 2002–9, 2002–1 C.B. 327 (as modified and amplified by Rev. Proc. 2002–19, amplified, clarified, and modified by Rev. Proc. 2002–54, and modified and clarified by Announcement 2002–17, 2002–1 C.B. 561), provides procedures under which taxpayers may apply for automatic consent of the Commissioner to change a method of accounting. Under both revenue procedures, as modified, adjustments under section 481(a) are taken into account entirely in the year of change (in the case of a net negative adjustment) and over 4 taxable years (in the case of a net positive adjustment), subject to certain exceptions.

Explanation of Provisions

Regulations under sections 263A and 448 currently provide rules for certain changes in method of accounting under those sections, including the number of taxable years over which an adjustment required under section 481(a) to effect the change is to be taken into account. The adjustment periods provided in the regulations may differ from the general 4-year (net positive adjustment) and 1 year (net negative adjustment) adjustment period rule provided in Rev. Proc. 97–27 and Rev. Proc. 2002–9, as modified. In certain cases, the difference creates a disincentive for certain taxpayers to change their method of accounting in the taxable year required by the regulations under section 263A or 448, as applicable.

The IRS and Treasury Department believe it is appropriate to amend the regulations under sections 263A and 448 to provide that the section 481(a) adjustment period for accounting method changes under those regulations be determined under the applicable administrative procedures issued by the Commissioner (namely, Rev. Proc. 97–27 and Rev. Proc. 2002–9, as modified, or successors). As a result of the amendment, the section 481(a) adjustment period for these changes generally will be 4 years for a net positive adjustment and 1 year for a net negative adjustment, unless otherwise provided in the regulations (see *e.g.*, §1.448–(g)(2)(ii) and (g)(3)(iii) (providing rules for extended or accelerated adjustment periods in certain cases)) or the applicable revenue procedure (see *e.g.*, section 7.03 of Rev. Proc. 97–27 and section 5.04(3) of Rev. Proc. 2002–9 (providing rules for accelerated adjustment periods in certain cases)). The IRS and Treasury Department believe that amending the regulations in this manner will eliminate the disincentive that currently exists and provide flexibility in the event that any future changes are made to the general section 481(a) adjustment periods.

The IRS and Treasury Department further believe it is appropriate to remove the special adjustment period rule for cooperatives in §1.448–1(g)(3)(ii), thus directing cooperatives to the rules in Rev. Proc. 97–27 or Rev. Proc. 2002–9, as modified, or successors. Currently, Rev. Proc. 97–27 (section 7.03(2)) and Rev. Proc. 2002–9 (section 5.04(3)(b)) provide that the section 481(a) adjustment period in the case of a cooperative (within the meaning of section 1381(a)) generally is 1 year, whether the net adjustment is positive or negative. The IRS and Treasury Department continue to believe that a 1 year adjustment period is appropriate in the case of accounting method changes by cooperatives. See Rev. Rul. 79–45, 1979–1 C.B. 284.

The IRS and Treasury Department contemplate issuing separate guidance on accounting method changes under section 381. Comments are requested on issues to be ad-

dressed in such guidance, including (1) whether the section 481(a) adjustment should be taken into account by the acquired corporation immediately prior to the transaction or the acquiring corporation immediately after the transaction; (2) whether the general section 481(a) adjustment periods of Rev. Proc. 97–27 and Rev. Proc. 2002–9, as modified, or successors, should apply to accounting method changes under section 381; (3) the method for computing the section 481(a) adjustment; (4) whether accounting method changes under section 381 should be requested by filing a Form 3115 or by requesting a private letter ruling; and (5) any other procedural or technical issues (*e.g.*, filing deadlines, audit protection).

Proposed Effective Date

The proposed regulations are applicable to taxable years ending on or after the date these regulations are published as final regulations. However, taxpayers may rely on the proposed regulations for taxable years ending on or after May 12, 2003, by filing a Form 3115, *Application for Change of Accounting Method*, in the time and manner provided in the regulations (in the case of a change in method of accounting under section 448) or applicable administrative procedure (in the case of a change in method of accounting under section 263A) for such a taxable year that reflects a section 481(a) adjustment period that is consistent with the proposed regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and because this proposed rule does not impose a collection of information on small entities, the provisions of the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply. Pursuant to section 7805(f) of the Internal Revenue Code, 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) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for August 13, 2003, beginning at 10 a.m. in the 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 the "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 electronic or written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by July 11, 2003.

A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal authors of these proposed regulations are Christian T. Wood and Grant Anderson of the Office of Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

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

PART 1 — INCOME TAXES

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

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

Par. 2. In §1.263A–7, paragraph (b)(2)(ii) is revised to read as follows:

§1.263A–7 Changing a method of accounting under section 263A.

* * * * *

(b) * * *

(2) * * *

(ii) Adjustment required by section 481(a). In the case of any taxpayer required or permitted to change its method of accounting for any taxable year under section 263A and the regulations thereunder, the change will be treated as initiated by the taxpayer for purposes of the adjustment required by section 481(a). The taxpayer must take the net section 481(a) adjustment into account over the section 481(a) adjustment period as determined under the applicable administrative procedures issued under §1.446–1(e)(3)(ii) for obtaining the Commissioner's consent to a change in accounting method (*e.g.*, Revenue Procedures 97–27 and 2002–9, or successors). This paragraph is effective for taxable years ending on or after the date these regulations are published as final regulations in the **Federal Register**. However, taxpayers may rely on this paragraph for taxable years ending on or after May 12, 2003, by filing, under the applicable administrative procedure, a Form 3115, *Application for Change in Accounting Method*, for such a taxable year that reflects a section 481(a) adjustment period that is consistent with this paragraph.

* * * * *

Par. 3. Section 1.448–1 is amended as follows:

1. Paragraph (g)(2)(i) is revised.

2. Paragraphs (g)(3)(i) and (ii), and (g)(6) are removed.

3. Paragraphs (g)(3)(iii) and (iv) are renumbered as (g)(3)(i) and (ii), respectively.

4. Paragraph (i)(1) is revised.

5. Paragraph (i)(5) is added.

The revisions and addition read as follows:

§1.448–1 Limitation on the use of the cash receipts and disbursements method of accounting.

* * * * *

(g) * * *

(2) * * *

(i) In general. Except as otherwise provided in paragraphs (g)(2)(ii) and (g)(3) of this section, a taxpayer required by this section to change from the cash method must take the net section 481(a) adjustment into account over the section 481(a) adjustment period as determined under the applicable administrative procedures issued under section 1.446–1(e)(3)(ii) for obtaining the Commissioner's consent to a change in accounting method (*e.g.*, Revenue Procedures 97–27 and 2002–9, or successors), provided the taxpayer complies with the provisions of paragraph (h)(2) or (h)(3) of this section for its first section 448 year.

* * * * *

(i) * * *

(1) In general. Except as provided in paragraphs (i)(2), (3), (4), and (5) of this section, this section applies to any taxable year beginning after December 31, 1986.

* * * * *

(5) *Effective date*. Paragraph (g)(2)(i) of this section is effective for taxable years ending on or after the date these regulations are published as final regulations in the **Federal Register**. However, taxpayers may rely on paragraph (g)(2)(i) of this section for taxable years ending on or after May 12, 2003, by filing, in the time and manner otherwise provided in this section, a Form 3115, *Application for Change in Accounting Method*, for such a taxable year that reflects a section 481(a) adjustment period that is consistent with paragraph (g)(2)(i).

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

(Filed by the Office of the Federal Register on May 9, 2003, 8:45 a.m., and published in the issue of the Federal Register for May 12, 2003, 68 F.R. 25310)

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.

Numerical Finding List[1]

Bulletins 2003–1 through 2003–22

Announcements:

Court Decisions:

Notices:

Notices—Continued:

Proposed Regulations:

Revenue Procedures:

Revenue Procedures—Continued:

Revenue Rulings:

[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2002–26 through 2002–52 is in Internal Revenue Bulletin 2003–1, dated January 6, 2003.

Revenue Rulings—Continued:

Tax Conventions:

Treasury Decisions:

Finding List of Current Actions on Previously Published Items[2]

Bulletins 2003–1 through 2003–22

Notices:

97–19
Modified by
Rev. Proc. 2003–1, 2003–1 I.R.B. *1*

97–32
Revoked by
T.D. 9058, 2003–22 I.R.B. *962*

2000–38
Modified by
Notice 2003–20, 2003–19 I.R.B. *894*

2001–26
Obsoleted by
T.D. 9032, 2003–7 I.R.B. *471*

2001–46
Modified by
Notice 2003–6, 2003–3 I.R.B. *298*

2001–69
Modified and superseded by
Notice 2003–1, 2003–2 I.R.B. *257*

2002–20
Superseded by
Rev. Proc. 2003–36, 2003–18 I.R.B. *859*

2002–27
Clarified by
Notice 2003–3, 2003–2 I.R.B. *258*

2002–40
Modified by
Ann. 2003–18, 2003–13 I.R.B. *675*

2002–46
Modified by
Notice 2003–10, 2003–5 I.R.B. *369*

Proposed Regulations:

REG–209500–86
Corrected by
Ann. 2003–6, 2003–6 I.R.B. *450*

REG–103829–99
Corrected by
Ann. 2003–12, 2003–10 I.R.B. *585*

REG–126485–01
Withdrawn by
REG–126485–01, 2003–9 I.R.B. *542*
Corrected by
Ann. 2003–25, 2003–17 I.R.B. *846*

REG–164754–01
Supplemented by
REG–164754–01, 2003–22 I.R.B. *975*

REG–131478–02
Corrected by
Ann. 2003–24, 2003–16 I.R.B. *810*

Proposed Regulations—Continued:

REG–143321–02
Corrected by
Ann. 2003–12, 2003–10 I.R.B. *585*

REG–164464–02
Corrected by
Ann. 2003–6, 2003–6 I.R.B. *450*

Revenue Procedures:

83–23
Supplemented by
Rev. Proc. 2003–21, 2003–6 I.R.B. *448*

84–37
Modified by
Rev. Proc. 2003–1, 2003–1 I.R.B. *1*

93–38
Obsoleted by
Rev. Proc. 2003–15, 2003–4 I.R.B. *321*

97–31
Modified by
Rev. Proc. 2003–9, 2003–8 I.R.B. *516*

98–13
Obsoleted by
T.D. 9032, 2003–7 I.R.B. *471*

2002–1
Superseded by
Rev. Proc. 2003–1, 2003–1 I.R.B. *1*

2002–2
Superseded by
Rev. Proc. 2003–2, 2003–1 I.R.B. *76*

2002–3
Superseded by
Rev. Proc. 2003–3, 2003–1 I.R.B. *113*

2002–4
Superseded by
Rev. Proc. 2003–4, 2003–1 I.R.B. *123*

2002–5
Superseded by
Rev. Proc. 2003–5, 2003–1 I.R.B. *163*

2002–6
Superseded by
Rev. Proc. 2003–6, 2003–1 I.R.B. *191*

2002–7
Superseded by
Rev. Proc. 2003–7, 2003–1 I.R.B. *233*

2002–8
Superseded by
Rev. Proc. 2003–8, 2003–1 I.R.B. *236*

2002–9
Modified and amplified by
Rev. Proc. 2003–20, 2003–6 I.R.B. *445*
Rev. Rul. 2003–3, 2003–2 I.R.B. *252*

2002–20
Supplemented by
Rev. Proc. 2003–26, 2003–13 I.R.B. *666*

Revenue Procedures—Continued:

2002–22
Modified by
Rev. Proc. 2003–3, 2003–1 I.R.B. *113*

2002–29
Modified by
Rev. Proc. 2003–10, 2003–2 I.R.B. *259*

2002–37
Modified by
Rev. Proc. 2002–34, 2002–18 I.R.B. *856*

2002–39
Modified by
Rev. Proc. 2002–34, 2002–18 I.R.B. *856*

2002–51
Superseded by
Rev. Proc. 2003–31, 2003–17 I.R.B. *838*

2002–52
Modified by
Rev. Proc. 2003–1, 2003–1 I.R.B. *1*

2002–53
Superseded by
Rev. Proc. 2003–30, 2003–17 I.R.B. *822*

2002–57
Superseded by
Rev. Proc. 2003–28, 2003–16 I.R.B. *759*

2002–67
Supplemented by
Ann. 2003–3, 2003–4 I.R.B. *361*

2002–75
Superseded by
Rev. Proc. 2003–3, 2003–1 I.R.B. *113*

2003–3
Amplified by
Rev. Proc. 2003–14, 2003–4 I.R.B. *319*

2003–7
Corrected by
Ann. 2003–4, 2003–5 I.R.B *396*

Revenue Rulings:

53–131
Modified by
Rev. Rul. 2003–12, 2003–3 I.R.B. *283*

57–190
Obsoleted by
Rev. Rul. 2003–18, 2003–7 I.R.B. *467*

65–190
Revoked by
Rev. Rul. 2003–3, 2003–2 I.R.B. *252*

66–118
Distinguished by
Rev. Rul. 2003–41, 2003–17 I.R.B. *814*

69–372
Revoked by
Rev. Rul. 2003–3, 2003–2 I.R.B. *252*

[2] A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2002–26 through 2002–52 is in Internal Revenue Bulletin 2003–1, dated January 6, 2003.

Revenue Rulings—Continued:

70–140
Distinguished by
Rev. Rul. 2003–51, 2003–21 I.R.B. *938*

70–522
Distinguished by
Rev. Rul. 2003–51, 2003–21 I.R.B. *938*

79–70
Distinguished by
Rev. Rul. 2003–51, 2003–21 I.R.B. *938*

79–194
Distinguished by
Rev. Rul. 2003–51, 2003–21 I.R.B. *938*

86–88
Supplemented by
Rev. Rul. 2003–46, 2003–19 I.R.B. *878*

88–36
Supplemented by
Rev. Rul. 2003–46, 2003–19 I.R.B. *878*

92–19
Supplemented in part by
Rev. Rul. 2003–24, 2003–10 I.R.B. *557*

2000–49
Modified and superseded by
Rev. Rul. 2003–49, 2003–20 I.R.B. *903*

2002–80
Distinguished by
Rev. Rul. 2003–43, 2003–21 I.R.B. *935*

2003–2
Revoked by
Rev. Rul. 2003–22, 2003–8 I.R.B. *494*

Treasury Decisions:

9002
Corrected by
Ann. 2003–8, 2003–6 I.R.B. *451*

9021
Corrected by
Ann. 2003–16, 2003–12 I.R.B. *641*

9022
Supplemented by
Ann. 2003–7, 2003–6 I.R.B. *450*
Corrected by
Ann. 2003–11, 2003–10 I.R.B. *585*

9048
Corrected by
Ann. 2003–23, 2003–16 I.R.B. *808*