Internal Revenue bulletin

Bulletin No. 2011-51
December 19, 2011

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

T.D. 9556, page 862.

Final regulations under section 6011 of the Code provide rules requiring the disclosure of listed transactions and transactions of interest with respect to the generation-skipping transfer tax and make conforming amendments under sections 6111 and 6112. The regulations provide guidance under section 6112 regarding the length of time a material advisor has to prepare the list that must be maintained after the list maintenance requirement first arises with respect to the reportable transaction and clarify the provisions regarding designation agreements.

T.D. 9557, page 855.

Final regulations under section 108 of the Code provide guidance in determining the discharge of indebtedness income of a partnership that transfers a partnership interest to a creditor in satisfaction of the partnership's indebtedness, provide that section 721 generally applies to a contribution of a partnership's indebtedness by a creditor to the partnership in exchange for an interest in the partnership, and provide guidance for how a partnership's discharge of indebtedness income is allowed as a minimum gain chargeback under section 704.

T.D. 9558, page 859.
REG–101273–10, page 873.

Temporary regulations under section 358 of the Code clarify that, in certain reorganizations where no stock or securities of the issuing corporation is issued and distributed in the transaction, the ability to designate the share of stock of the issuing corporation to which the basis, if any, of the stock or securities surrendered will attach applies only to a shareholder that owns actual shares in the issuing corporation.

Announcement 2011–77, page 874.

This announcement informs bankruptcy trustees (or debtors-in-possession) of a change of address for the Centralized Insolvency Operation that should be used for the submission of requests for tax refunds under section 505(a) of the Bankruptcy Code or requests for prompt determinations of any unpaid tax liability of the estate incurred during the bankruptcy case under section 505(b) of the Bankruptcy Code. Rev. Procs. 2010–27 and 2006–24 modified.

Announcement 2011–80, page 903.

This announcement describes a correction to final and temporary regulations (T.D. 9554, 2011–50 I.R.B. 843) extending the exceptions from taxes under the Federal Insurance Contributions Act ("FICA") and the Federal Unemployment Tax Act ("FUTA") under sections 3121(b)(3) (concerning individuals who work for certain family members), 3127 (concerning members of religious faiths), and 3306(c)(5) (concerning persons employed by children and spouses and children under 21 employed by their parents) of the Code to entities that are disregarded as separate from their owners for Federal tax purposes. The temporary regulations also clarify the existing rule that the owners of disregarded entities, except for qualified subchapter S subsidiaries, are responsible for backup withholding and related information reporting requirements under section 3406.

(Continued on the next page)

Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

EMPLOYEE PLANS

Announcement 2011–78, page 874.
This announcement describes rules that the Treasury Department and the IRS are considering proposing relating to the determination of whether a plan is a governmental plan within the meaning of section 414(d) of the Code and contains an appendix that includes a draft notice of proposed rulemaking on which Treasury Department and IRS invite comments.

Announcement 2011–79, page 892.
This announcement describes rules that the Treasury Department and the IRS are considering proposing relating to the determination of whether a plan of an Indian tribal government is a governmental plan within the meaning of section 414(d) of the Code and contains an appendix that includes a draft notice of proposed rulemaking on which Treasury Department and IRS invite comments.

ESTATE TAX

T.D. 9556, page 862.
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REG–112196–07, page 865.
Proposed regulations will amend regulations section 20.2032-1 to provide guidance that clarifies for the executor of an estate that elects to use the alternate valuation method under section 2032 of the Code what constitutes a distribution, sale, exchange, or other disposition and what post-death occurrences the executor may consider when valuing property includible in the gross estate on the alternate valuation date. A public hearing is scheduled for March 9, 2012.

Announcement 2011–77, page 874.
This announcement informs bankruptcy trustees (or debtors-in-possession) of a change of address for the Centralized Insolvency Operation that should be used for the submission of requests for tax refunds under section 505(a) of the Bankruptcy Code or requests for prompt determinations of any unpaid tax liability of the estate incurred during the bankruptcy case under section 505(b) of the Bankruptcy Code. Rev. Procs. 2010–27 and 2006–24 modified.

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ADMINISTRATIVE

T.D. 9556, page 862.
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The IRS Mission

Provide America's taxpayers top-quality service by helping them understand and meet their tax responsibilities and enforce the 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 compiled 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 last 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 last Bulletin of each semiannual period.

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

Section 108.—Income From Discharge of Indebtedness

26 CFR 1.108–8: Indebtedness satisfied by partnership interest.

T.D. 9557

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Application of Section 108(e)(8) to Indebtedness Satisfied by a Partnership Interest

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the application of section 108(e)(8) of the Internal Revenue Code (Code) to partnerships and their partners. These regulations provide guidance regarding the determination of discharge of indebtedness income of a partnership that transfers a partnership interest to a creditor in satisfaction of the partnership's indebtedness. The final regulations also address the application of section 721 to a contribution of a partnership's recourse or nonrecourse indebtedness by a creditor to the partnership in exchange for a capital or profits interest in the partnership. Moreover, the final regulations address how a partnership's discharge of indebtedness income is allocated as a minimum gain chargeback under section 704. The regulations affect partnerships and their partners.

DATES: *Effective Date:* These regulations are effective on November 17, 2011.

Applicability Date: For dates of applicability, see §§1.108–8(d), 1.704–2(l)(1)(v), and 1.721–1(d)(4).

FOR FURTHER INFORMATION CONTACT: Joseph R. Worst or Megan A. Stoner, Office of Associate Chief Counsel (Passthroughs and Special Industries), (202) 622–3070 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to 26 CFR part 1 under sections 108, 704, and 721 of the Code relating to the application of section 108(e)(8) to partnerships.

Section 108(e)(8) was amended by section 896 of the American Jobs Creation Act of 2004, Public Law 108–357 (118 Stat. 1648), to include discharges of partnership indebtedness occurring on or after October 22, 2004. Prior to the amendment, section 108(e)(8) only applied to discharges of corporate indebtedness. Section 108(e)(8), as amended, provides that, for purposes of determining income of a debtor from discharge of indebtedness (COD income), if a debtor corporation transfers stock or a debtor partnership transfers a capital or profits interest in such partnership to a creditor in satisfaction of its recourse or nonrecourse indebtedness, such corporation or partnership shall be treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock or interest. In the case of a partnership, any COD income recognized under section 108(e)(8) shall be included in the distributive shares of the partners in the partnership immediately before such discharge.

A notice of proposed rulemaking and a notice of public hearing (REG–164370–05, 2008–46 I.R.B. 1157) were published in the **Federal Register** (73 FR 64903) on October 31, 2008, proposing amendments to the regulations regarding the application of section 108(e)(8) to partnerships and their partners, including the determination of COD income of a partnership that transfers a partnership interest to a creditor in satisfaction of the partnership's indebtedness (debt-for-equity exchange). The proposed regulations also provide that section 721 generally applies to a contribution of a partnership's recourse or nonrecourse indebtedness by a creditor to the partnership in exchange for a capital or profits interest in the partnership. A public hearing on the proposed regulations was scheduled for February 19, 2009, but was cancelled because no one requested to speak. However, comments responding to the proposed regulations were received. After consideration of these comments, the proposed regulations are adopted as revised by this Treasury decision. These final regulations generally retain the provisions of the proposed regulations with the modifications discussed in the preamble.

Summary of Comments and Explanation of Provisions

1. *Valuation of Partnership Interest Transferred in Satisfaction of Partnership Indebtedness*

Section 108(e)(8) provides that, for purposes of determining COD income of a debtor partnership, the partnership shall be treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the interest transferred to the creditor. Generally, the amount by which the indebtedness exceeds the fair market value of the partnership interest transferred is the amount of COD income required to be included in the distributive shares of the partners that were partners in the debtor partnership immediately before the discharge.

The proposed regulations provide that, for purposes of determining the amount of COD income, the fair market value of the partnership interest transferred to the creditor in a debt-for-equity exchange (debt-for-equity interest) is the liquidation value of the partnership interest if four requirements are satisfied (liquidation value safe harbor). For this purpose, liquidation value equals the amount of cash that the creditor would receive with respect to the debt-for-equity interest if, immediately after the transfer, the partnership sold all of its assets (including goodwill, going concern value, and any other intangibles) for cash equal to the fair market value of those assets, and then liquidated.

The four conditions of the liquidation value safe harbor in the proposed regulations are that (i) the debtor partnership determines and maintains capital accounts

of its partners in accordance with the capital accounting rules of §1.704–1(b)(2)(iv) (capital account maintenance requirement); (ii) the creditor, debtor partnership, and its partners treat the fair market value of the indebtedness as being equal to the liquidation value of the debt-for-equity interest for purposes of determining the tax consequences of the debt-for-equity exchange (consistency requirement); (iii) the debt-for-equity exchange is an arm's-length transaction (arm's-length requirement); and (iv) subsequent to the debt-for-equity exchange, neither the partnership redeems nor any person related to the partnership purchases the debt-for-equity interest as part of a plan at the time of the debt-for-equity exchange which has as a principal purpose the avoidance of COD income by the partnership (anti-abuse provision). If these requirements are not satisfied, all of the facts and circumstances are considered in determining the fair market value of the debt-for-equity interest for purposes of applying section 108(e)(8). Each of the four requirements of the proposed regulations is discussed in the preamble.

The first requirement is the capital account maintenance requirement. Commenters requested that the final regulations clarify that this requirement does not necessitate compliance with all aspects of the substantial economic effect safe harbor under §1.704–1(b)(2), notably the requirement that the partnership liquidate in accordance with the positive capital account balances of its partners. To eliminate confusion over the capital account maintenance requirement in the liquidation value safe harbor, the IRS and the Treasury Department have decided to remove the capital account maintenance requirement from the liquidation value safe harbor because the maintenance of capital accounts is not necessary to the determination of the liquidation value of the partner's interest.

The second requirement of the liquidation value safe harbor in the proposed regulations is the consistency requirement. This requirement is intended to ensure consistent reporting by the creditor, debtor partnership, and its partners. One commenter suggested narrowing the scope of this requirement in the final regulations so that the failure of a partner to consistently treat the fair market value of the indebtedness as being equal to the liquidation value of the debt-for-equity interest does not invalidate the partnership's use of the liquidation value safe harbor, provided the creditor and the partnership otherwise consistently determine and report COD income based on such valuation. The IRS and the Treasury Department considered the issue and decided to not modify this requirement in the final regulations. The amount of COD income computed under the liquidation value safe harbor may differ from the amount computed using the fair market value of the partnership interest. Thus, in order for the partnership to use the liquidation value safe harbor, the IRS and the Treasury Department believe that the partnership and all of its partners must report consistently.

One commenter suggested that taxpayers should not be able to selectively exploit to their benefit the discrepancy between liquidation value and fair market value and suggested that the final regulations require that a partnership apply a consistent valuation methodology to all equity issued in any debt-for-equity exchange that is part of the same overall transaction. The IRS and the Treasury Department agree, and therefore the final regulations add this as a condition to the liquidation value safe harbor.

The third requirement of the liquidation value safe harbor in the proposed regulations is the arm's-length requirement. Commenters requested that the final regulations clarify whether this requirement can be satisfied where the exchange is between the partnership and an existing partner. The IRS and the Treasury Department believe that the liquidation value safe harbor should be available where the transaction involves related parties and have clarified this requirement in the final regulations to provide that, as long as the debt-for-equity exchange has terms that are comparable to terms that would be agreed to by unrelated parties negotiating with adverse interests, the third requirement is satisfied even if the transaction is between related parties.

The fourth requirement of the liquidation value safe harbor in the proposed regulations is an anti-abuse provision. The final regulations follow the anti-abuse provision of the proposed regulations by adding a restriction on subsequent purchases of the debt-for-equity interest by a person related to any partner (in addition to purchases by a person related to the partnership) as part of a tax-avoidance plan. Thus, under the final regulations, the partnership cannot redeem and no person related to the partnership or to any partner can purchase the debt-for-equity interest as part of a plan at the time of the debt-for-equity exchange that has as a principal purpose the avoidance of COD income by the partnership. Commenters requested that the final regulations clarify the meaning of "related" in this context. The IRS and the Treasury Department agree that clarification is warranted and therefore the final regulations refer to sections 267(b) and 707(b) for the meaning of "related" in the anti-abuse provision.

The final regulations also address the application of the liquidation value safe harbor rule to a partnership (upper-tier partnership) that directly or indirectly owns an interest in one or more partnerships (lower-tier partnership(s)). The final regulations provide that, with respect to interests held in one or more lower-tier partnerships, the liquidation value of an interest in an upper-tier partnership is determined by taking into account the liquidation value of such lower-tier partnership interest.

The final regulations provide that if the fair market value of the debt-for-equity interest does not equal the fair market value of the indebtedness exchanged, then general tax law principles shall apply to account for the difference. Moreover, section 707(a)(2)(A), as it relates to the treatment of payments to partners for transfers of property, will be considered, if appropriate.

2. *Application of Section 721 to Debt-for-Equity Exchanges*

The proposed regulations generally provide that the nonrecognition rule of section 721 applies to the debt-for-equity exchange. Under the proposed regulations, the creditor does not recognize a loss or a bad debt deduction in the debt-for-equity exchange. The creditor's basis in the debt-for-equity interest is increased under section 722 by the adjusted basis of the indebtedness. The preamble to the proposed regulations requested comments on alternative approaches.

A number of commenters agreed with the general application of section 721 to

the debt-for-equity exchange, but recommended that the rule be modified in the final regulations. The commenters argued that the application of section 721 to the debt-for-equity exchange may result in asymmetry in the timing of the partnership's COD income inclusion and the creditor's loss, character conversion for the creditor from ordinary loss to capital loss, and disparities between the partners' aggregate bases in their partnership interests and the partnership's basis in its assets. Some commenters suggested that these results could be alleviated if the final regulations bifurcate the debt-for-equity exchange into two transactions, namely the cancellation of a portion of the indebtedness, and the contribution of the balance in exchange for an interest in the partnership in a transaction to which section 721 applies (bifurcation approach). Another commenter, however, stated that a bifurcation approach is not consistent with section 721 or case law.

The IRS and the Treasury Department agree with the latter comment and believe that the bifurcation approach would be inconsistent with the treatment of analogous corporate debt-for-equity transactions involving corporate indebtedness evidenced by a security in which section 351 would apply, for example. Further, comments in favor of the bifurcation approach assume a creditor has not validly taken a bad debt deduction under section 166 prior to the debt-for-equity exchange in a transaction independent of and separate from the debt-for-equity exchange. After consideration of the issue, the IRS and the Treasury Department have determined that the final regulations will not adopt the bifurcation approach.

3. *Obligations for Unpaid Rent, Royalties, and Interest*

The proposed regulations provide that section 721 does not apply to the transfer of a partnership interest to a creditor in satisfaction of a partnership's recourse or nonrecourse indebtedness for unpaid rent, royalties, or interest on indebtedness (including accrued original issue discount). These items generally give rise to ordinary income to the creditor and a deduction to the partnership. Most commenters agreed that the general nonrecognition rule under section 721 should not apply to the transfer of a partnership interest in satisfaction of these items. The IRS and the Treasury Department believe that the exception to section 721 for these items is necessary to prevent the conversion of ordinary income into capital gain.

The final regulations retain the exception for these ordinary income items, but, in response to a comment, limit the scope of the exception. The commenter suggested that the exception be limited to items that accrued on or after the beginning of the creditor's holding period for the indebtedness. The IRS and the Treasury Department agree with the comment, and therefore, the final regulations provide that section 721 does not apply to a debt-for-equity exchange to the extent the partnership interest is exchanged for the partnership's indebtedness for unpaid rent, royalties, or interest on the partnership's indebtedness (including accrued original issue discount) that accrued on or after the beginning of the creditor's holding period for the indebtedness.

The preamble to the proposed regulations states the general rule that when property is transferred as payment on indebtedness (or in satisfaction thereof), gain or loss on the property is recognized. Under that approach, in a debt-for-equity exchange, if the partnership is treated as satisfying its indebtedness for unpaid rent, royalties, or interest on indebtedness (including accrued original issue discount) with a fractional interest in each asset of the partnership, the partnership could recognize gain or loss equal to the difference between the fair market value of each partial asset deemed transferred to the creditor and the adjusted basis in that partial asset. The IRS and the Treasury Department believe that in a debt-for-equity exchange where the partnership has not disposed of any of its assets, the partnership should not be required to recognize gain or loss on the transfer of a partnership interest in satisfaction of its indebtedness for unpaid rent, royalties, or interest. Therefore, under the final regulations, a debtor partnership will not recognize gain or loss upon the transfer of a partnership interest to a creditor in a debt-for-equity exchange for unpaid rent, royalties, or interest that accrued on or after the beginning of the creditor's holding period for the indebtedness.

4. *COD Income as First-tier Item for Minimum Gain Chargeback Rules*

The preamble to the proposed regulations requested comments regarding the manner in which COD income arising from a debt-for-equity exchange should be treated for purposes of the minimum gain chargeback rules under §1.704–2(f)(6). Section 1.704–2(f)(6) provides that any minimum gain chargeback required for a partnership taxable year consists first of certain gains recognized from the disposition of partnership property subject to one or more partnership nonrecourse liabilities and then, if necessary, of a *pro rata* portion of the partnership's other items of income and gain for that year. A similar rule applies to chargebacks of partner nonrecourse debt minimum gain. See §1.704–2(i)(4).

Commenters recommended that, where a minimum gain chargeback results from the discharge of partnership or partner nonrecourse debt, the first-tier of the minimum gain chargeback should include COD income relating to such debt. The IRS and the Treasury Department agree with this comment, and therefore the final regulations provide that COD income arising from a discharge of a partnership or partner nonrecourse indebtedness is treated as a first-tier item for minimum gain chargeback purposes under §§1.704–2(f)(6), 1.704–2(j)(2)(i)(A), and 1.704–2(j)(2)(ii)(A).

5. *Disposition of Installment Obligations*

Section 453B provides rules regarding dispositions of installment obligations. Generally, if an installment obligation of a taxpayer is satisfied at other than its face value or the taxpayer distributes, transmits, sells, or otherwise disposes of an installment obligation, the taxpayer recognizes any deferred gain or loss. However, §1.453–9(c)(2) provides that the contribution of an installment obligation to a partnership under section 721, for example, does not constitute a disposition. The IRS and the Treasury Department believe that this exception does not apply to a creditor who disposes of an installment obligation of a partnership by contributing it to the debtor partnership, even if the transaction qualifies under section 721. In that case, the creditor must recognize

gain or loss under section 453B. This treatment is consistent with the corporate rules that require a creditor to recognize gain or loss under section 453B on the disposition of an installment obligation of a corporation to the debtor corporation in a transaction that qualifies under section 351. Rev. Rul. 73–423, 1973–2 C.B. 161, (see §601.601(d)(2)(ii)(*b*)). Accordingly, the IRS and the Treasury Department are proposing regulations under section 453B to clarify this issue.

6. *Additional Issues*

The preamble to the proposed regulations requested comments on whether any special allocation rules of COD income should apply where partnership indebtedness owed to a preexisting partner is satisfied with the transfer of a partnership interest. The proposed regulations did not address this issue. Commenters recommended that the final regulations not impose any special allocation rules regarding COD income realized under section 108(e)(8) from the cancellation of a partnership indebtedness owed to a preexisting partner. Commenters suggested that Rev. Rul. 92–97, 1992–2 C.B. 124, and Rev. Rul. 99–43, 1999–2 C.B. 506, (see §601.601(d)(2)(ii)(*b*)), provide an appropriate framework for determining how COD income should be allocated, whether or not the creditor is a partner in the partnership. The IRS and the Treasury Department agree that existing guidance provides a framework for allocating COD income and, thus, the final regulations do not adopt any additional guidance regarding the allocation of COD income among partners in a debt-for-equity exchange.

Effective/Applicability Date

These final regulations apply to debt-for-equity exchanges occurring on or after the date these final regulations are published in the **Federal Register**.

Special Analyses

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

Drafting Information

The principal authors of these regulations are Joseph R. Worst and Megan A. Stoner of the Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and the Treasury Department participated in their development.

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Adoption of Amendment to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.108–8 is added to read as follows:

§1.108–8 Indebtedness satisfied by partnership interest.

(a) *In general*. For purposes of determining income of a debtor from discharge of indebtedness (COD income), if a debtor partnership transfers a capital or profits interest in the partnership to a creditor in satisfaction of its recourse or nonrecourse indebtedness (a debt-for-equity exchange), the partnership is treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the partnership interest.

(b) *Determination of fair market value*—(1) *In general*. All the facts and circumstances are considered in determining the fair market value of a partnership interest transferred by a debtor partnership to a creditor in satisfaction of the debtor partnership's indebtedness (debt-for-equity interest) for purposes of paragraph (a) of this section. If the fair market value of the debt-for-equity interest does not equal the fair market value of the indebtedness exchanged, then general tax law principles shall apply to account for the difference.

(2) *Safe harbor*—(i) *General rule*. For purposes of paragraph (a) of this section, the fair market value of a debt-for-equity interest is deemed to be equal to the liquidation value of the debt-for-equity interest, as defined in paragraph (b)(2)(iii) of this section, if the following requirements are satisfied—

(A) The creditor, debtor partnership, and its partners treat the fair market value of the indebtedness as being equal to the liquidation value of the debt-for-equity interest for purposes of determining the tax consequences of the debt-for-equity exchange;

(B) If, as part of the same overall transaction, the debtor partnership transfers more than one debt-for-equity interest to one or more creditors, then each creditor, debtor partnership, and its partners treat the fair market value of each debt-for-equity interest transferred by the debtor partnership to such creditors as equal to its liquidation value;

(C) The debt-for-equity exchange is a transaction that has terms that are comparable to terms that would be agreed to by unrelated parties negotiating with adverse interests; and

(D) Subsequent to the debt-for-equity exchange, the debtor partnership does not redeem the debt-for-equity interest, and no person bearing a relationship to the debtor partnership or its partners that is specified in section 267(b) or section 707(b) purchases the debt-for-equity interest, as part of a plan at the time of the debt-for-equity exchange that has as a principal purpose the avoidance of COD income by the debtor partnership.

(ii) *Tiered-partnership rule*. For purposes of this paragraph (b)(2), the liquidation value of a debt-for-equity interest in a partnership (upper-tier partnership) that directly or indirectly owns an interest in one or more partnerships (lower-tier partnership(s)) is determined by taking into account the liquidation value of such lower-tier partnership interests.

(iii) *Definition of liquidation value*. For purposes of this paragraph (b)(2), the liquidation value of a debt-for-equity interest equals the amount of cash that the creditor would receive with respect to the debt-for-equity interest if, immediately after the debt-for-equity exchange, the partnership sold all of its assets (including goodwill, going concern value, and any other intangibles) for cash equal to the fair market value of those assets and then liquidated.

(c) *Example*. The following example illustrates the provisions of this section:

Example. (i) AB partnership has $1,000 of outstanding indebtedness owed to C. C agrees to transfer to AB partnership the $1,000 indebtedness in a debt-for-equity exchange for a debt-for-equity interest in AB partnership. The liquidation value of C's debt-for-equity interest is $700, which is the amount of cash that C would receive with respect to that interest if, immediately after the debt-for-equity exchange, AB partnership sold all of its assets for cash equal to the fair market value of those assets and then liquidated. Each of the requirements of the liquidation value safe harbor described in paragraph (b)(2) of this section is satisfied.

(ii) Because the requirements in paragraph (b)(2) of this section are satisfied, the fair market value of C's debt-for-equity interest in AB partnership for purposes of determining AB partnership's COD income is the liquidation value of C's debt-for-equity interest, or $700. Accordingly, AB partnership is treated as satisfying the $1,000 indebtedness for $700 under section 108(e)(8).

(d) *Effective/applicability date*. This section applies to debt-for-equity exchanges occurring on or after November 17, 2011.

Par. 3. Section 1.704–2 is amended as follows:

1. In paragraph (f)(6), the first sentence is revised and in the last sentence, the language "(j)(2)(i) and (iii)" is removed and the language "(j)(2)(i) and (j)(2)(iii)" is added in its place.

2. Paragraphs (j)(2)(i)(A) and (j)(2)(ii)(A) are revised.

3. In paragraph (l), revise the paragraph heading and add a new paragraph (l)(1)(v).

The revisions and additions read as follows:

§1.704–2 Allocations attributable to nonrecourse liabilities.

* * * * *

(f) * * *

(6) * * * Any minimum gain chargeback required for a partnership taxable year consists first of a *pro rata* portion of certain gains recognized from the disposition of partnership property subject to one or more partnership nonrecourse liabilities and income from the discharge of indebtedness relating to one or more partnership nonrecourse liabilities to which partnership property is subject, and then, if necessary, consists of a *pro rata* portion of the partnership's other items of income and gain for that year.* * *

* * * * *

(j) * * *

(2) * * *

(i) * * *

(A) First, a *pro rata* portion of gain from the disposition of property subject to partnership nonrecourse liabilities and discharge of indebtedness income relating to partnership nonrecourse liabilities to which property is subject;

* * * * *

(ii) * * *

(A) First, a *pro rata* portion of gain from the disposition of property subject to partner nonrecourse debt and discharge of indebtedness income relating to partner nonrecourse debt to which property is subject.

* * * * *

(l) *Effective/applicability dates*. * * *

(1) * * *

(v) The first sentence of paragraph (f)(6) of this section and paragraphs (j)(2)(i)(A) and (j)(2)(ii)(A) of this section apply on and after November 17, 2011.

* * * * *

Par. 4. Section 1.721–1 is amended by adding new paragraph (d) to read as follows:

§1.721–1 Nonrecognition of gain or loss on contribution.

* * * * *

(d) *Debt-for-equity exchange*—(1) *In general*. Except as otherwise provided in section 721 and the regulations under section 721, section 721 applies to a contribution of a partnership's indebtedness by a creditor to the debtor partnership in exchange for a capital or profits interest in the partnership (debt-for-equity exchange). See §1.108–8(a) for rules in determining the debtor partnership's discharge of indebtedness income.

(2) *Exception*. Section 721 does not apply to a debt-for-equity exchange to the extent the transfer of the partnership interest to the creditor is in exchange for the partnership's indebtedness for unpaid rent, royalties, or interest (including accrued original issue discount) that accrued on or after the beginning of the creditor's holding period for the indebtedness. The debtor partnership will not recognize gain or loss upon the transfer of a partnership interest to a creditor in a debt-for-equity exchange for unpaid rent, royalties, or interest (including accrued original issue discount).

(3) *Cross reference*. For rules in determining whether a partnership interest transferred to a creditor in a debt-for-equity exchange is treated as payment of interest or accrued original issue discount, see §§1.446–2 and 1.1275–2, respectively.

(4) *Effective/applicability date*. This paragraph (d) applies to debt-for-equity exchanges occurring on or after November 17, 2011.

Steven T. Miller,
Deputy Commissioner for Services and Enforcement.

Approved November 8, 2011.

Emily S. McMahon,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on November 15, 2011, 11:15 a.m., and published in the issue of the Federal Register for November 17, 2011, 76 F.R. 71255)

Section 358.—Basis to Distributees

26 CFR 1.358–2: Allocation of basis among nonrecognition property.

T.D. 9558

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Corporate Reorganizations; Allocation of Basis in "All Cash D" Reorganizations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains temporary regulations regarding the determination of the basis of stock or securities in a reorganization where no stock or securities of the issuing corporation is issued and distributed in the transaction. These temporary regulations clarify that, in certain reorganizations where no stock or securities of the issuing corporation is issued and distributed in the transaction, the ability to designate the share of stock of the issuing corporation to which the basis, if any, of the stock or securities surrendered will attach applies only to a shareholder that owns actual shares in the issuing corporation. These temporary regulations affect corporations engaging in such transactions and their shareholders. The text of the temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in this issue of the Bulletin.

DATES: *Effective Date:* These regulations are effective on November 21, 2011.

Applicability Date: For dates of applicability, see §1.358–2T(d).

FOR FURTHER INFORMATION CONTACT: Lisa A. Fuller at (202) 622–7550 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On December 19, 2006, the IRS and the Treasury Department published a notice of proposed rulemaking (REG–125632–06, 2007–5 I.R.B. 415) in the **Federal Register** (71 FR 75898) that included regulations under section 368 (the Temporary Regulations). These regulations provided guidance regarding whether the distribution requirement under sections 368(a)(1)(D) and 354(b)(1)(B) is satisfied if there is no actual distribution of stock or securities. On December 18, 2009, the IRS and the Treasury Department published final regulations (T.D. 9475, 2010–4 I.R.B. 304) in the **Federal Register** (71 FR 75879) that, in addition to providing guidance regarding the qualification of certain transactions as reorganizations described in section 368(a)(1)(D), amended the regulations under §1.358–2(a)(2)(iii) to provide that in the case of a reorganization in which the property received consists solely of non-qualifying property equal to the value of the assets transferred (as well as a nominal share described in the final regulations), the shareholder or security holder may designate the share of stock of the issuing corporation to which the basis, if any, of the stock or securities surrendered will attach. The IRS and the Treasury Department issued these regulations in response to comments that, in a transaction where the consideration received consists solely of cash and a nominal share, the mechanics of preserving basis, if any, in the shares of the stock or securities surrendered in the basis of the stock of the issuing corporation were unclear under current law.

The IRS and the Treasury Department have become aware that some maintain these rules, as written, could be interpreted to allow an inappropriate allocation of basis by persons that do not own actual shares of stock in the issuing corporation. This interpretation would most likely be asserted in the context of a lower-tier reorganization transaction involving corporations in two different ownership chains that have the same ultimate indirect shareholder(s). Specifically, the argument is that the rules could be interpreted to allow persons who do not own actual shares of stock of the issuing corporation to allocate the adjusted basis of the nominal share to an actual share of stock of the issuing corporation directly owned by someone else before the nominal share is deemed to be further transferred through the chains of ownership to reflect the actual ownership of the target and issuing corporations. Under this interpretation of the rules, the actual share to which the basis was allocated could then be sold to recognize a loss, and taxpayers would avoid losing the nominal share's basis, which would otherwise be zero following its deemed transfer through the chains of ownership to the actual shareholder of the issuing corporation.

For example, assume that J owns all the stock of corporations X and Y, and X owns all of the stock of corporation T. X has a $150 basis in the T stock. The corporations do not join in the filing of a consolidated return. T sells all of its assets to Y for $100 cash, their fair market value, and liquidates. Pursuant to §1.368–2(l), Y will be deemed to issue a nominal share of Y stock to T in addition to the $100 actually exchanged for the T assets, and T will be deemed to distribute the nominal share of Y stock to X. X will have a basis of $50 in the nominal share of Y stock under section 358(a). Pursuant to §1.368–2(l), the nominal share of Y stock is deemed to be further transferred to J in order to reflect the actual ownership of Y. J's basis in the nominal share of Y stock would be zero under section 301(d). However, some argue that the rule, as currently written, could be interpreted as allowing X to allocate the $50 of basis in the nominal share to an actual share of Y stock owned by J prior to the nominal share of Y stock being deemed to be further distributed to J.

The IRS and the Treasury Department did not intend for the final regulations to allow such an inappropriate allocation of basis and do not believe the current regulations support such an allocation. Accordingly, the IRS and the Treasury Department are proposing rules in this issue of the Bulletin, to clarify that, in certain reorganizations where no stock or securities of the issuing corporation is issued and distributed in the transaction, the ability to designate the share of stock of the issuing corporation to which the basis, if any, of the stock or securities surrendered will attach applies only to a shareholder that owns actual shares in the issuing corporation.

Explanation of Provisions

The preamble to the final regulation noted that the IRS and the Treasury Department believe the ability to designate any remaining basis is consistent with current law regarding basis determination, as a similar result would occur under §1.358–2 if an amount of issuing corporation stock was actually issued in the transaction (74 FR 67053; 74 FR 67056; T.D. 9475). To complete the analogy, however, in the case where stock is actually issued in a lower-tier transfer, such stock would then be transferred through chains of ownership, and in the process, if basis in the stock exceeded value, the basis in the shares would be reduced to the fair market value of the shares in the hands of the distributee, under section 301(d). Accordingly, in such a case, basis in excess of the value of the issuing corporation shares would generally be preserved only where the shareholder of the transferor corporation does not further distribute the stock of

the issuing corporation in a transaction to which section 301 applies.

Consistent with this view, these temporary regulations clarify and amend the final regulations (T.D. 9475) under §1.358–2(a)(2)(iii) by providing that if an actual shareholder of the issuing corporation is deemed to receive a nominal share of stock of the issuing corporation described in §1.368–2(l), such shareholder must, after allocating and adjusting the basis of the nominal share in accordance with the rules of this section and §1.358–1, and after adjusting the basis in the nominal share for any transfers described in §1.358–1, designate the share of stock of the issuing corporation to which the basis, if any, of the nominal share will attach.

The IRS and the Treasury Department also are clarifying the effective date for a 2009 amendment to the regulations under §1.358–2(a)(iii).

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. For the applicability of the Regulatory Flexibility Act, please refer to the cross-reference notice of proposed rulemaking published elsewhere in this Bulletin. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

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

* * * * *

PART 1—INCOME TAXES

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

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

Section 1.358–2 also issued under 26 U.S.C. 358(b)(1).

Par. 2. Section 1.358–2 is amended by:

1. Revising paragraph (a)(2)(iii).

2. Revising paragraph (d).

The revisions read as follows:

§1.358–2 Allocation of basis among nonrecognition property.

(a) * * *

(2) * * *

(iii) [Reserved]. For further guidance, see §1.358–2T(a)(2)(iii).

* * * * *

(d) *Effective/applicability date.* This section generally applies to exchanges and distributions of stock and securities occurring on or after January 23, 2006. However, paragraph (a)(2)(iii) of this section applies to exchanges and distributions of stock and securities occurring on or after November 21, 2011. See §1.358–2(a)(2)(iii), as contained in 26 CFR part 1 revised as of April 1, 2010, for exchanges and distributions of stock and securities occurring on or after January 23, 2006, and before November 21, 2011.

Par. 3. Section 1.358–2T is added to read as follows:

§1.358–2T Allocation of basis among nonrecognition property (temporary).

(a)(1) through (a)(2)(ii) [Reserved]. For further guidance, see §1.358–2(a)(1) through (a)(2)(ii).

(iii) For purposes of this section, if a shareholder or security holder surrenders a share of stock or a security in a transaction under the terms of section 354 (or so much of section 356 as relates to section 354) in which such shareholder or security holder receives no property or property (including property permitted by section 354 to be received without the recognition of gain or "other property" or money) with a fair market value less than that of the stock or securities surrendered in the transaction, such shareholder or security holder shall be treated as follows.

(A) First, the shareholder or security holder shall be treated as receiving the stock, securities, other property, and money actually received by the shareholder or security holder in the transaction and an amount of stock of the issuing corporation (as defined in §1.368–1(b)) that has a value equal to the excess of the value of the stock or securities the shareholder or security holder surrendered in the transaction over the value of the stock, securities, other property, and money the shareholder or security holder actually received in the transaction. If the shareholder owns only one class of stock of the issuing corporation the receipt of which would be consistent with the economic rights associated with each class of stock of the issuing corporation, the stock deemed received by the shareholder pursuant to the previous sentence shall be stock of such class. If the shareholder owns multiple classes of stock of the issuing corporation the receipt of which would be consistent with the economic rights associated with each class of stock of the issuing corporation, the stock deemed received by the shareholder shall be stock of each such class owned by the shareholder immediately prior to the transaction, in proportion to the value of the stock of each such class owned by the shareholder immediately prior to the transaction. The basis of each share of stock or security deemed received and actually received shall be determined under the rules of this section.

(B) Second, the shareholder or security holder shall then be treated as surrendering all of its shares of stock and securities in the issuing corporation, including those shares of stock or securities held immediately prior to the transaction, those shares of stock or securities actually received in the transaction, and those shares of stock deemed received pursuant to the previous sentence, in a reorganization under section 368(a)(1)(E) in exchange for the shares of stock and securities of the issuing corporation that the shareholder or security holder actually holds immediately after the transaction. The basis of each share of stock and security deemed received in the reorganization under section 368(a)(1)(E) shall be determined under the rules of this section.

(C) If an actual shareholder of the issuing corporation is deemed to receive a nominal share of stock of the issuing corporation described in §1.368–2(l), such shareholder must, after allocating and adjusting the basis of the nominal share in accordance with the rules of this section and §1.358–1, and after adjusting the ba-

sis in the nominal share for any transfers described in §1.368–2(l), designate the share of stock of the issuing corporation to which the basis, if any, of the nominal share will attach.

(a)(2)(iv) through (c), *Example 14* [Reserved]. For further guidance, see §1.358–2(a)(2)(iv) through (c), *Example 14*.

Example 15. (i) *Facts*. Each of Corporation X and Corporation Y has a single class of stock outstanding, all of which is owned by J, an individual. J acquired 100 shares of Corporation X stock on Date 1 for $1.50 each. On Date 2, Corporation Y acquires the assets of Corporation X for $100 of cash, their fair market value, in a transaction described in §1.368–2(l). Pursuant to the terms of the exchange, Corporation X does not receive any Corporation Y stock. Corporation X distributes the $100 of cash to J in liquidation. Pursuant to §1.368–2(l), Corporation Y will be deemed to issue a nominal share of Corporation Y stock to Corporation X in addition to the $100 of cash actually exchanged for the Corporation X assets, and Corporation X will be deemed to distribute all of the consideration to J. J will have a basis of $50 in the nominal share of Corporation Y stock under section 358(a).

(ii) *Analysis*. Under paragraph (a)(2)(iii) of this section, J is the actual shareholder of Corporation Y, the issuing corporation, deemed to receive the nominal share of Corporation Y stock described in §1.368–2(l). Therefore, J must designate any share of Corporation Y stock to which the basis of $50 in the nominal share of Corporation Y stock will attach.

Example 16. (i) *Facts*. Each of Corporation X and Corporation Y has a single class of stock outstanding, all of which is owned by Corporation P. Corporation T has a single class of stock outstanding, all of which is owned by Corporation X. The corporations do not join in the filing of a consolidated return. Corporation X acquired 100 shares of Corporation T stock on Date 1 for $1.50 each. On Date 2, Corporation Y acquires the assets of Corporation T for $100 of cash, their fair market value, in a transaction described in §1.368–2(l). Pursuant to the terms of the exchange, Corporation T does not receive any Corporation Y stock. Corporation T distributes the $100 of cash to Corporation X in liquidation. Pursuant to §1.368–2(l), Corporation Y will be deemed to issue a nominal share of Corporation Y stock to Corporation T in addition to the $100 of cash actually exchanged for the Corporation T assets, and Corporation T will be deemed to distribute all of the consideration to Corporation X. Corporation X will have a basis of $50 in the nominal share of Corporation Y stock under section 358(a). Corporation X will be deemed to distribute the nominal share of Corporation Y stock to Corporation P. Corporation X does not recognize the loss on the deemed distribution of the nominal share to Corporation P under section 311(a). Corporation P's basis in the nominal share is zero, its fair market value, under section 301(d).

(ii) *Analysis*. Corporation X is deemed to receive the nominal share of Corporation Y stock described in §1.368–2(l). However, under paragraph (a)(2)(iii) of this section, Corporation X is not an actual shareholder of Corporation Y, the issuing corporation. Therefore, Corporation X cannot designate any share of Corporation Y stock to which the basis, if any, of the nominal share of Corporation Y stock will attach. Furthermore, Corporation P cannot designate a share of Corporation Y stock to which basis will attach because Corporation P receives the nominal share with a basis of zero.

(d) *Effective/applicability date*. This section applies to exchanges and distributions of stock and securities occurring on or after November 21, 2011.

(e) *Expiration date*. This section expires on or before November 18, 2014.

Steven T. Miller,
Deputy Commissioner for Services and Enforcement.

Approved November 1, 2011.

Emily S. McMahon,
Acting Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on November 18, 2011, 8:45 a.m., and published in the issue of the Federal Register for November 21, 2011, 76 F.R. 71878)

Section 6011.—General Requirement of Return, Statement, or List

26 CFR 26.6011–4: Requirement of statement disclosing participation in certain transactions by taxpayers.

T.D. 9556

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 26 and 301

Generation-Skipping Transfers (GST) Section 6011 Regulations and Amendments to the Section 6112 Regulations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that provide rules relating to the disclosure of listed transactions and transactions of interest with respect to the generation-skipping transfer tax under section 6011 of the Internal Revenue Code (Code), conforming amendments under sections 6111 and 6112, and rules relating to the preparation and maintenance of lists with respect to reportable transactions under section 6112. The regulations affect taxpayers participating in listed transactions and transactions of interest and material advisors to such transactions. The final regulations also contain rules under section 6112 that affect material advisors to reportable transactions. These regulations provide guidance regarding the length of time a material advisor has to prepare the list that must be maintained after the list maintenance requirement first arises with respect to a reportable transaction. These regulations also clarify guidance regarding designation agreements.

DATE: These regulations are effective November 14, 2011.

FOR FURTHER INFORMATION CONTACT: Charles D. Wien, (202) 622–3070 (not a toll-free number).

Background

This document contains final regulations that amend 26 CFR part 26 to provide rules for purposes of the generation-skipping transfer tax that require the disclosure of listed transactions and transactions of interest by certain taxpayers on their Federal tax returns under section 6011. This document also contains final regulations that modify and clarify some of the rules under 26 CFR part 301 relating to the disclosure obligations of material advisors under section 6111 and the list maintenance requirements of material advisors with respect to reportable transactions under section 6112.

On July 31, 2007, the IRS and Treasury Department issued final regulations under section 6011 (T.D. 9350, 72 FR 43146) 6111 (T.D. 9351, 72 FR 43157) and 6112 (T.D. 9352, 72 FR 43154) (the July 2007 regulations) that were published in the **Federal Register** on August 3, 2007. In the July 2007 regulations, the IRS and Treasury Department amended 26 CFR parts 20, 25, 31, 53, 54, and 56 to provide that certain taxpayers would be required to disclose transactions of interest, in addition to listed transactions,

on their Federal tax returns under section 6011. On September 10, 2009, the IRS and Treasury Department issued a notice of proposed rulemaking under sections 6011, 6111, and 6112 (REG–136563–07) (the September 2009 proposed regulations). The September 2009 proposed regulations were published in the **Federal Register** (74 FR 46705) on September 11, 2009.

In response to the September 2009 proposed regulations, the IRS and Treasury Department received two written public comments. A public hearing was not requested. After consideration of the comments received, the IRS and Treasury Department are adopting the proposed regulations without change.

Explanation of Comments

Two commentators expressed concern that if the IRS and Treasury Department designate a transaction involving gift, estate, or generation-skipping transfer taxes as a listed transaction or transaction of interest, that a corporate fiduciary, merely by acting as an executor or trustee with respect to an estate or trust that is incidental to the transaction, would be treated as a material advisor under section 6112 and the regulations thereunder. One of the commentators proposed that the September 2009 proposed regulations and existing final regulations under sections 6011, 6111, and 6112 be amended to require public comment before a transaction involving Chapters 11, 12, and 13 of the Code can be designated as a listed transaction or transaction of interest.

The IRS and Treasury Department believe that in the situation described by the commentators the existing regulations under sections 6111 and 6112 properly address which parties are material advisors, and transactions involving gift, estate, or generation-skipping transfer taxes should not be treated differently than other transactions. A fiduciary will not be treated as a material advisor merely by acting as an executor or trustee with respect to an estate or trust that is incidental to a transaction. A fiduciary will be treated as a material advisor only if the fiduciary provides material aid, assistance or advice as described in §301.6111–3(b)(2), the fiduciary directly or indirectly derives gross income in excess of the threshold amount as described in §301.6111–3(b)(3), and the transaction is entered into by the taxpayer.

In addition, the regulations are not amended to require advance notice before designating a transaction as a transaction of interest or as a listed transaction as suggested by a commentator. In appropriate circumstances, the IRS and Treasury Department may choose to publish advance notice of a transaction of interest and request comments in certain circumstances. The IRS and Treasury Department will determine whether to provide advance notice and a request for comments on a transaction by transaction basis. Accordingly, the proposed regulations will be adopted without change.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that most of the material advisors affected by these regulations are not small entities and for those material advisors that are small entities most of the information is already required under the current regulations. Any additional recordkeeping burdens on material advisors that result from this regulation are insubstantial. Also, the collection of information referenced in these regulations has been approved under OMB control number 1545–1686. The clarification and new information required by these final regulations add little or no new burden to those existing requirements. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

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

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 26 and 301 are amended as follows:

PART 26—GENERATION-SKIPPING TRANSFER TAX REGULATIONS UNDER THE TAX REFORM ACT OF 1986

Paragraph 1. The authority citation for part 26 is amended to read in part as follows:

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

Section 26.6011–4 also issued under 26 U.S.C. 6011 * * *

Par. 2. Section 26.6011–4 is added to read as follows:

§26.6011–4 Requirement of statement disclosing participation in certain transactions by taxpayers.

(a) *In general.* If a transaction is identified as a *listed transaction* or a *transaction of interest* as defined in §1.6011–4 of this chapter by the Commissioner in published guidance, and the listed transaction or transaction of interest involves a tax on generation-skipping transfers under chapter 13 of subtitle B of the Internal Revenue Code, the transaction must be disclosed in the manner stated in such published guidance.

(b) *Effective/applicability date.* This section applies to listed transactions and transactions of interest entered into on or after November 14, 2011.

PART 301—PROCEDURE AND ADMINISTRATION

Par. 3. The authority citation for part 301 continues to read in part as follows:

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

Par. 4. Section 301.6111–3 is amended as follows:

1. Paragraphs (b)(2)(i)(A) and (b)(3)(i)(B) are amended by adding the language "26.6011–4," after each occurrence of "25.6011–4,".

2. Paragraphs (c)(2) and (c)(13) are amended by adding the language "26.6011–4," after "25.6011–4,".

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

The revision reads as follows:

§301.6111–3 Disclosure of reportable transactions.

* * * * *

(i) *Effective/applicability date*—(1) *In general*. This section applies to transactions with respect to which a material advisor makes a tax statement on or after August 3, 2007. However, this section applies to transactions of interest entered into on or after November 2, 2006, with respect to which a material advisor makes a tax statement under this section on or after November 2, 2006. Paragraphs (b)(2)(i)(A), (b)(3)(i)(B), (c)(2), and (c)(13) of this section apply to transactions with respect to which a material advisor makes a tax statement under this section after November 14, 2011. Paragraph (h) of this section applies to ruling requests received on or after November 2, 2006. Otherwise, the rules that apply on or before November 14, 2011 are contained in this section in effect prior to November 14, 2011, (see 26 CFR part 301 revised as of April 1, 2011).

* * * * *

Par. 5. Section 301.6112–1 is amended as follows:

1. Paragraph (b)(1) is revised.

2. Paragraphs (c)(3) and (c)(12) are amended by adding the language "26.6011–4," after "25.6011–4,".

3. Paragraphs (f) and (g) are revised.

The revisions read as follows:

§301.6112–1 Material advisors of reportable transactions must keep lists of advisees, etc.

* * * * *

(b) * * * (1) *In general*. A separate list must be prepared and maintained for each reportable transaction. However, one list must be maintained for substantially similar transactions. A material advisor will have 30 calendar days from the date the list maintenance requirement first arises (see §301.6111–3(b)(4) and paragraph (a) of this section) with respect to a reportable transaction to prepare the list that must be maintained under this section with respect to that transaction. The Commissioner in his discretion also may provide in published guidance designating a transaction as a reportable transaction a list preparation time period greater than 30 calendar days. If a list is requested under this section during the list preparation time period, the request for the list will be treated as having been made on the day after the list preparation time period ends. A list must be maintained in a form that enables the IRS to determine without undue delay or difficulty the information required in paragraph (b)(3) of this section. The Commissioner in his discretion may provide in published guidance a form or method for maintaining or furnishing the list.

* * * * *

(f) *Designation agreements*. If more than one material advisor is required to maintain a list of persons for a reportable transaction, in accordance with paragraph (b) of this section, the material advisors may designate by written agreement a single material advisor (the designated material advisor) to maintain the list or a portion of the list. A designation agreement does not relieve material advisors from their obligation to maintain a list in accordance with paragraph (b) of this section or to furnish their list to the IRS in accordance with paragraph (e)(1) of this section, but a designation agreement may allow one material advisor to maintain a list on behalf of the other material advisors who are a party to the designation agreement. A material advisor is not relieved from the requirement of this section because a material advisor is unable to obtain the list from any designated material advisor, any designated material advisor did not maintain a list, or the list maintained by any designated material advisor is not complete. The existence of a designation agreement does not affect the ability of the IRS to request a list from any party to the designation agreement. The IRS may request a list from any party to the designation agreement, and the party receiving the request must furnish their list to the IRS in accordance with paragraph (e)(1) of this section, regardless of whether their list was maintained by another party pursuant to the terms of a designation agreement.

(g) *Effective/applicability date*. In general, this section applies to transactions with respect to which a material advisor makes a tax statement under §301.6111–3 on or after August 3, 2007. However, this section applies to transactions of interest entered into on or after November 2, 2006, with respect to which a material advisor makes a tax statement under §301.6111–3 on or after November 2, 2006. Paragraphs (b)(1), (c)(3), (c)(12), and (f) of this section apply to transactions with respect to which a material advisor makes a tax statement under §301.6111–3 after November 14, 2011.

Otherwise, the rules that apply on or before November 14, 2011, are contained in this section in effect prior to November 14, 2011, (see 26 CFR part 301 revised as of April 1, 2011).

Steven T. Miller,
Deputy Commissioner for Services and Enforcement.

Approved November 4, 2011.

Emily S. McMahon,
Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on November 10, 2011, 8:45 a.m., and published in the issue of the Federal Register for November 14, 2011, 76 F.R. 70340)

Part IV. Items of General Interest

Notice of Proposed Rulemaking and Notice of Public Hearing

Gross Estate; Election to Value on Alternate Valuation Date

REG–112196–07

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations that provide guidance respecting the election to use the alternate valuation method under section 2032 of the Internal Revenue Code (Code). The proposed regulations will affect estates that file Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return* and elect to use the alternate valuation method. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by February 16, 2012. Outlines of topics to be discussed at the public hearing scheduled for March 9, 2012, at 10:00 a.m. must be received by February 17, 2012.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–112196–07), Internal Revenue Service, Room 5203, PO Box 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:LPD:PR (REG–112196–07), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC 20224; or sent electronically via the Federal eRulemaking Portal at *http://www.regulations.gov* (IRS-REG–112196–07). The public hearing will be held in the Auditorium, beginning at 10 a.m., at the Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Theresa M. Melchiorre, (202) 622–3090; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Richard Hurst at *Richard.A.Hurst@irscounsel.treas.gov* or at (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Section 2001 imposes a tax on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States. Section 2033 provides that the value of the gross estate includes the value of all property to the extent of the interest of the decedent at the time of his death. Section 2031(a) provides that the value of the decedent's gross estate includes the value at the time of the decedent's death of all property, real or personal, tangible or intangible, wherever situated. Section 2032(a) provides that the value of the gross estate may be determined, if the executor so elects, by valuing all the property includible in the gross estate as follows. Property distributed, sold, exchanged, or otherwise disposed of during the 6-month period immediately after the date of death (alternate valuation period) is valued as of the date of distribution, sale, exchange, or other disposition (transaction date). I.R.C. section 2032(a)(1). Property not distributed, sold, exchanged, or otherwise disposed of during the alternate valuation period is valued as of the date that is 6 months after the decedent's death (6-month date). I.R.C. section 2032(a)(2). Any interest or estate that is affected by the mere lapse of time is includible at its value as of the date of death (instead of any later date), with adjustment for any difference in its value as of the later date that is not due to the mere lapse of time. I.R.C. section 2032(a)(3).

Section 2031(c) was enacted by the Taxpayer Relief Act of 1997, 105 Public Law 34 section 508(a), 111 Stat. 788 (August 5, 1997). Pursuant to this section, a decedent's estate may elect to exclude from the gross estate a portion of the fair market value of property includible in the decedent's gross estate by granting a qualified conservation easement on that property after the date of the decedent's death but on or before the due date (including extensions) for filing the Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*.

On April 25, 2008, a notice of proposed rulemaking (REG–112196–07, 2008–21 I.R.B. 1021) relating to amendments to the Estate Tax Regulations (26 CFR part 20) under section 2032 of the Code was published in the **Federal Register** (73 FR 22300). Those regulations (73 FR 22300) proposed to clarify that the election to use the alternate valuation method under section 2032 is available to estates that experience a reduction in the value of the gross estate during the alternate valuation period, but only to the extent that the reduction in value is due to market conditions and not to other post-death events (events occurring during the alternate valuation period). The term "market conditions" was defined as events outside of the control of the decedent (or the decedent's executor or trustee) or other person whose property is being valued that affect the fair market value of the property includible in the decedent's gross estate. Changes in value due to mere lapse of time or to other post-death events would be ignored in determining the value of the decedent's gross estate under the alternate valuation method.

No hearing was held because no person or organization requested to speak at a hearing. However, written comments were received. Some commentators expressed concern that the proposed regulations (73 FR 22300) would create administrative problems because an estate would be required to trace property and to obtain appraisals based on hypothetical property. Some commentators stated that the current and the proposed regulations (73 FR 22300) did not adequately address the application of section 2032 to certain types of property, such as property the title to which passes at death due to contract, and to transactions carried out during the alternate valuation period between an estate and partnerships, corporations, or other entities. For example, §20.2032–1(c)(1) does not address the consequences of the estate

contributing property to a partnership during the alternate valuation period.

In addition, commentators requested guidance on the effect of a section 2032 election in calculating the portion of a trust includible in the decedent's gross estate under section 2036. This would arise in the situation where the decedent had retained the right to an annuity, unitrust, or other payment from the trust for life, for any period not ascertainable without reference to the grantor's death, or for a period that does not in fact end before the grantor's death. Further, some commentators requested guidance on the treatment of the grant, during the alternate valuation period, of a qualified conservation easement under section 2031(c).

Many commentators acknowledged that estates may enter into a transaction during the alternate valuation period that could result in the abuse of the section 2032 election. They suggested that the IRS and Treasury Department would better serve taxpayers and address any potential abuse by ensuring that the regulations address the issues described in this preamble rather than finalizing the approach taken in the proposed regulations.

In view of the comments, the Treasury Department and the IRS are withdrawing the proposed regulations (73 FR 22300) by the publication of these proposed regulations in the **Federal Register**. Nevertheless, see the background section of those proposed regulations (73 FR 22300) for a summary of the legislative history of section 2032 and the purpose for issuing these proposed regulations.

This document contains revised proposed amendments to the regulations promulgated under section 2032. These proposed regulations make irrelevant, for purposes of determining the value of property as of the transaction date or the 6-month date, whichever is applicable (alternate valuation date), the percentage of ownership or control in an entity includible in the gross estate and the extent of participation by the estate (or other holder of property includible in the gross estate) in the relevant post-death events.

Certain provisions in the current regulations that have been in effect since 1954 are restated in the proposed regulations for purposes of clarity. The effective date of those provisions is not changed.

Explanation of Provisions

These regulations propose to amend several sections of §20.2032–1. Generally, paragraph (c)(1)(i) identifies transactions that constitute distributions, sales, exchanges, or dispositions of property. If an estate's (or other holder's) property is subject to such a transaction during the alternate valuation period, the estate must value that property on the transaction date. The value included in the gross estate is the fair market value of that property on the date of and immediately prior to the transaction. The term "property" refers to the property includible in the decedent's gross estate under section 2033.

Sections 20.2032–1(c)(1)(ii) and (c)(1)(iii)(A) identify two exceptions to the rule in §20.2032–1(c)(1)(i). If either exception applies, the estate may use the 6-month date and value the property held on that date. The exception in §20.2032–1(c)(1)(ii) applies only to transactions in which an interest in a corporation, partnership, or other entity (entity) includible in the decedent's gross estate is exchanged for one or more different interests (for example, a different class of stock) in the same entity or in an acquiring or resulting entity or entities during the alternate valuation period. Such transactions may include, without limitation, reorganizations, recapitalizations, mergers, or similar transactions. This exception substitutes a fair market value test for the corporate provisions in the current regulations. Specifically, this paragraph proposes that, if, during the alternate valuation period, the interest in an entity includible in the gross estate is exchanged for a different interest in the same entity, or in an acquiring or resulting entity or entities, and if the fair market value of the interest on the date of the exchange equals the fair market value of the property for which it was exchanged, then the transaction will not be treated as an exchange for purposes of section 2032(a)(1). As a result, the estate may use the 6-month date to value the interest in the same entity or in the acquiring or resulting entity or entities received in the exchange. For this purpose, the fair market values of the surrendered property and received interest are deemed to be equal if the difference between the fair market values of the surrendered property and the received interest does not exceed 5 percent of the fair market value of the surrendered property as of the transaction date. This section has no effect on any other provision of the Code that is applicable to the transaction. For example, the provisions of chapter 14 may apply even if the transaction does not result in a deemed exchange for section 2032 purposes as a result of satisfying the provisions of §20.2032–1(c)(1)(ii).

Section 20.2032–1(c)(1)(iii)(A) proposes that, if, during the alternate valuation period, an estate (or other holder) receives a distribution from a business entity, bank account, or retirement trust (entity) and an interest in that entity is includible in the decedent's gross estate, the estate may use the 6-month date to value the property held in the estate if the following requirement is satisfied. The fair market value of the interest in the entity includible in the gross estate immediately before the distribution must equal the sum of the fair market value of the distributed property on the date of the distribution and the fair market value of the interest in the entity includible in the gross estate immediately after the distribution. If this requirement is not satisfied, the estate must use the fair market value as of the distribution date and immediately prior to the distribution of the entire interest in the entity includible in the gross estate. For purposes of this section, any distribution is deemed to consist first of excluded property (as defined in §20.2032–1(d)), if any, and then of included property.

Section 20.2032–1(c)(1)(iv) proposes an aggregation rule to use in calculating the fair market value of each portion of property that is, or is deemed to be distributed, sold, exchanged, or otherwise disposed of during the alternate valuation period, and that remains in the gross estate on the 6-month date.

Section 20.2032–1(c)(iii)(B) provides a special rule to use in determining the portion of a trust includible, by reason of a retained interest, in the decedent's gross estate under section 2036 as of the alternate valuation date. An example is added to §20.2032–1(e) to illustrate this special rule and the effect of the provisions of §20.2032–1(d) and §20.2032–1(f)(2)(i) on this calculation.

Section 20.2032–1(c)(2) is amended to clarify when property, the title to which passes by contract or by operation of law, is

deemed to be distributed, sold, exchanged, or otherwise disposed of for section 2032 purposes. Section 20.2032–1(c)(3) is amended to clarify the person or entity that will be treated as having sold, exchanged, or otherwise disposed of the property for section 2032 purposes.

Section 20.2032–1(c)(4) is added to provide that if Congress, by statute, has deemed that a post-death event has occurred on the decedent's date of death, the post-death event will not result in a distribution, sale, exchange, or other disposition of the property for section 2032 purposes. To date, the only post-death event that satisfies this exception is the grant, during the alternate valuation period, of a conservation easement in accordance with section 2031(c). With respect to such a grant, for section 2032 purposes, the estate must determine the fair market value of the property as of the date of death and as of the alternate valuation date, taking into account the effect of the easement on each of those valuation dates.

Section 20.2032–1(c)(5) provides examples, not intended to be exclusive, illustrating the provisions of §20.2032–1(c).

Section 20.2032–1(f) is revised to clarify the types of factors that impact the fair market value of property and the effect of which will be recognized under section 2032. This paragraph also explains and illustrates these rules.

Proposed Effective/Applicability Date

Section 20.2032–1(c)(2) except the second sentence of the introductory text, §20.2032–1(c)(3) except §20.2032–1(c)(3)(i)(C), the chart in *Example 1* of §20.2032–1(e), §20.2032–1(f)(2) except the last sentence, and the first and third sentences in §20.2032–1(f)(2)(ii) are applicable to decedents dying after August 16, 1954. Sections 20.2032–1(a) introductory text, 20.2032–1(a)(1), 20.2032–1(a)(2), 20.2032–1(c)(1)(i), (c)(1)(ii), (c)(1)(iii), (c)(1)(iv), (c)(3)(i)(C), (c)(4), (c)(5), (f)(1), (f)(2)(i), and (f)(3), the second sentence in §20.2032–1(c)(2) introductory text, §20.2032–1(e) except the chart in *Example 1*, the last sentence in §20.2032–1(f)(2) introductory text, and the second sentence in §20.2032–1(f)(2)(ii) are applicable to estates of decedents dying on or after the date of publication of the Treasury decision adopting these rules as final in the **Federal Register**.

Special Analyses

It has been determined that this proposed regulation is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and, because these regulations do not impose on small entities a collection of information requirement, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this regulation has been 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 also 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 March 9, 2012 at 10:00 a.m. in Auditorium, Internal Revenue Building. Due to building security procedures, visitors must use the main building entrance 1111 Constitution Avenue NW, Washington, DC. 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 more information about having your name placed on the 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 written (a signed original and eight (8) copies) or electronic comments by February 16, 2012 and an outline of the topics to be discussed and the time to be devoted to each topic by February 17, 2012. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is Theresa M. Melchiorre, Office of Associate Chief Counsel (Passthroughs and Special Industries).

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Withdrawal of Notice of Proposed Rulemaking

Under the authority of 26 U.S.C. 7805, the notice of proposed rulemaking (REG–112196–07) that was published in the **Federal Register** on April 25, 2008 (73 FR 22300) is withdrawn.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 20 is proposed to be amended as follows:

PART 20—ESTATE TAX; ESTATES OF DECEDENTS DYING AFTER AUGUST 16, 1954

Paragraph 1. The authority citation for part 20 continues to read in part as follows:

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

§20.2032–1[AMENDED]

Par. 2. For each entry in the table, each paragraph in the "Old Paragraph" column is redesignated as indicated in the "New Paragraph" column:

Old Paragraph	New Paragraph
20.2032–1(c)(1)	20.2032–1(c)(1)(i)
20.2032–1(c)(3)	20.2032–1(c)(3)(i)
20.2032–1(c)(3)(i)	20.2032–1(c)(3)(i)(A)
20.2032–1(c)(3)(ii)	20.2032–1(c)(3)(i)(B)
20.2032–1(c)(3)(iii)	20.2032–1(c)(3)(i)(C)
20.2032–1(c)(3)(iv)	20.2032–1(c)(3)(i)(D)
20.2032–1(c)(3)(v)	20.2032–1(c)(3)(i)(E)
20.2032–1(f)	20.2032–1(f)(2)
20.2032–1(f)(1)	20.2032–1(f)(2)(i)
20.2032–1(f)(2)	20.2032–1(f)(2)(ii)

Par. 3. Section 20.2032–1 is amended by:

1. Revising paragraph (a) introductory text.

2. Revising paragraphs (a)(1) and (a)(2).

3. Revising newly-designated paragraph (c)(1)(i), newly-designated paragraph (c)(3)(i)(C), paragraph (e) introductory text, the introductory text of paragraph (e) *Example 1* preceding the table, the last sentence in newly-designated paragraph (f)(2) introductory text, newly-designated paragraph (f)(2)(i), and the second sentence in newly-designated paragraph (f)(2)(ii).

4. Adding new paragraphs (c)(1)(ii), (c)(1)(iii), (c)(1)(iv), (c)(4), (c)(5), (f)(1), and (f)(3).

5. Adding a paragraph heading and a new second sentence in paragraph (c)(2) introductory text.

6. Adding a paragraph heading to paragraph (c)(3).

7. Designating the undesignated language following newly-designated paragraph (c)(3)(i)(E) as paragraph (c)(3)(ii) and adding a paragraph heading to this paragraph.

8. Designating the table in paragraph (e) as *Example 1* and adding paragraph (e) *Example 2* following the table.

9. Revising the paragraph heading and adding two sentences at the end of paragraph (h).

The additions and revisions read as follows.

§20.2032–1 Alternate valuation.

(a) *In general.* — In general, section 2032 provides for the valuation of a decedent's gross estate at a date (alternate valuation date) other than the date of the decedent's death. More specifically, if an executor elects the alternate valuation method under section 2032, the property includible in the decedent's gross estate on the date of death (decedent's interest) is valued as of whichever of the following dates is applicable:

(1) Any property distributed, sold, exchanged, or otherwise disposed of within 6 months (1 year, if the decedent died on or before December 31, 1970) after the decedent's death (alternate valuation period) is valued as of the date on which it is first distributed, sold, exchanged, or otherwise disposed of (transaction date).

(2) Any property not distributed, sold, exchanged, or otherwise disposed of during the alternate valuation period is valued as of the date 6 months (1 year, if the decedent died on or before December 31, 1970) after the date of the decedent's death (6-month date).

* * * * *

(c) *Meaning of "distributed, sold, exchanged, or otherwise disposed of"*—(1) *In general.*

(i) *Transactions included.* The phrase "distributed, sold, exchanged, or otherwise disposed of" comprehends all possible ways by which property ceases to form a part of the gross estate. This phrase includes, but is not limited to:

(A) The use of money on hand at the date of the decedent's death to pay funeral or other expenses of the decedent's estate;

(B) The use of money on hand at the date of the decedent's death to invest in other property;

(C) The exercise of employee stock options;

(D) The surrender of stock for corporate assets in partial or complete liquidation of a corporation, and similar transactions involving partnerships or other entities;

(E) The distribution by the estate (or other holder) of included property as defined in paragraph (d) of this section;

(F) The transfer or exchange of property for other property, whether or not gain or loss is currently recognized for income tax purposes;

(G) The contribution of cash or other property to a corporation, partnership, or other entity, whether or not gain or loss is currently recognized for income tax purposes;

(H) The exchange of interests in a corporation, partnership, or other entity (entity) for one or more different interests (for example, a different class of stock) in the same entity or in an acquiring or resulting entity or entities (see, however, paragraph (c)(1)(ii) of this section); and

(I) Any other change in the ownership structure or interests in, or in the assets of, a corporation, partnership, or other entity, an interest in which is includible in the gross estate, such that the included property after the change does not reasonably represent the included property at the decedent's date of death (see, however, paragraph (c)(1)(iii)(A) of this section). Such a change in the ownership structure or inter-

ests in or in the assets of an entity includes, without limitation—

(*1*) The dilution of the decedent's ownership interest in the entity due to the issuance of additional ownership interests in that entity;

(*2*) An increase in the decedent's ownership interest in the entity due to the entity's redemption of the interest of a different owner;

(*3*) A reinvestment of the entity's assets; and

(*4*) A distribution or disbursement of property (other than excluded property as defined in paragraph (d) of this section) by the entity (other than expenses, such as rents and salaries, paid in the ordinary course of the entity's business), with the effect that the fair market value of the entity before the occurrence does not equal the fair market value of the entity immediately thereafter.

(ii) *Exchange of an interest in an existing corporation, partnership, or other entity includible in the gross estate.* If an interest in a corporation, partnership, or other entity (entity) is includible in the gross estate at death and that interest is exchanged as described in paragraph (c)(1)(i)(H) of this section for one or more different interests in the same entity or in an acquiring or resulting entity or entities, the transaction does not result in an exchange or disposition under section 2032(a)(1) and paragraph (c)(1)(i)(H) of this section if, on the date of the exchange, the fair market value of the interest in the entity equals the fair market value of the interest(s) in the same entity or the acquiring or resulting entity or entities. Such transactions may include, without limitation, reorganizations, recapitalizations, mergers, or similar transactions. In determining whether the exchanged properties have the same fair market value, a difference in value equal to or less than 5 percent of the fair market value, as of the transaction date, of the property interest includible in the gross estate on the decedent's date of death is ignored. If the transaction satisfies the requirements of this paragraph, the property to be valued on the 6-month date (or on the transaction date, if any, subsequent to this transaction) is the property received in the exchange, rather than the property includible in the decedent's gross estate at the date of death. This paragraph has no effect on any other provision of the Internal Revenue Code that is applicable to the transaction. For example, even if the transaction does not result in a deemed exchange as a result of satisfying the requirements of this paragraph, the provisions of chapter 14 may be applicable to determine fair market value for Federal estate tax purposes.

(iii) *Distributions from an account or entity in which the decedent held an interest at death.*

(A) *In general.* If during the alternate valuation period, an estate (or other holder of the decedent's interest) receives a distribution or disbursement (to the extent the distribution or disbursement consists of included property, as defined in paragraph (d) of this section) (payment) from a partnership, corporation, trust (including an IRA, Roth IRA, 403(b), 401(k), Thrift Savings Plan, etc.), bank account or similar asset, or other entity (entity), and an interest in that entity is includible in the gross estate, the payment does not result in a distribution under paragraph (c)(1)(i)(I) of this section. However, this rule applies only if, on the date of the payment, the fair market value of the decedent's interest in the entity before the payment equals the sum of the fair market value of the payment made to the estate (or other holder of the decedent's interest in the entity) and the fair market value of the decedent's interest in the entity, not including any excluded property, after the payment. In this case, the alternate valuation date of the payment is the date of the payment, and the alternate valuation date of the decedent's remaining interest in the entity, if any, is the 6-month date (or the transaction date, if any, subsequent to this payment). If this requirement is not met, the payment is a distribution under paragraph (c)(1)(i) of this section, and the alternate valuation date of the decedent's entire interest in the entity is the date of the payment. For purposes of this section, a distribution or disbursement is deemed to consist first of excluded property, if any, and then of included property, as those terms are defined in paragraph (d) of this section.

(B) *Special rule.* If the decedent's interest in an entity that is includible in the gross estate consists of the amount needed to produce an annuity, unitrust, remainder, or other such payment valued under section 2036, then assuming the distribution satisfies the general rule set forth in paragraph (c)(1)(iii)(A) of this section, the value of each distribution (to the extent it is deemed to consist of included property) payable (whether or not actually paid) during the alternate valuation period shall be added to the value of the entity on the alternate valuation date. The sum of the fair market value of these distributions when made and the fair market value of the entity on the alternate valuation date shall be used as the fair market value of the entity in computing the amount, valued as of the alternate valuation date, to be included in the decedent's gross estate under section 2036. See *Example 2* of paragraph (e) of this section.

(iv) *Aggregation.* For purposes of this section, a special aggregation rule applies in two situations to determine the value to be included in the gross estate pursuant to an alternate valuation election. Those two situations arise when, during the alternate valuation period, less than all of the interest includible in the decedent's gross estate in a particular property is the subject of a transaction described in paragraphs (c)(1)(i), (c)(1)(ii), (c)(1)(iii), or (c)(2) of this section. In one situation, one or more portions of the includible interest are subject to such a transaction and a portion is still held on the 6-month date. In the other situation, the entire interest includible in the gross estate is disposed of in two or more such transactions during the alternate valuation period, so that no part of that interest remains on the 6-month date. In both of these situations, the fair market value of each portion of the interest includible in the gross estate is to be determined as follows. The fair market value of each portion subject to such a transaction, and the portion remaining, if any, on the 6-month date, is the fair market value, as of the transaction date, or the 6-month date for any remaining portion, of the entire interest includible in the gross estate on the decedent's date of death, multiplied by a fraction. The numerator of that fraction is the portion of the interest subject to that transaction, or the portion remaining on the 6-month date, and the denominator is the entire interest includible in the gross estate at the decedent's date of death.

(2) *Property distributed.* * * * Property is not considered "distributed" merely because property passes directly at death as a result of a beneficiary designation or other

contractual arrangement or by operation of law. * * *

(3) *Person able to sell, exchange, or otherwise dispose of property includible in the gross estate*. (i) * * *

(A) * * *

(B) * * *

(C) An heir, devisee, or other person to whom title to property passes directly on death by reason of a beneficiary designation or other contractual arrangement or by operation of law;

(D) * * *

(E) * * *

(ii) *Binding contracts*.* * *

(4) *Certain post-death events*. If the effect of any other provision of the Internal Revenue Code is that a post-death event is deemed to have occurred on the date of death, the post-death event will not be considered a transaction described in paragraph (c)(1)(i) of this section. For example, the grant, during the alternate valuation period, of a qualified conservation easement in accordance with section 2031(c) is not a transaction described in paragraph (c)(1)(i) of this section. Pursuant to section 2031(c), the post-death grant of the easement is effective for Federal estate tax purposes as of the date of the decedent's death. As a result, for purposes of determining both the estate's eligibility to make an election under this section and the value of the property on the alternate valuation date, the fair market value of the property as of the date of death must be compared to the fair market value of that property as of the alternate valuation date, in each case as that value is adjusted by reason of the existence of the section 2031(c) qualified easement.

(5) *Examples*. The application of paragraph (c) of this section is illustrated in the following examples. In each example, decedent's (D's) estate elects to value D's gross estate under the alternate valuation method, so that the alternate valuation date of the property includible in the gross estate on D's date of death is either the transaction date or the 6-month date. In each example, assume that the only factors affecting value during the alternate valuation period, and the only occurrences described in paragraphs (c)(1)(i) and (c)(2) of this section, are those described in the example.

Example 1. At D's death, D owned property with a fair market value of $100X. Two months after D's death (Date 1), D's executor and D's family members formed a limited partnership. D's executor contributed all of the property to the partnership and received an interest in the partnership in exchange. The investment of the property in the partnership is a transaction described in paragraph (c)(1)(i)(F) and/or (G) of this section. As a result, the alternate valuation date of the property is the date of its contribution and the value to be included in D's gross estate is the fair market value of the property immediately prior to its contribution to the partnership. The result would be the same if D's estate instead had contributed property to a limited partnership formed prior to D's death by D and/or other parties, related or unrelated to D. Further, the result would be the same if D's estate had contributed the property to a corporation, publicly traded or otherwise, or other entity after D's death and prior to the 6-month date.

Example 2. At D's death, D held incentive stock options that were qualified under section 422. D's executor exercised all of the stock options prior to the 6-month date. The exercise of the stock options is a transaction described in paragraph (c)(1)(i)(C) of this section. Thus, the alternate valuation date of the stock options is the date of their exercise and the value to be included in D's gross estate is the fair market value of the stock options immediately prior to their exercise. The result would be the same if the stock options were not qualified under section 422 and were taxable under section 83 upon exercise.

Example 3. D's gross estate includes a controlling interest in Y, a corporation. During the alternate valuation period, Y issued additional shares of stock and awarded them to certain key employees. D's interest in Y was diluted to a non-controlling interest by Y's issuance of the additional stock. Y's issuance of the stock is a transaction described in paragraph (c)(1)(i)(I) of this section. The value to be included in D's gross estate is the fair market value of D's stock immediately prior to Y's issuance of the additional stock. The result would be the same if D's estate included a minority interest in Y on the date of death and that interest became a controlling interest during the alternate valuation period as the result of Y's redemption of the shares of another shareholder.

Example 4. At D's death, D owned stock in Y, a corporation. During the alternate valuation period, the Board of Directors of Y contributed all of Y's assets to a partnership in exchange for interests therein. The contribution is a transaction described in paragraph (c)(1)(i)(I)(*3*) of this section. Therefore, the alternate valuation date of D's stock in Y is the date of the reinvestment of Y's assets and the value to be included in D's gross estate is the fair market value of D's stock in Y immediately prior to the reinvestment. The result would be the same even if the Board of Directors had contributed only a portion of Y's assets to the partnership during the alternate valuation period.

Example 5. (i) At D's death, D owned common stock in Y, a corporation. Two months after D's death (Date 1), there was a reorganization of Y. In the reorganization, D's estate exchanged all of its stock for a new class of stock in X. On the date of the reorganization, the difference between the fair market value of the stock D's estate received and the fair market value on that date of the stock includible in D's gross estate at death was greater than 5% of the fair market value, as of the date of the reorganization, of the stock D held at death. The reorganization is a transaction described in paragraph (c)(1)(i)(H) of this section and does not satisfy the exception described in paragraph (c)(1)(ii) of this section. Thus, the alternate valuation date is the date of the reorganization and the value to be included in D's gross estate is the fair market value of the stock immediately prior to the reorganization. This result is not affected by whether or not the reorganization is a tax-free reorganization for Federal income tax purposes. The result would be the same if the stock had been held, for example, in an IRA with designated beneficiaries. See paragraph (c)(3)(i)(C) of this section.

(ii) If, instead, the difference between the two fair market values as of the date of the reorganization was equal to or less than 5% of the fair market value, as of the date of the reorganization, of the stock D held at death, the reorganization would satisfy the exception provided in paragraph (c)(1)(ii) of this section. Thus, the alternate valuation date would be the 6-month date. The value to be included in D's gross estate would be the fair market value, determined as of the 6-month date, of the new class of stock in Y that D's estate received in the reorganization.

Example 6. (i) At D's death, D owned an interest in Partnership X that is includible in D's gross estate. During the alternate valuation period, X made a cash distribution to each of the partners. The distribution consists entirely of included property as defined in paragraph (d) of this section. The distribution is a transaction described in paragraph (c)(1)(i)(I)(*4*) of this section. On the date of the distribution, the fair market value of D's interest in X before the distribution equaled the sum of the distribution paid to D's estate and the fair market value of D's interest in X immediately after the distribution. Thus, pursuant to paragraph (c)(1)(iii)(A) of this section, the alternate valuation date of the property distributed is the date of the distribution, and the alternate valuation date of D's interest in X is the 6-month date.

(ii) If, instead, the fair market value of D's interest in X before the distribution did not equal the sum of the distribution paid to D's estate and the fair market value of D's interest in X (not including any excluded property) immediately after the distribution, then pursuant to paragraph (c)(1)(i)(I)(*4*) of this section, the alternate valuation date of D's entire interest in X would be the date of the distribution.

Example 7. D died owning 100% of Blackacre. D's will directs that an undivided 70% interest in Blackacre is to pass to Trust A for the benefit of D's surviving spouse, and an undivided 30% interest is to pass to Trust B for the benefit of D's surviving child. Three months after D's death (Date 1), the executor of D's estate distributed a 70% interest in Blackacre to Trust A. Four months after D's death (Date 2), the executor of D's estate distributed a 30% interest in Blackacre to Trust B. The following values are includible in D's gross estate pursuant to paragraphs (c)(1)(i)(E) and (c)(1)(iv): the fair market value of the 70% interest in Blackacre, determined by calculating 70% of the fair market value of all (100%) of Blackacre as of Date 1; and the fair market value of the 30% interest in Blackacre, determined by calculating 30% of the fair market value of all (100%) of Blackacre as of Date 2.

Example 8. At D's death, D owned 100% of the units of a limited liability company (LLC). Two months after D's death (Date 1), D's executor sold 20% of the LLC units to an unrelated third party.

Three months after D's death (Date 2), D's executor sold 40% of the LLC units to D's child. On the 6-month date, the estate held the remaining 40% of the units in the LLC. The alternate valuation date of the units sold is their sale date (Date 1 and Date 2, respectively) pursuant to paragraph (a) of this section. The alternate valuation date of the units remaining in the estate is the 6-month date, as these units have not been distributed, sold, exchanged, or otherwise disposed of in a transaction described in paragraphs (c)(1)(i) or (c)(2) of this section prior to this date. Pursuant to paragraph (c)(1)(iv) of this section, the value of the units disposed of on Date 1 and Date 2 is the fair market value of the 20% and 40% interests, determined by calculating 20% and 40% of the fair market value as of Date 1 and Date 2, respectively, of all the units (100%) includible in the gross estate at D's death. Similarly, the value of the units held on the 6-month date to be included in D's gross estate is the fair market value of those units, determined by taking 40% of the fair market value on the 6-month date of all of the units (100%) includible in the gross estate at D's death. As a result, the fact that the partial sales resulted in the creation of three minority interests is not taken into account in valuing under section 2032 any portion of the LLC interests held by D at D's death.

Example 9. Husband died owning an interest in a brokerage account titled in the names of Husband and Wife with rights of survivorship. On Husband's death, the account held marketable securities, corporate bonds, municipal bonds, certificates of deposit, and cash. During the alternate valuation period, Wife's stockbroker advised her that the account could not be held under the social security number of a deceased individual. Accordingly, approximately one month after Husband's death, Wife directed the stockbroker to transfer the account into an account titled in Wife's sole name. Because title to the joint account passes to Wife at the moment of Husband's death by operation of law, the transfer of the joint account into an account in Wife's sole name is not a transaction described in paragraph (c)(1)(i) of this section. Accordingly, the value of the assets held in Wife's solely owned account will be includible in Husband's gross estate at their fair market value on the 6-month date. The result would be the same if the brokerage firm automatically transferred title to the account into Wife's name, or if Wife changed the beneficiary designation for the account. Finally, the result would be the same if, instead of an account with a brokerage firm, the assets were held in Husband's retirement account (IRA or similar trust such as a Roth IRA, 403(b) plan, or 401(k) plan) or Wife's ownership of the account was the result of a contract (a beneficiary designation form) rather than operation of law.

Example 10. Assume the same facts as in *Example 9* except that, during the alternate valuation period, Wife directed the stockbroker to sell a bond in the account. The sale is a transaction described in paragraph (c)(1)(i)(I)(*4*) of this section. Wife is an individual described in paragraph (c)(3)(i)(D) of this section. Thus, the alternate valuation date of the bond is the date of its sale. The values to be included in D's gross estate are the fair market value of the bond on date of its sale, and the fair market value of the balance of the account on the 6-month date. The result would be the same if the bond had matured and was retired during the alternate valuation period. The result also would be the same if the bond was held within a retirement account (IRA or similar trust such as a Roth IRA, 403(b) plan, or 401(k) plan).

Example 11. Assume the same facts as in *Example 9* except that, during the alternate valuation period, Wife withdrew cash from the account or otherwise received income or other disbursements from the account. Each such withdrawal or disbursement from the account (to the extent it consists of included property as defined in paragraph (d) of this section) is a distribution described in paragraph (c)(1)(i)(I)(*4*) of this section. Provided that, on the date of each distribution, the fair market value of the account before the distribution (not including excluded property) equals the sum of the included property distributed and the fair market value of the included property in the account immediately after the distribution in accordance with paragraph (c)(1)(iii)(A) of this section, the alternate valuation date for each distribution is the date of the distribution and the alternate valuation date for the account is the 6-month date. The value to be included in the gross estate is the fair market value of each distribution of included property (determined as of the date of distribution) and the fair market value of the account on the 6-month date. The result would be the same if the assets were held in an IRA or similar trust, such as a Roth IRA, 403(b) plan, or 401(k) plan.

Example 12. Husband died with a retirement account, having named his three children, in specified shares totaling 100%, as the designated beneficiaries of that account. During the alternate valuation period, the account was divided into three separate retirement accounts, each in the name of a different child and funded with that child's designated share. The division of the retirement account is not a transaction described in paragraph (c)(1)(i) of this section by reason of paragraph (c)(2) of this section, so the alternate valuation date for each of the new accounts is the 6-month date.

Example 13. (i) D's gross estate includes real property. During the alternate valuation period, D's executor grants a conservation easement that restricts the property's use under local law but does not satisfy the requirements of section 2031(c). The easement reduces the fair market value of the property. The executor's grant of the conservation easement is a transaction described in paragraph (c)(1)(i)(E) of this section and does not satisfy the exception described in paragraph (c)(4) of this section. Therefore, the alternate valuation date for the property is the date the easement was granted, and the value to be included in D's gross estate is the fair market value of the property immediately prior to the grant.

(ii) Assume, instead, that the easement satisfied the requirements of section 2031(c) and, thus, satisfied the exception described in paragraph (c)(4) of this section. Pursuant to paragraph (c)(4), for purposes of determining both the estate's eligibility to make an election under section 2032 and the value of the property on the 6-month date, the section 2031(c) qualified easement is taken into account in determining both the fair market value of the property on D's date of death and the fair market value of the property on the 6-month date.

* * * * *

(e) *Examples.* — The application of paragraph (d) of this section regarding "included property" and "excluded property" is illustrated by the following examples.

Example 1. Assume that the decedent (D) died on January 1, 1955: * * *

Example 2. (i) At death, D held a qualified interest described in section 2702(b) in the form of an annuity in a grantor retained annuity trust (GRAT) D had created and funded with $150,000. The trust agreement provides for an annual annuity payment of $12,000 per year to D or D's estate for a term of 10 years. At the expiration of the 10-year term, the remainder is to be distributed to D's child. D dies prior to the expiration of the 10-year term. On D's date of death, the fair market value of the property in the GRAT is $325,000.

(ii) The only assets in the GRAT are an apartment building and a bank account. Three months after D's date of death, an annuity payment of $12,000 is paid in cash to D's estate. The monthly rents from the apartment building total $500. After the date of death and prior to the payment date, the GRAT received $1,500 in excluded property in the form of rent. Pursuant to paragraph (c)(1)(iii)(A) of this section, $1,500 of the $12,000 distributed is deemed to be excluded property for purposes of section 2032. The distribution is a transaction described in paragraph (c)(1)(i)(I)(*4*) of this section. On the date of the distribution, the fair market value of D's interest in the GRAT before the distribution equals the sum of the distribution paid to D's estate and the fair market value of D's interest in the GRAT immediately after the distribution. Thus, pursuant to paragraph (c)(1)(iii)(A) of this section, the alternate valuation date for the $10,500 cash distribution, which is included property, is the date of its distribution, and the alternate valuation date of the GRAT is the 6-month date.

(iii) The calculation of the value of D's interest in the GRAT includible in D's gross estate at D's death pursuant to section 2036 must be computed under the special rule of paragraph (c)(1)(iii)(B) of this section as a result of the estate's election to use the alternate valuation method under section 2032. On the 6-month date, the section 7520 interest rate is 6% and the fair market value of the property in the GRAT is $289,500. Pursuant to paragraph (c)(1)(iii)(B) of this section, the fair market value of the GRAT property deemed to be included property is $300,000 ($289,500 plus $10,500). Accordingly, for purposes of determining the fair market value of the *corpus* includible in D's gross estate under section 2036(a)(1) as of the 6-month date, see §20.2036–1(c)(2), using a GRAT *corpus* of $300,000 and, pursuant to paragraph (f)(2)(i) of this section, a section 7520 rate of 6%.

(f) *Post-death factors and occurrences*.—(1) *In general*. The election to use the alternate valuation method under section 2032 permits property includible in the gross estate on the decedent's date of death to be valued on the 6-month date, rather than on the date of death. Thus, the election permits a valuation for Federal estate tax purposes that reflects the impact of factors such as economic or market conditions, occurrences described

in section 2054 (to the extent not compensated by insurance or otherwise, and not deducted under that section), and other factors or occurrences during the alternate valuation period, as set forth in guidance issued by the Secretary. Those factors and occurrences do not include the mere lapse of time described in paragraph (f)(2) of this section, or transactions described in paragraph (c)(1)(i) or (c)(2) of this section that are not excluded under paragraphs (c)(1)(ii), (c)(1)(iii)(A), and (c)(4) of this section. Generally, management decisions made in the ordinary course of operating a business, such as a corporation, a partnership, or other business entity, are taken into account under this section as occurrences related to economic or market conditions. To the extent, however, that these decisions change the ownership or control structure of the business entity, or otherwise are included in paragraph (c)(1)(i) or (c)(2) of this section and are not excluded by paragraphs (c)(1)(ii), (c)(1)(iii)(A), or (c)(4) of this section, they will be treated as described in paragraph (c)(1)(i) of this section.

(2) *Mere lapse of time*. * * * The application of this paragraph is illustrated in paragraphs (f)(2)(i) and (f)(2)(ii) of this section:

(i) *Life estates, remainders, and similar interests*. (A) The fair market value of a life estate, remainder, term interest or similar interest as of the alternate valuation date is determined by applying the methodology prescribed in §20.2031–7, subject to the following two sentences. The age of each person whose life expectancy may affect the fair market value of the interest shall be determined as of the date of the decedent's death. The fair market value of the property and the applicable interest rate under section 7520 shall be determined using values applicable on the alternate valuation date.

(B) *Examples*. The application of paragraph (f)(2)(i)(A) of this section is illustrated in the following examples.

Example 1. Assume that the decedent (D) or D's estate was entitled to receive certain property upon the death of A, who was entitled to the income from the property for life. At the time of D's death after April 30, 2009, the fair market value of the property was $50,000, and A was 47 years and 5 months old. In the month in which D died, the section 7520 rate was 6.2%, but rose to 7.4% on the 6-month date. The fair market value of D's remainder interest as of D's date of death was $9,336.00 ($50,000 x 0.18672, the single life remainder factor from Table S for a 47 year old at a 6.2% interest rate), as illustrated in *Example 1* of §20.2031–7T(d)(5). If, because of economic conditions, the property declined in value during the alternate valuation period and was worth only $40,000 on the 6-month date, the fair market value of the remainder interest would be $5,827 ($40,000 X 0.14568, the Table S value for a 47 year old at a 7.4% interest rate), even though A would have been 48 years old on the 6-month date.

Example 2. D created an *intervivos* charitable remainder annuity trust (CRAT) described in section 664(d)(1). The trust instrument directs the trustee to hold, invest, and reinvest the *corpus* of the trust and to pay to D for D's life, and then to D's child (C) for C's life, an amount each year equal to 6% of the initial fair market value of the trust. At the termination of the trust, the *corpus*, together with the accumulated income, is to be distributed to N, a charitable organization described in sections 170(c), 2055(a), and 2522(a). D died, survived by C. D's estate is entitled to a charitable deduction under section 2055 for the present value of N's remainder interest in the CRAT. Pursuant to §1.664–2(c) and §20.7520–2, in determining the fair market value of the remainder interest as of the alternate valuation date, D's executor may elect to use the section 7520 rate in effect for either of the two months immediately preceding the month in which the alternate valuation date occurs. Regardless of the section 7520 rate selected, however, the factor to be used to value the remainder interest is the appropriate factor for C's age on the date of D's death.

(2)(ii) *Patents*. * * * Six months after the date of the decedent's death, the patent was sold for its then fair market value that had decreased to $60,000 because of the lapse of time. * * *

(3) *Examples*. The following examples illustrate the application of this paragraph (f). In each example, decedent's (D's) estate elects to value D's gross estate under the alternate valuation method, so that the alternate valuation date of the property includible in the gross estate on D's date of death is either the transaction date or the 6-month date. In each example, assume that the only factors affecting value, and the only occurrences described in paragraph (c)(1)(i) or (c)(2) of this section, taking place during the alternate valuation period are those described in the example.

Example 1. At D's death, D's gross estate includes a residence. During the alternate valuation period, the fair market value of the residence (as well as the residential market in the area generally) declines due to a reduction in the availability of credit throughout the United States and, consequently, a decline in the availability of mortgages. The decline in the availability of mortgages is an economic or market condition. Therefore, in valuing the residence on the 6-month date, the effect of this decline on the fair market value of the residence is to be taken into account.

Example 2. (i) At D's death, D is the sole shareholder of corporation Y, a manufacturing company. Four months after D's death, Y's physical plant is destroyed as a result of a natural disaster. The disaster affects a large geographic area and, as a result, the economy of that area is negatively affected. Five months after D's death, Y's Board of Directors votes to liquidate and dissolve Y. The liquidation and dissolution proceeding is not completed as of the 6-month date. The natural disaster is a factor that affects economic and market conditions. Therefore, the disaster, to the extent not compensated by insurance or otherwise, is taken into account in valuing the Y stock on the 6-month date.

(ii) Assume instead that Y's plant is severely damaged due to flooding from the failure of pipes in the facility. The damage is an occurrence described in section 2054. Therefore, the damage, to the extent not compensated by insurance or otherwise, is taken into account in valuing the property on the 6-month date.

Example 3. At D's death, D has an interest in an S corporation, W. During the alternate valuation period, it is discovered that an employee of W has embezzled significant assets from W. W does not reasonably expect to recover the funds or any damages from the employee, and insurance proceeds are not sufficient to cover the loss. The theft is an occurrence described in section 2054. Therefore, the theft, to the extent not compensated by insurance or otherwise, is taken into account in valuing D's interest in W on the 6-month date.

(h) *Effective/applicability date*. * * * All of paragraph (c)(2) of this section except the second sentence of the introductory text, all of paragraph (c)(3) of this section except paragraph (c)(3)(i)(C) of this section, the chart in *Example 1* of paragraph (e) of this section, all of paragraph (f)(2) of this section except the last sentence, and the first and third sentences in paragraph (f)(2)(ii) of this section are applicable to decedents dying after August 16, 1954. All of paragraphs (a) introductory text, (a)(1), (a)(2), (c)(1)(i), (c)(1)(ii), (c)(1)(iii), (c)(1)(iv), (c)(3)(i)(C), (c)(4), (c)(5), (f)(1), (f)(2)(i), and (f)(3) of this section, the second sentence of the introductory text in paragraph (c)(2) of this section, all of paragraph (e) of this section except the chart in *Example 1*, the last sentence in the introductory text of paragraph (f)(2) of this section, and the second sentence in paragraph (f)(2)(ii) of this section are applicable to estates of decedents dying on or after the date of publication of the Treasury decision adopting these rules as final in the **Federal Register**.

Steven T. Miller,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on November 17, 2011, 8:45 a.m., and published in the issue of the Federal Register for November 18, 2011, 76 F.R. 71491)

Notice of Proposed Rulemaking by Cross Reference to Temporary Regulation

Corporate Reorganizations; Allocation of Basis in "All Cash D" Reorganizations

REG–101273–10

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rule making by cross-reference to temporary regulations.

SUMMARY: In this issue of the Bulletin, the IRS is issuing temporary regulations (T.D. 9558) that provide guidance regarding the determination of the basis of stock or securities in a reorganization where no stock or securities of the issuing corporation is issued and distributed in the transaction. These regulations clarify that, in certain reorganizations where no stock or securities of the issuing corporation is issued and distributed in the transaction, the ability to designate the share of stock of the issuing corporation to which the basis, if any, of the stock or securities surrendered will attach applies only to a shareholder that owns actual shares in the issuing corporation. These regulations affect corporations engaging in such transactions and their shareholders. The text of those temporary regulations published in this issue of the Bulletin also serves as the text of these proposed regulations.

DATE: Written or electronic comments and requests for a public hearing must be received by February 21, 2012.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–101273–10), Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered or sent electronically, via the Federal eRulemaking Portal at *www.regulations.gov* (IRS REG–101273–10).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Lisa A. Fuller, (202) 622–7550; concerning submission of comments, Oluwafunmilayo Taylor, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Temporary regulations in this issue of the Bulletin amend 26 CFR part 1. The temporary regulations provide guidance regarding the determination of the basis of stock or securities in a reorganization where no stock or securities of the issuing corporation is issued and distributed in the transaction. The text of those regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the amendments.

Explanation of Provisions

These temporary regulations clarify that, in certain reorganizations where no stock or securities of the issuing corporation is issued and distributed in the transaction, the ability to designate the share of stock of the issuing corporation to which the basis, if any, of the stock or securities surrendered will attach applies only to a shareholder that owns actual shares in the issuing corporation.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866, as defined in Executive Order 13563. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and the Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the Bulletin.

Drafting Information

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

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Section 1.358–2 also issued under 26 U.S.C. 358(b)(1).

Par. 2. Section 1.358–2 is amended by:

1. Revising paragraph (a)(2)(iii).

2. Adding a new *Example 15* and *Example 16* to paragraph (c).

3. Revising paragraph (d).

The revision and addition reads as follows:

§1.358–2 Allocation of basis among nonrecognition property.

(a) * * *

(2) * * *

(iii) [The text of this proposed amendments to §1.358–2(a)(2)(iii) is the same as

the text of §1.358–2T(a)(2)(iii) published elsewhere in this issue of the Bulletin]

* * * * *

(c) Examples * * *

[The text of this proposed amendments to §1.358–2, *Examples 15* and *16* are the same as the text of *Examples 15* and *16* in §1.358–2T published elsewhere in this issue of the Bulletin].

* * * * *

(d) [The text of this proposed amendment to §1.358–2(d) is the same as the text of §1.358–2T(d) published elsewhere in this issue of the Bulletin].

Steven T. Miller,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on November 18, 2011, 8:45 a.m., and published in the issue of the Federal Register for November 21, 2011, 76 F.R. 71919)

Change of Address for the Centralized Insolvency Operation and Further Information Concerning Additional Requirements for the Filing of Requests for a Prompt Determination of Unpaid Tax Liability

Announcement 2011–77

This announcement informs bankruptcy trustees (or debtors-in-possession) of a change of address for the Centralized Insolvency Operation that should be used for the submission of requests for tax refunds under section 505(a) of the Bankruptcy Code or requests for prompt determinations of any unpaid tax liability of the estate incurred during the bankruptcy case under section 505(b) of the Bankruptcy Code. This announcement also describes where further information concerning additional requirements for filing those requests may be found.

Rev. Proc. 2010–27, 2010–31 I.R.B. 183, informs bankruptcy trustees (or debtors-in-possession) of the application procedure to be followed to properly request a tax refund from the Service under section 505(a) of the Bankruptcy Code. Rev. Proc. 2006–24, 2006–1 C.B. 943, establishes the procedure by which bankruptcy trustees (or debtors-in-possession) may request from the Service a prompt determination of any unpaid tax liability of the estate incurred during the bankruptcy case under section 505(b) of the Bankruptcy Code. Both Rev. Proc. 2010–27 and Rev. Proc. 2006–24 provide that requests must be filed with the Centralized Insolvency Operation. The new address, effective immediately, is: Centralized Insolvency Operation, P.O. Box 7346, Philadelphia, PA 19101–7346.

Further information concerning additional requirements, including updated address information for service of requests, may be found on a webpage on the IRS's website, *www.IRS.gov.* To access this webpage, type *http://www.irs.gov/* into the address box on your internet browser. Once the webpage opens, type "IRS Tips for Bankruptcy Trustees" into the search field in the top right hand corner of the webpage. Then click on the result with that heading. Or you may type *http://www.irs.gov/businesses/small/article/0,,id=240599,00.html* into the address box on your internet browser.

EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2010–27, 2010–31 I.R.B. 183, and Rev. Proc. 2006–24, 2006–1 C.B. 943, are modified.

The principal author of this announcement is Tammie A. Geier of the Office of Associate Chief Counsel (Procedure and Administration). For further information regarding this announcement, contact Tammie A. Geier at (202) 622–3620 (not a toll-free call).

Determination of Governmental Plan Status

Announcement 2011–78

AGENCY: Internal Revenue Service (IRS), Department of the Treasury.

ACTION: Advance notice of proposed rulemaking.

SUMMARY: The Treasury Department and IRS anticipate issuing regulations under section 414(d) of the Internal Revenue Code (Code) to define the term "governmental plan." This document describes the rules that the Treasury Department and IRS are considering proposing relating to the determination of whether a plan is a governmental plan within the meaning of section 414(d) and contains an appendix that includes a draft notice of proposed rulemaking on which the Treasury Department and IRS invite comments from the public. This document applies to sponsors of, and participants and beneficiaries in, employee benefit plans that are determined to be governmental plans.

DATE: Written or electronic comments must be received by February 6, 2012.

ADDRESSES: Send submissions relating to the section 414(d) draft general regulations to: CC:PA:LPD:PR (REG–157714–06), room 5203, Internal Revenue Service, PO Box 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:LPD:PR (REG–157714–06), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC.

Alternately, taxpayers may submit comments relating to the section 414(d) draft general regulations electronically via the Federal eRulemaking Portal at *www.regulations.gov* (IRS-REG–157714–06).

FOR FURTHER INFORMATION CONTACT: Concerning the ANPRM, Pamela R. Kinard, at (202) 622–6060; concerning submission of comments, Richard A. Hurst, at *Richard.A.Hurst@irscounsel.treas.gov* or at (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document describes rules that the Treasury Department and IRS are considering proposing and contains a draft notice of proposed rulemaking (in the Appendix to this ANPRM) under section 414(d) of the Internal Revenue Code (Code). Under the draft notice of proposed rulemaking (in the Appendix to this ANPRM), the rules would provide general guidance relating to the determination of whether a retirement plan is a governmental plan within the meaning of section 414(d) (section 414(d)

draft general regulations). The principles described in this ANPRM could also apply for purposes of certain parallel terms in sections 403(b) and 457 of the Code.

Section 414(d) of the Code provides that the term "governmental plan" generally means a plan established and maintained for its employees by the Government of the United States, by the government of any State or political subdivision thereof, or by any agency or instrumentality of any of the foregoing. See sections 3(32) and 4021(b)(2) of the Employee Retirement Income Security Act of 1974 (ERISA) for definitions of the term "governmental plan," which govern respectively for purposes of title I and title IV of ERISA[1].

The term "governmental plan" also includes any plan to which the Railroad Retirement Act of 1935 or 1937 (49 Stat. 967, as amended by 50 Stat. 307) applies and which is financed by contributions required under that Act and any plan of an international organization which is exempt from taxation by reason of the International Organizations Immunities Act (59 Stat. 669). See section 414(d)(2) of the Code.

Section 414(d) was amended by the Pension Protection Act of 2006, Public Law 109–280 (120 Stat. 780) (PPA '06) to include certain plans of Indian tribal governments and related entities.[2] Section 906(a)(1) of PPA '06 provides that the term "governmental plan" includes a plan which is established and maintained by an Indian tribal government (as defined in section 7701(a)(40)), a subdivision of an Indian tribal government (determined in accordance with section 7871(d)), or an agency or instrumentality of either (ITG), and all the participants of which are employees of such entity substantially all of whose services as such an employee are in the performance of essential governmental functions but not in the performance of commercial activities (whether or not an essential governmental function).

Neither section 414(d) of the Code, section 3(32) of ERISA, nor section 4021(b)(2) of ERISA define key terms relating to governmental plans, including the terms "established and maintained," "political subdivision," "agency," and "instrumentality." Currently, there are no regulations interpreting section 414(d). Revenue Ruling 89–49, 1989–1 C.B. 117, see §601.601(d)(2), sets forth a facts and circumstances analysis for determining whether a retirement plan is a governmental plan within the meaning of section 414(d).[3] This analysis is used by the IRS in issuing letter rulings.

Governmental plans are subject to different rules than retirement plans of non-governmental employers. Governmental plans are excluded from the provisions of titles I and IV of ERISA. In addition, governmental plans receive special treatment under the Code. These plans are exempt from certain qualification requirements and they are deemed to satisfy certain other qualification requirements under certain conditions. As a result, the principal qualification requirements for a tax-qualified governmental plan[4] are that the plan—

- Be established and maintained by the employer for the exclusive benefit of the employer's employees or their beneficiaries;
- Provide definitely determinable benefits;
- Be operated pursuant to its terms;
- Satisfy the direct rollover rules of section 401(a)(31);
- Satisfy the section 401(a)(17) limitation on compensation;
- Comply with the statutory minimum required distribution rules under section 401(a)(9);
- Satisfy the pre-ERISA vesting requirements under section 411(e)(2);[5]
- Satisfy the section 415 limitations on benefits, as applicable to governmental plans; and
- Satisfy the prohibited transaction rules in section 503.

State and local governments, political subdivisions thereof, and agencies or instrumentalities thereof are generally not permitted to offer cash or deferred arrangements under section 401(k). However, an ITG is permitted to offer a cash or deferred arrangement under section 401(k).

For further background, see the "Background" section of the preamble in the section 414(d) draft general regulations in the Appendix to this ANPRM under the headings, "Exclusion of Governmental Plans from ERISA," "Exemption of Governmental Plans from Certain Qualified Plan Rules," and "Exemption of Governmental Plans from Other Employee Benefit Rules Relating to Retirement Plans."

Over the past several years, the IRS has been coordinating with the Department of Labor (DOL) and Pension Benefit Guaranty Corporation (PBGC) (the "Agencies") on governmental plan determinations. Although the anticipated proposed regulations would only be applicable for purposes of section 414(d), the DOL and PBGC were consulted when drafting this proposal. DOL and PBGC agreed that it would be advantageous for the Agencies and the regulated community for there to be coordinated criteria for determining whether a plan is a governmental plan within the meaning of section 414(d) of the Code, section 3(32) of ERISA, and section 4021(b)(2) of ERISA. See the "Background" section of the preamble in the section 414(d) draft general regulations in the Appendix to this ANPRM under the heading, "Interagency Coordination on Governmental Plan Determinations."

The Treasury Department and the IRS have determined to seek public comment on the draft proposed regulations in the

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[1] The three definitions of the term "governmental plan" are essentially the same. The only difference is that, in defining the term "governmental plan," section 3(32) of ERISA uses the phrase "established or maintained," whereas section 414(d) of the Code and section 4021(b) of ERISA use the term "established and maintained."

[2] Section 906(a) of PPA '06 made similar amendments to sections 3(32) and 4021(b)(2) of ERISA.

[3] See also Rev. Rul. 57–128, 1957–1 C.B. 311, see § 601.601(d)(2), which provides guidance on determining when an entity is a governmental instrumentality for purposes of the exemption from employment taxes under section 3121(b)(7) and 3306(c)(7).

[4] A special rule applies to contributory plans of certain governmental entities. Section 414(h)(2) provides that, for a qualified plan established by a State government or political subdivision thereof, or by any agency or instrumentality of the foregoing, where the contributions of the governmental employer are designated as employee contributions under section 414(h)(1) but the governmental employer picks up the contributions, the contributions picked up will be treated as employer contributions.

[5] Section 411(e)(2) states that a plan described in section 411(e)(1) is treated as meeting the requirements of section 411 if the plan meets the vesting requirements resulting from the application of section 401(a)(4) and (a)(7) as in effect on September 1, 1974.

Appendix to this ANPRM in advance of issuing a notice of proposed rulemaking. In light of the interaction of the governmental plan definitions in the Code and ERISA, a copy of the comments will be forwarded to DOL and PBGC.

Explanation of Provisions

Attached to the Appendix to this ANPRM is a draft notice of proposed rulemaking. The draft regulations include proposed rules, a preamble, and a request for comments. The Treasury Department and IRS invite the public to comment on the rules that the Treasury Department and IRS are considering proposing, which would generally define the term "governmental plan" within the meaning of section 414(d), as well as other key related terms, including "State," "political subdivision of a State," and "agency or instrumentality of a State or political subdivision of a State."

In determining whether an entity is an agency or instrumentality of the United States or an agency or instrumentality of a State or political subdivision of a State, the anticipated guidance would provide a facts and circumstances analysis. The factors used in these analyses are drawn from the factors historically used in governmental plan determinations, including Rev. Ruls. 57–128 and 89–49. The anticipated guidance would provide several examples illustrating the application of the facts and circumstances tests. See the "Explanation of Provisions" section in the section 414(d) draft general regulations in the Appendix to this ANPRM under the headings, "Definitions of the United States and agency or instrumentality of the United States" and "Definition of agency or instrumentality of a State or a political subdivision of a State." See §601.601(d)(2).

The anticipated proposed regulations would include numerous factors for determining whether an entity is an agency or instrumentality of a State or a political subdivision of a State. The section 414(d) draft proposed regulations in the Appendix to this ANPRM would categorize these factors into major factors and other factors. The section 414(d) draft general regulations would also request comments from the public on whether the final regulations should eliminate the distinction between main and other factors. In addition, the section 414(d) draft general regulations would request comments on the ordering and application of main and other factors; for example, whether, as an alternative to the ranking of major factors and other factors, the regulations could provide a safe harbor standard focusing on control and fiscal responsibility under which the entity would be treated as an agency or instrumentality of a State or a political subdivision of a State. For further explanation of the safe harbor standard, see the "Comments and Public Hearing" section in the preamble of the section 414(d) draft general regulations, which is located in the Appendix to this ANPRM.

The anticipated proposed regulations do not address the special rules that apply in determining whether a plan of an Indian tribal government is a governmental plan within the meaning of section 414(d). That topic would be reserved in the proposed regulations and is addressed in an ANPRM (REG–133223–08) that is being published elsewhere in this issue of the Bulletin.

The anticipated proposed regulations would provide rules for determining whether a governmental entity has established and maintained a plan for purposes of section 414(d). The anticipated proposed regulations might provide that a plan is established and maintained for the employees of a governmental entity if: (1) the plan is established and maintained by an employer within the meaning of §1.401–1(a)(2), (2) the employer is a governmental entity, and (3) the only participants covered by the plan are employees of that governmental entity. The anticipated proposed regulations might also provide rules covering circumstances involving a change in status of an entity (that is, when a private entity becomes a governmental entity or when a governmental entity becomes a private entity) due to an acquisition or asset transfer. See the "Explanation of Provisions" section in the section 414(d) draft general regulations in the Appendix to this ANPRM under the heading, "Requirements for establishing and maintaining a section 414(d) governmental plan."

Recognizing that the guidance might affect numerous governmental plan participants and their beneficiaries, the anticipated proposed regulations request comments on transition rules, including transitional relief for governmental plans that permitted participation of a small number of former employees in their plans. See the "Comments and Public Hearing" section in the preamble of the section 414(d) draft general regulations that is located in the Appendix to this ANPRM.

Request for Comments

Before the notice of proposed rulemaking is issued, 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. Copies of the comments will be provided to the DOL and PBGC.

The IRS and Department of Treasury plan to schedule a public hearing on the ANPRM. That hearing will be scheduled and announced at a later date. In addition to a public hearing, the Treasury Department and IRS anticipate scheduling "Town Hall" meetings in order to obtain comments from the public on the section 414(d) draft general regulations. It is expected that these "Town Hall" meetings will take place in different locations across the country. Participants will be encouraged to pre-register for the meetings. Information relating to these "Town Hall" meetings, including dates, times, locations, registration, and the procedures for submitting written and oral comments, will be available on the IRS website relating to governmental plans at *http://www.irs.gov/retirement/article/0,,id=181779,00.html*.

Drafting Information

The principal author of this advance notice of proposed rulemaking is Pamela R. Kinard, Office of the Chief Counsel (Tax-exempt and Government Entities), however, other personnel from the IRS and Treasury Department participated in its development.

Steven T. Miller,
Deputy Commissioner for Services and Enforcement.

APPENDIX

The following is draft language for a notice of proposed rulemaking that would set forth rules relating to the determination

of whether a plan is a governmental plan within the meaning of section 414(d). The IRS and Treasury release this draft language in order to solicit comments from the governmental plans community:

Background

This document contains proposed regulations under section 414(d) of the Internal Revenue Code (Code). These regulations, when finalized, would provide guidance relating to the determination of whether a retirement plan is a governmental plan within the meaning of section 414(d). The definition of a governmental plan under section 414(d) applies for purposes of Part I of Subchapter D of Chapter 1 of Subtitle A (Income Taxes) of the Code (sections 401 through 420) and certain other Code provisions that refer to section 414(d) (such as sections 72(t)(10), 501(c)(25)(C), 4975(g)(2), 4980B(d)(2), 9831(a)(1), and 9832(d)(1)). It is expected that the principles set forth in these regulations would generally also apply for purposes of sections 403(b) and 457.

Statutory Definition of Governmental Plan

Both the Code and the Employee Retirement Income Security Act of 1974 (ERISA) define the term "governmental plan." Section 414(d) of the Code provides that the term "governmental plan" generally means a plan established and maintained for its employees by the Government of the United States, by the government of any State or political subdivision thereof, or by any agency or instrumentality of any of the foregoing. See sections 3(32) and 4021(b)(2) of ERISA for parallel definitions of the term *governmental plan*, discussed under the heading, "Exclusion of Governmental Plans from ERISA."

The term "governmental plan" also includes any plan to which the Railroad Retirement Act of 1935 or 1937 (49 Stat. 967, as amended by 50 Stat. 307) applies and which is financed by contributions required under that Act and any plan of an international organization which is exempt from taxation by reason of the International Organizations Immunities Act, Public Law 79–291 (59 Stat. 669). Section 414(d) was amended by the Pension Protection Act of 2006, Public Law 109–280 (120 Stat. 780) (PPA '06) to include certain plans of Indian tribal governments.[6] See Notice 2006–89, 2006–2 C.B. 772, see §601.601(d)(2), for guidance relating to plans established and maintained by Indian tribal governments.[7] These proposed regulations do not provide any guidance concerning the special provisions in section 414(d) relating to the Railroad Retirement Act of 1935 or 1937, the International Organizations Immunities Act, or Indian tribal governments.

Application of Section 414(d)

These proposed regulations are only applicable for purposes of section 414(d), and not for any other purpose under the Code.[8] However, the section 414(d) definition of "governmental plan" applies for other sections of the Code, including:

- Section 72(t)(10)(A) (exception to the early withdrawal tax for certain distributions from a defined benefit governmental plan);
- Section 457(e)(17) (special rules for: (1) direct trustee-to-trustee transfers from a section 457 deferred compensation plan to a section 414(d) governmental plan in order to purchase permissive service credit under section 414(n)(3)(A) or (2) the repayments of cashouts under governmental plans);
- Section 501(c)(25)(C)(ii) (exempting section 414(d) governmental plans from taxation);
- Section 503(a)(1) (applying the prohibited transaction rules in section 503 to governmental plans as defined in section 4975(g)(2));
- Section 818(a)(6)(A) (defining the term "pension plan contract");
- Section 1400Q(d)(2)(A)(ii) (special timing rule for section 414(d) governmental plans to make certain conforming amendments);
- Section 4972(d)(1)(B) (exempting section 414(d) governmental plans from the excise tax on nondeductible contributions to a qualified employer plan);
- Section 4975(g)(2) (exempting section 414(d) governmental plans from the prohibited transaction rules of section 4975);
- Section 4980(c)(1)(B) (exempting section 414(d) governmental plans from the tax on the reversion of qualified plan assets to an employer under section 4980);
- Section 4980B(d)(2) (exempting section 414(d) governmental plans from the COBRA requirements under section 4980B);
- Section 4980F(f)(2) (exempting section 414(d) governmental plans from the requirement to provide a notice required under section 204(h) of ERISA);
- Section 6057(c)(2) (providing rules relating to the voluntary submission of annual registration statements by section 414(d) governmental plans); and,
- Sections 9831(a)(1) and 9832(d)(2) (exempting section 414(d) governmental plans from the group health plan requirements).

The definitions and rules also apply for purposes of section 101(h)(1)(A) (special rule exempting governmental plan survivor benefits attributable to service of a public safety officer killed in the line of duty).

Currently, there are no regulations interpreting section 414(d). Neither section 414(d) of the Code nor ERISA defines key terms relating to governmental plans, including the terms "established and maintained," "political subdivision," "agency," and "instrumentality."

Executive Order 13132

Executive Order 13132 requires that Federal departments and agencies engage in consultation procedures in certain cir-

[6] Section 906(a)(1) of PPA '06 provides that the term "governmental plan" includes a plan which is established and maintained by an Indian tribal government (as defined in section 7701(a)(40)), a subdivision of an Indian tribal government (determined in accordance with section 7871(d)), or an agency or instrumentality of either, and all the participants of which are employees of such entity substantially all of whose services as such an employee are in the performance of essential governmental functions but not in the performance of commercial activities (whether or not an essential government function). Section 906(a) of PPA '06 made similar amendments to sections 3(32) and 4021(b) of ERISA.

[7] See also Notice 2007–67, 2007–2 C.B. 467), see §601.601(d)(2) (extending transitional relief for plans of Indian tribal governments to comply with the requirements of section 906 of PPA '06).

[8] However, as indicated earlier, it is expected that the principles set forth in these regulations would also be taken into account for purposes of sections 403(b) and 457.

cumstances where regulations are issued which have a substantial direct effect on States. While these regulations when issued as final regulations would not have such a substantial direct effect, the IRS and Treasury Department have followed similar procedures, including issuance not only of these proposed regulations, but also an advance notice of these regulations which was published (date to be provided) in the **Federal Register**.

Judicial Determinations of Governmental Entity Status

Historically, courts have used the test in *NLRB v. Natural Gas Utility District of Hawkins County, Tennessee*, 402 U.S. 600 (1971), in determining whether an entity is an agency or instrumentality of a State or a political subdivision of a State. In *Hawkins County*, the Supreme Court interpreted the term "political subdivision" for purposes of 29 U.S.C. 152(2) (section 2(2) of the National Labor Relations Act (NLRA), as amended by the Labor-Management Relations Act).[9] Although the Supreme Court in *Hawkins County* analyzed whether the employer at issue was a political subdivision for purposes of the NLRA, courts use the same analysis for determining whether an entity is an agency or instrumentality of a State or a political subdivision of a State for purposes of ERISA.[10] The two-prong test in *Hawkins County* analyzes whether the entity has been "(1) created directly by the state, so as to constitute departments or administrative arms of the government, or (2) administered by individuals who are responsible to public officials or to the general electorate." *Hawkins County*, 402 U.S. at 604–05. In addition to this two-prong test, the Supreme Court also analyzed other factors, including: whether the utility had broad powers to accomplish its public purpose; whether the utility's property and revenue were exempt from state and local taxes (as well as whether its bonds were tax-exempt); whether the utility had the power of eminent domain; whether the utility was required to maintain public records; whether the utility's commissioners were appointed by an elected county judge; and whether the commissioners could be removed by the State of Tennessee pursuant to State procedures for removal of public officials. Many of these factors are similar to the factors used in determining whether an entity is an agency or instrumentality of a State or a political subdivision of a State under these proposed regulations.

In determining whether an entity is an agency or instrumentality of the United States, courts either apply a facts and circumstances analysis or look to the relationship between the entity and its employees. In *Alley v. Resolution Trust Corporation*, 984 F.2d 1201 (D.C.Cir. 1993), in analyzing whether the Federal Asset Disposition Association (FADA), a savings and loan association established by the Federal Home Loan Bank Board, was a Federal instrumentality for governmental plan purposes, the court focused on the employment relationship between the entity and its employees.[11] In looking at the employer-employee relationship, the *Alley* court concluded that FADA functioned more like a private enterprise than a governmental agency in the area of its employment relations. "Measured by the terms and conditions of their employment, FADA personnel far more closely resembled private sector employees than they did government workers. Like employees of 'ordinary' Federally chartered S&Ls, FADA's employees were outside the civil service system, and were not subject to the personnel rules or restrictions on salaries and benefits imposed generally on Federal employees."[12]

However, in *Berini v. Federal Reserve Bank of St. Louis, Eighth District*, 420 F.Supp.2d 1021 (E.D. Mo. 2005), the court reviewed administrative and judicial authority in determining whether an entity is a Federal agency or instrumentality and applied a multi-factor test in determining whether the employee benefit plans maintained by the Federal Reserve System are governmental plans within the meaning of section 3(32) of ERISA. The *Berini* test was based on the six factors in Rev. Rul. 57–128, 1957–1 C.B. 311, see §601.601(d)(2), which was also the test applied by the court in *Rose v. Long Island Railroad Pension Plan*, 828 F.2d 910, 918 (2nd Cir. 1987), *cert. denied*, 485 U.S. 936 (1988). Factors weighed by the *Berini* court included that the Federal reserve banks were established directly by Congressional legislation to perform an important governmental function (to increase control of the nation's currency and banking system), the banks exist only by an enabling statute, they possess only the powers granted by the legislation, the private interests involved do not have the typical interests of an owner, and the banks are controlled by the Federal Reserve Board of Governors, which is a governmental agency.[13]

Agency Guidance Regarding Governmental Entity Status

Revenue Ruling 57–128 provides guidance on when an entity is a governmental instrumentality for purposes of the exemption from employment taxes under sections 3121(b)(7) and 3306(c)(7). The revenue ruling lists the following factors to be considered in determining whether an organization is an instrumentality of one or more States or political subdivisions thereof: (1) whether the organization is used for a governmental purpose and performs a governmental function; (2)

[9] 29 U.S.C. 152(2) provides that the term "employer" includes any person acting as an agent of an employer, directly or indirectly, but shall not include the United States or any wholly owned Government corporation, or any Federal Reserve Bank, or any State or political subdivision thereof, or any person subject to the Railway Labor Act, as amended from time to time, or any labor organization (other than when acting as an employer), or anyone acting in the capacity of officer or agent of such labor organization.

[10] "The NLRB guidelines are a useful aid in interpreting ERISA's governmental exemption, because ERISA, like the National Labor Relations Act, 'represent[s] an effort to strike an appropriate balance between the interests of employers and labor organizations.'" *Rose v. Long Island Railroad Pension Plan,* 828 F.2d 910, 916 (2nd Cir. 1987), *cert. denied*, 485 U.S. 936 (1988) (quoting H.R. Rep. No. 533, reprinted in 1974 USCCAN at 4647). *See also, Shannon v. Shannon*, 965 F.2d 542, 547 (7th Cir. 1992), *cert. denied*, 506 U.S. 1028 (1992) (stating that the proper test for determining whether an entity is an agency or instrumentality of a State or political subdivision for purposes of ERISA is the *Hawkins* test), *Koval v. Washington County Redevelopment Authority*, 574 F.3d 238, 242 (3rd Cir. 2009) (stating that the *Hawkins* test is the most fitting analysis for determining whether an entity is a political subdivision), and *Brooks v. Chicago Housing Authority*, No. 89–C–9304, 1990 WL 103572 at 1, 1990 U.S. Dist. LEXIS 8233 at 3 (N.D. Ill. July 5, 1990) (applying the *Hawkins* test).

[11] "We focus our attention . . . on what should be the core concern for ERISA purposes—the nature of an entity's relationship to and governance of its employees." *Alley v. Resolution Trust Corporation*, 984 F.2d at 1206, n. 11.

[12] *Alley v. Resolution Trust Corporation*, 984 F.2d at 1206.

[13] *Berini v. Federal Reserve Bank of St. Louis*, 420 F.Supp.2d at 1026–29.

whether performance of its function is on behalf of one or more States or political subdivisions; (3) whether there are any private interests involved, or whether the States or political subdivisions involved have the powers and interests of an owner; (4) whether control and supervision of the organization is vested in public authority or authorities; (5) whether express or implied statutory authority or other authority is necessary for the creation and/or use of such an instrumentality, and whether such authority exists; and (6) the degree of the organization's financial autonomy and the source of its operating expenses.

Revenue Ruling 89–49, 1989–1 C.B. 117, see §601.601(d)(2), provides guidance for determining whether a retirement plan maintained by an organization is a governmental plan within the meaning of section 414(d). The revenue ruling lists several factors for determining whether a sponsoring organization is an agency or instrumentality of the United States or any State or political subdivision thereof. While the factors in Rev. Rul. 89–49 are similar to the factors listed in Rev. Rul. 57–128, Rev. Rul. 89–49 focuses more on the degree of control that the Federal or State government has over the organization's everyday operations. Other factors considered include: whether there is specific legislation creating the organization; the source of funds for the organization; the manner in which the organization's trustees or operating board are selected; and whether the applicable government unit considers the employees of the organization to be employees of the applicable government unit. Rev. Rul. 89–49 provides that satisfaction of one or all of the factors is not necessarily determinative of whether an organization is a governmental entity. See §601.601(d)(2)(ii)(*b*).

In Rev. Rul. 89–49, citizens of a municipality organized a volunteer fire company. The company was incorporated under its State laws as a nonprofit corporation, and the company was managed under the exclusive control of a board of trustees elected by the volunteer firefighters. Area municipalities, including the municipality that created the company, entered into contracts with the company to receive fire protection services. Under the contracts, it was agreed that the operations of the volunteer fire company would be under the exclusive control of the board of trustees. While the municipalities made payments for fire protection services to the volunteer fire company pursuant to these contracts, the municipalities did not contribute to the company's retirement plan, and the employees of the company were not considered employees of the State or any of the participating municipalities. The ruling concludes that the retirement plan established and maintained by the volunteer fire company is not a governmental plan within the meaning of section 414(d) because the degree of control that the participating municipalities exert over the volunteer fire company is minimal.

Exclusion of Governmental Plans from ERISA

Section 4(b)(1) of ERISA provides that title I of ERISA does not apply to an employee benefit plan that is a governmental plan as defined in section 3(32) of ERISA. Section 3(32) of ERISA generally provides that the term "governmental plan" means a plan established or maintained for its employees by the Government of the United States, by the government of any State or political subdivision thereof, or by any agency or instrumentality of any of the foregoing.[14] The ERISA section 3(32) definition of a governmental plan also includes any plan to which the Railroad Retirement Act of 1935 or 1937 applies, and which is financed by contributions required under that Act and any plan of an international organization which is exempt from taxation under the provisions of the International Organizations Immunities Act. Section 906 of PPA '06 amended section 3(32) of ERISA to include in the definition of governmental plan a plan which is established and maintained by an Indian tribal government (as defined in section 7701(a)(40)), a subdivision of an Indian tribal government (determined in accordance with section 7871(d)), or an agency or instrumentality of either. Under this definition, all of the participants of which are employees of such entity substantially all of whose services as such an employee are in the performance of essential governmental functions but not in the performance of commercial activities (whether or not an essential government function).

Section 4021(b)(2) of ERISA provides that title IV of ERISA does not apply to any plan established and maintained for its employees by the Government of the United States, by the government of any State or political subdivision thereof, or by any agency or instrumentality of any of the foregoing, or to which the Railroad Retirement Act of 1935 or 1937 applies and which is financed by contributions required under that Act. Similar to section 3(32) of ERISA, section 4021(b) of ERISA was amended by section 906 of PPA '06 to include certain plans of Indian tribal governments in the definition of governmental plan for purposes of section 4021(b) of ERISA.

Neither the DOL nor the PBGC has issued regulations interpreting the terms of sections 3(32) and 4021(b) of ERISA. Both agencies have, however, provided guidance for specific entities in the form of administrative determinations, and advisory opinions or other opinion letters. The IRS, the Department of Labor (DOL), and the Pension Benefit Guaranty Corporation (PBGC) have generally applied a facts and circumstances approach in providing governmental plan determinations.[15] For example, the IRS issues private letter rulings relating to governmental plan status using a facts and circumstances analysis.

Exemption of Governmental Plans from Certain Qualified Plan Rules

Governmental plans under Code section 414(d) are exempt from certain qualification requirements and are deemed to satisfy certain other qualification requirements under certain conditions. For example, the nondiscrimination and minimum participation rules do not apply to governmental plans. Section 1505 of the

[14] In defining the term "governmental plan," section 3(32) of ERISA uses the phrase "established or maintained," whereas section 414(d) of the Code and section 4021(b) of ERISA use the term "established and maintained." For further discussion, see the Explanation of Provisions section of the preamble under the heading, "Requirements for establishing and maintaining a section 414(d) governmental plan."

[15] The DOL issues advisory opinions. The PBGC issues administrative determinations and opinion letters. The IRS issues letter rulings relating to section 414(d) governmental plans. For this purpose, a letter ruling is a written statement issued to a taxpayer by the IRS that interprets and applies tax laws or any nontax laws applicable to employee benefit plans to the taxpayer's specific set of facts. See section 3.02 of Rev. Proc. 2011–4, 2011–1 I.R.B. 123, 127), see §601.601(d)(2).

Taxpayer Relief Act of 1997, Public Law 105–34 (111 Stat. 788, 1063) (TRA '97), amended sections 401(a)(5)(G) and 401(a)(26)(G) of the Code to provide that the minimum participation standards and nondiscrimination requirements of section 410 and the additional participation requirements under section 401(a)(26)(G) do not apply to State or local governmental plans.[16] Section 1505 of TRA '97 also amended section 401(k)(3)(G) of the Code to provide that certain State and local governmental plans are treated as meeting the requirements of the average deferral percentage test of section 401(k)(3) and the average contribution percentage test of section 401(m)(2).[17]

Section 861 of PPA '06 exempts all governmental plans (as defined in section 414(d)) from the nondiscrimination and minimum participation requirements of sections 401(a)(5)(G) and 401(a)(26)(G) of the Code, as well as the nondiscrimination and participation requirements applicable to qualified cash or deferred arrangements under section 401(k)(3)(G) of the Code.

In addition to the nondiscrimination requirements, the Code provides other exemptions for governmental plans:

- Section 401(a)(10)(B)(iii), which provides that the top heavy requirements of section 416 do not apply to a governmental plan.
- Section 410(c)(1)(A), which provides that the minimum participation provisions of section 410 do not apply to a governmental plan.
- Section 411(e), which provides that a governmental plan is treated as satisfying the requirements of section 411 if the plan meets the pre-ERISA vesting requirements.
- Section 412(e)(2)(C), which provides that the minimum funding standards of section 412 do not apply to a governmental plan.
- Section 417, which provides rules relating to qualified joint and survivor annuities and qualified preretirement survivor annuities.

Section 415 also provides a number of special rules for governmental plans. The special rules include section 415(b)(11) (the 100 percent of a participant's average high 3 compensation limitation does not apply), section 415(b)(2)(C) (the reduced limitation to the annual benefit payable beginning before age 62 and the reduction in the dollar limitation to the annual benefit payable for participation or services of less than 10 years do not apply to disability or survivor benefits received from a governmental plan), section 415(m) (benefits provided under a qualified governmental excess benefit arrangement are not taken into account in determining the section 415 benefit limitations under a section 414(d) governmental plan), and section 415(n) (permissive service credit).[18]

As a result, the principal qualification requirements for a tax-qualified governmental plan[19] are the requirements that the plan —

- Be established and maintained by the employer for the exclusive benefit of the employer's employees or their beneficiaries,
- Provide definitely determinable benefits,
- Satisfy the direct rollover rules of sections 401(a)(31) and 402(f),
- Be operated pursuant to its terms,
- Satisfy the section 401(a)(17) limitation on compensation,
- Comply with the statutory minimum required distribution rules under section 401(a)(9),
- Satisfy the pre-ERISA vesting requirements under section 411(e)(2),
- Satisfy the section 415 limitations on benefits, as applicable to governmental plans, and
- Satisfy the prohibited transaction rules in section 503.

State and local governments, political subdivisions thereof, and agencies or instrumentalities thereof are generally not permitted to offer cash or deferred arrangements under section 401(k). Instead, they can offer a somewhat similar elective contribution program through an eligible governmental section 457(b) plan to which section 457(g) applies. In addition, section 403(b) includes special rules for plans covering public school teachers, including rules under which, in conjunction with an eligible governmental section 457(b) plan, the maximum dollar amount of the elective contribution for a public school teacher is in effect double the maximum for other public or private employees.

Exemption of Governmental Plans from Other Employee Benefit Rules Relating to Retirement Plans

The Code and regulations also provide that plans of governmental entities are treated differently than plans of non-governmental entities with respect to certain requirements for section 403(b) plans and eligible section 457(b) plans, including:

- Section 403(b)(1)(A)(ii), which provides that the exclusion allowance under section 403(b)(1) applies to employees who perform services for a public school of a State, a political subdivision of a State, or an agency or instrumentality of any one or more of the foregoing.
- Section 403(b)(12)(C), which provides that the nondiscrimination requirements of section 403(b)(12) (other than the compensation limitations of section 401(a)(17)) do not apply to a State or local governmental plan within the meaning of section 414(d).
- Section 457(f)(2)(E), under which section 457(f) (relating to nonqualified deferred compensation) does not

[16] In addition, section 1505(a)(3) of TRA '97 amended section 410(c)(2) to provide that all governmental plans within the meaning of section 414(d) are treated as satisfying the nondiscrimination requirements of section 410.

[17] A State or local government, political subdivision, or agency or instrumentality thereof, is not permitted to establish and maintain a section 401(k) plan. See section 401(k)(4)(B)(ii). There is an exception for a grandfathered section 401(k) plan, which is generally a plan established by a governmental unit (a State or local government or political subdivision thereof) before May 7, 1986. See §1.401(k)–1(e)(4).

[18] See also Notice 89–23, 1989–1 C.B. 654, and Notice 96–64, 1996–2 C.B. 229, see § 601.601(d)(2), for guidance relating to the nondiscrimination rules that apply to qualified plans maintained by governments.

[19] A special rule applies to contributory plans of certain governmental entities. Section 414(h)(2) provides that, for a qualified plan established by a State government or political subdivision thereof, or by any agency or instrumentality of the foregoing, where the contributions of the governmental employer are designated as employee contributions under section 414(h)(1) but the governmental employer picks up the contributions, the contributions picked up will be treated as employer contributions.

apply to a qualified governmental excess benefit arrangement under section 415(m).

- Section 457(e)(1)(B), which includes as an eligible employer a State, political subdivision, or agency or instrumentality thereof and any tax-exempt organization other than a governmental unit.
- Section 457(g), which provides that a deferred compensation plan maintained by a State, political subdivision of a State, or any agency or instrumentality thereof is not treated as an eligible section 457(b) plan unless the assets and income of the plan are held in trust for the exclusive benefit of plan participants and beneficiaries.
- Section 402(c)(8)(B)(v), which provides that an eligible section 457(b) governmental plan is an eligible retirement plan for purposes of the rollover rules under section 402(c), so that payments from an eligible section 457(b) governmental plan can be rolled over to another eligible retirement plan, such as a qualified plan or an IRA, and payments from an eligible retirement plan can be rolled over into an eligible section 457(b) governmental plan.[20] An eligible section 457(b) plan of a nongovernmental tax-exempt entity is not eligible for this rollover treatment.

Legislative History of ERISA

The legislative history of ERISA and its predecessor bills indicate that there were two reasons for the governmental plan exemption: (1) federalism concerns; and (2) the taxing power of State and local governments was thought to offer sufficient protection for participants in public plans.[21] In a summary of ERISA's predecessor bill, Senator Lloyd Bentsen commented that "State and local governments must be allowed to make their own determination of the best method to protect the pension rights of municipal and state employees. These are questions of state and local sovereignty and the Federal Government should not interfere."[22]

While Congress was concerned about pension protection for public as well as private employees, governmental plans have been excluded from many of the qualification requirements because, in addition to federalism concerns, Congress believed that "the ability of governmental bodies to fulfill their obligations to employees through their taxing powers is an adequate substitute for termination insurance."[23] As a result, ERISA includes exclusions for governmental plans under titles I and IV of ERISA and an exemption for governmental plans from most of the qualification requirements under the Code that were added under title II of ERISA (as described in this preamble under the heading, "Exemption of Governmental Plans from Certain Qualified Plan Rules").

Interagency Coordination on Governmental Plan Determinations

Historically, the IRS, DOL, and PBGC (the Agencies) have informally conferred prior to making determinations on governmental plan status in individual cases. In Notice 2005–58, 2005–2 C.B. 295, see §601.601(d)(2), the Treasury Department and the IRS stated their intention of publishing guidance regarding governmental plans under section 414(d). The Agencies have become increasingly concerned with the growing number of requests for governmental plan determinations from plan sponsors whose relationships to States or political subdivisions thereof are increasingly remote and whose arguments for concluding that their plans are governmental plans raise novel issues. The use of differing approaches by the courts and the Agencies has resulted in uncertainty as entities with organizational, regulatory, and contractual connections with States or political subdivisions of States try to ascertain which statutory and regulatory requirements apply to their retirement plans. These proposed regulations are intended to address this issue by establishing coordinated criteria for determining whether a plan is a governmental plan within the meaning of section 414(d) of the Code. Although these proposed regulations are only applicable for purposes of section 414(d), the DOL and the PBGC were consulted in developing this proposal. The DOL and the PBGC agreed that it would be advantageous for the Agencies and other affected parties to have coordinated criteria for determining whether a plan is a governmental plan within the meaning of section 414(d) of the Code, section 3(32) of title I of ERISA, and section 4021(b) of title IV of ERISA. In that regard, comments are requested on any issues arising from these proposed regulations in light of the interaction of the governmental plan definition in the Code with the governmental plan definitions in section 3(32) of title I of ERISA and section 4021(b) of title IV of ERISA. Copies of the comments on these regulations will be forwarded to the DOL and the PBGC.

Explanation of Provisions

I. Overview

A. In general.

These proposed regulations would generally define the term "governmental plan" within the meaning of section 414(d) of the Code. These proposed regulations would also define other key terms relating to the general definition of "governmental plan," including the definitions of "State," "political subdivision of a State," and "agency or instrumentality of a State or political subdivision of a State." While these terms are commonly used in other Code sections, the definitions in these proposed regulations are only applicable for purposes of section 414(d), and not for any other purpose under the Code. For example, the definition of the term "instrumentality" under these proposed regulations may be different for other purposes under the Code.

As stated, the regulations under section 414(d) would only define the term "agency

[20] Section 402(c)(8)(B) defines an eligible retirement plan as an individual retirement account under section 408(a), an individual retirement annuity under section 408(b), a qualified plan, a section 403(a) annuity, a section 403(b) plan, and an eligible section 457(b) governmental plan.

[21] ERISA included a directive for the Committee on Education and Labor and the Committee on Ways and Means of the House of Representatives and the Committees on Finance and on Labor and Public Welfare of the Senate to study pension retirement plans sponsored by Federal, State, and local governments and analyze: (1) the adequacy of existing levels of participation, vesting and financing arrangements; (2) existing fiduciary standards; and (3) the necessity for Federal legislation and standards with respect to such plans. See Staff of House Comm. On Education and Labor, 95th Cong., 2d Sess., *Pension Task Force Report on Public Employee Retirement Systems* (Comm. Print 1978).

[22] Staff of the Senate Comm. on Labor and Public Welfare, 94th Cong., Legislative History of the Employee Retirement Income Security Act of 1974, Vol. I 220 (Comm. Print 1976).

[23] S. Rep. No. 93–383, at 81 (1973). See also H.R. Rep. No. 93–807, at 164–5 (1974).

or instrumentality of the United States" and "agency or instrumentality of a State or political subdivision of a State" for purposes of determining whether a plan is a governmental plan under section 414(d). Thus, the rules in these proposed regulations would not apply for purposes of defining the term "instrumentality," under any other provisions of the Code.

In addition, these regulations do not address certain issues relating to governmental entities, including when an entity is so closely related to a State that it constitutes an "integral part" of a State.[24] The criteria for treating an entity as an "integral part" of a State will be the subject of a separate guidance project. Such guidance defining "integral part" may include stricter criteria than would apply under these proposed regulations for determining whether an entity is an agency or instrumentality of a State.

B. Definition of governmental plan.

These proposed regulations reflect the statutory definition of the term "governmental plan" as a plan established and maintained for its employees by the Government of the United States, by the government of any State or political subdivision thereof, or by any agency or instrumentality of the foregoing. Within this definition, there are several key terms relating to governmental plans, the definitions of which are set forth in these proposed regulations. As mentioned in the "Background" section of this preamble, section 414(d) also includes special rules relating to the Railroad Retirement Act of 1935 or 1937, the International Organizations Immunities Act, and plans of Indian tribal governments. These proposed regulations do not address the term "governmental plan" as it relates to the special provisions in section 414(d) relating to the Railroad Retirement Act of 1935 or 1937, or the International Organizations Immunities Act. The special rules for Indian tribal governments are reserved in these proposed regulations and are in a separate notice of proposed rulemaking, which is being published elsewhere in this issue of the Bulletin.

C. Definitions of the United States and agency or instrumentality of the United States.

These proposed regulations would define the term "United States," for purposes of the governmental plan definition under section 414(d), as having the same meaning set forth in section 7701(a)(9). Section 7701(a)(9) provides that the term "United States," when used in a geographical sense, includes only the States and the District of Columbia.

Whether an entity is an "agency or instrumentality of the United States" is determined based on the specific purpose for which the designation is sought and is decided by determining if Congress intended the entity to be treated as a Federal entity for the specific purpose.[25] The proposed regulations would define the term "agency or instrumentality of the United States" as an entity that satisfies the facts and circumstances test as set forth in these regulations. The facts and circumstances test, similar to the factors weighed by the *Berini* court, focuses on the "degree to which the entity is connected with the . . . federal government."[26] The factors in this test are a compilation of various different tests used for governmental plan determinations, including factors in the *Berini* and *Rose* cases, as well as Rev. Ruls. 57–128 and 89–49. The facts and circumstances test is similar to that proposed for agencies and instrumentalities of a State or political subdivision thereof, (which is described in this preamble under the heading, "Definition of agency or instrumentality of a State or political subdivision of a State") but modified to reflect that this definition does not implicate the federalism concerns present in making determinations relating to agencies and instrumentalities of a State or political subdivision thereof.

The proposed regulations provide that, in making a determination of whether an entity is an "agency or instrumentality of the United States," the factors to be considered include whether:

- The entity performs or assists in the performance of a governmental function.
- There are no private interests involved, or the Government of the United States has all of the powers and interests of an owner. In determining whether an entity that holds stock has a private interest, stock will not be considered a private interest if the stock of the corporation is not acquired for investment purposes or for purposes of control.[27]
- The control and supervision of the entity is vested in the Government of the United States. Control must be more than the government's extensive Federal regulation of an industry.
- The entity is exempt from Federal, State, and local tax by an Act of Congress.
- The entity is created by the United States Government pursuant to a specific enabling statute that prescribes the purposes, powers, and manner in which the entity is to be established and operated.
- The entity receives financial assistance from the Government of the United States. However, an entity is not a governmental entity merely because it receives funds from the Government of the United States under a contract to provide a governmental service.
- The entity is determined to be an agency or instrumentality of the United States by a Federal court.
- Other governmental entities recognize and rely on the entity as an arm of the Government of the United States.
- The entity's employees are treated in the same manner as Federal employees for purposes other than providing employee benefits (for example, the entity's employees are granted civil service protection).

[24] Over the years, the IRS has extended the income tax exemption it provides to states and political subdivisions to entities it regards as their "integral parts." See Rev. Rul. 87–2, 1987–1 C.B. 18; *see also* Treas. Reg. § 301.7701–1(a)(3).

[25] See *Berini v. Federal Reserve Bank of St. Louis*, 420 F.Supp.2d at 1025.

[26] *Id.*

[27] The Department of Treasury and the IRS recognize that an entity may hold stock for purposes other than investment and control. For example, the federal reserve banks are required to hold stock in the Federal Reserve Bank of its district because ownership is a condition of being a member in the Federal Reserve System. Unlike stock in a private corporation, this stock is not acquired for investment purposes or for purposes of control. *See Berini v. Federal Reserve Bank of St. Louis*, 420 F. Supp. 2d at 1024, citing *Lee Const. Co., Inc. v. Federal Reserve Bank of Richmond*, 558 F.Supp. 165, 177 n.17 (D.Mich. 1982), citing 4 F. Solomon, W. Schlicting, T. Rice & J. Cooper, *Banking Law*, § 77.02, at 77–6 to 77–7 (1982).

These proposed regulations also provide an example, illustrating the application of the facts and circumstances test to a particular entity — a Federal credit union. As announced in previous guidance, one purpose of these regulations is to address whether a Federal credit union is a governmental entity for purposes of determining whether the Federal credit union can maintain an eligible nonqualified deferred compensation plan. Notice 2005–58 addresses certain income tax issues with respect to nonqualified deferred compensation plans maintained by Federal credit unions, including whether a Federal credit union can maintain an eligible nonqualified deferred compensation plan described in section 457(b). Under Notice 2005–58, a plan in effect on August 15, 2005, that is maintained by a Federal credit union and that is intended to be an eligible nonqualified deferred compensation plan of a non-governmental tax-exempt employer would not fail to be an eligible plan under section 457(b) solely because the employer is a Federal credit union, provided that certain conditions are satisfied (including the condition that the plan of the Federal credit union not have claimed to be a governmental plan for purposes of section 414(d) of the Code and section 3(32) of ERISA). The rule in Notice 2005–58 only applies pending the issuance of future guidance regarding section 414(d). See §601.601(d)(2)(ii)(*b*). Accordingly, upon adoption of these regulations as final regulations, the special treatment provided in Notice 2005–58 for Federal credit unions will no longer apply. However, after issuance of these regulations as final regulations, a Federal credit union can be an eligible employer within the meaning of section 457(e)(1)(B) on the basis that Federal credit unions are non-governmental tax-exempt organizations.

D. Definitions of State and political subdivision of a State.

The proposed regulations define the term "State" as any State of the United States and the District of Columbia. This definition, which is based on the definition of "State" in section 7701(a)(10), is different from the definition of "State" under section 3(10) of ERISA, which defines, in relevant part, the term "State" as any State of the United States, the District of Columbia, Puerto Rico, the Virgin Islands, America Samoa, Guam, and Wake Island.

The term "political subdivision of a State" is defined in these proposed regulations as a regional, territorial, or local authority, such as a county or municipality (including a municipal corporation), that is created or recognized by State statute to exercise sovereign powers.[28] Examples of sovereign powers include the power of taxation, the power of eminent domain, and the police power. The definition of "political subdivision of a State" also provides that the governing officers of the authority must be appointed by State officials or publicly elected.

The term "political subdivision of a State" has been used for purposes other than section 414(d), including the NLRA and section 103.[29] The definition in these proposed regulations of the term "political subdivision of a State" applies only for purposes of section 414(d), and not for any other purposes under the Code or any other statute, including whether an entity is treated as a political subdivision for purposes of the NLRA or section 103 of the Code.

E. Definition of agency or instrumentality of a State or a political subdivision of a State.

These proposed regulations would provide guidance on determining whether an entity is an "agency or instrumentality of a State or a political subdivision of a State." These regulations would provide that the determination is based on a facts and circumstances test. The proposed regulations provide that numerous factors have been applied by the IRS in determining whether an entity is an agency or instrumentality of a State or a political subdivision of a State. Satisfaction of one or more of the factors is not necessarily determinative of whether an organization is a governmental entity. One factor that is not weighed by the IRS is the way the entity refers to itself. For example, the mere fact that an entity is called the "Educational Service Agency of City A" would not be a factor in determining whether the entity is an agency or instrumentality of City A.

Major factors for determining whether an entity is an agency or instrumentality of a State or political subdivision of a State are whether:

- The entity's governing board or body is controlled by a State or political subdivision.
- The members of the governing board or body are publicly nominated and elected.
- The entity's employees are treated in the same manner as employees of the State (or political subdivision thereof) for purposes other than providing employee benefits (for example, the entity's employees are granted civil service protection).
- A State (or political subdivision thereof) has fiscal responsibility for the general debts and other liabilities of the entity (including funding responsibility for the employee benefits under the entity's plans).
- In the case of an entity that is not a political subdivision, the entity is delegated, pursuant to a statute of a State or political subdivision, the authority to exercise sovereign powers of the State or political subdivision (such as, the power of taxation, the power of eminent domain, and the police power).

It is expected that, in applying the factor relating to whether the entity's governing board or body is controlled by a State or political subdivision, the control cannot be a mere legal possibility. Examples of situations in which the control factor might be a mere legal possibility are cases in which there are a number of tiers of intervening corporations between the entity and the State, and cases in which the legal power to control is shared among so many

[28] For certain purposes, the effect of an entity being determined to be a political subdivision of a State may be similar to the entity being determined to be an agency or instrumentality of a State or political subdivision and for other purposes the effects may be different. Examples in which it is relevant whether an entity is a political subdivision in contrast to an agency or instrumentality of a State or political subdivision include the exclusion provided under section 402(l), the excise tax under section 4965, and the exception to the 10 percent additional tax under section 72(t)(10).

[29] Two court cases that have analyzed whether an entity is a "political subdivision of a State" for purposes of section 103 of the Code are *Commissioner of Internal Revenue v. Shamberg's Estate*, 144 F.2d 998 (2nd Cir. 1944), *cert. denied*, 323 U.S. 792 (1945), and *Commissioner of Internal Revenue v. White's Estate*, 144 F.2d 1019 (2nd Cir. 1944), *cert. denied*, 323 U.S. 792 (1945).

governing entities that none of them can be said to be responsible in the event of a failure to exercise control. In addition, since these two factors are interrelated, an entity that would satisfy the control factor would not be expected to satisfy the factor relating to whether members of the governing board or body are publicly elected or nominated. Alternatively, an entity that would satisfy the factor relating to whether members of the governing board or body are publicly elected or nominated would not be expected to satisfy the control factor.

Other factors for determining whether an entity is an agency or instrumentality of a State or political subdivision of a State are whether:

- The entity is created by a State government or political subdivision pursuant to a specific enabling statute that prescribes the purposes and powers of the entity, and the manner in which the entity is to be established and operated.
- The entity is directly funded through tax revenues or other public sources.
- The entity is treated as a governmental entity for Federal employment tax or income tax purposes (for example, whether the entity has the authority to issue tax-exempt bonds under section 103(a) of the Code) or under other Federal laws.
- The entity's operations are controlled by a State or political subdivision.
- The entity is determined to be an agency or instrumentality of a State or political subdivision thereof for purposes of State law. For example, the entity is subject to open meetings laws or the requirement to maintain public records that apply only to governmental entities, or the State attorney general represents the entity in court under a State statute that only permits representation of State entities.
- The entity is determined to be an agency or instrumentality of a State or political subdivision thereof by a State or Federal court for purposes other than section 414(d).

There are two additional factors to be considered. First, if a party other than a State (or political subdivision, agency, or instrumentality thereof) has an ownership interest, or other similar interests, in the entity, this factor would indicate that the entity is not an agency or instrumentality of a State or political subdivision thereof (however, an entity would not necessarily be considered an agency or instrumentality of a State or political subdivision thereof merely because there is no private ownership in the entity or the entity serves a governmental purpose). Second, if an entity does not serve a governmental purpose, this factor would indicate that it is not an agency or instrumentality of a State (or political subdivision thereof).

The proposed regulations include a variety of examples to illustrate whether an entity is an agency or instrumentality of a State or political subdivision thereof. Many of these examples are drawn from prior judicial opinions, as well as the Agencies' determinations.[30] Within the description of particular factors, there are some examples that illustrate whether a particular factor is satisfied. However, the mere satisfaction of a particular factor is not conclusive in determining whether an entity is an agency or instrumentality within the meaning of these regulations.

F. Requirements for establishing and maintaining a section 414(d) governmental plan.

The proposed regulations would provide that a plan is established and maintained for the employees of a governmental entity if the following requirements are satisfied: (1) the plan is established and maintained by an employer within the meaning of §1.401–1(a)(2) of the Income Tax Regulations;[31] (2) the employer is a governmental entity; and (3) the only participants covered by the plan are employees of the governmental entity. For purposes of determining whether employees covered by a plan are employees of a governmental entity, employee representatives described in section 413(b)(8) (including individuals who are employed by the plan) would be treated as employees of the plan sponsor.[32]

The proposed regulations would provide rules for changes in status of an entity from a private entity to a governmental entity and from a governmental entity to a private entity. As mentioned in the "Background" section of this preamble, the qualification requirements for a private qualified plan differ substantially from those of a governmental qualified plan. The issue of whether a plan of a private employer that later becomes a governmental entity can be a governmental plan raises a question regarding the interaction among the three definitions of the term "governmental plan" in ERISA. Section 414(d) of the Code defines the term "governmental plan" as "a plan established and maintained by the Government of the United States, by the government of any State or political subdivision thereof, or by any agency or instrumentality of the foregoing." In title IV of ERISA, section 4021(b)(2) provides that any plan "established and maintained for its employees by the Government of the United States, by the government of any State or political subdivision thereof, or by any agency or instrumentality of the foregoing" is exempt from coverage by ERISA. In title I of ERISA, section 3(32) defines a governmental plan as "a plan established or maintained by the Government of the United States, by the government of any State or political subdivision thereof, or by any agency or instrumentality of the foregoing." While the definitions in title II of ERISA (Code) and title IV of ERISA (PBGC provisions) use the language "established *and* maintained" by a governmental employer, the title I definition uses the language "established *or* maintained."

This difference in statutory language was addressed in *Rose v. Long Island Railroad Pension Plan*, 828 F.2d 910 (2nd Cir. 1987), *cert. denied*, 485 U.S. 936 (1988). In *Rose*, the State of New York, through the Metropolitan Transportation Authority (MTA), acquired the Long Island Railroad Company in 1966 (LIRR). The LIRR had originally been chartered as a private stock corporation. As part of the acquisition, the State also assumed sponsorship of the Long Island Railroad Pension Plan (LIRR

[30] *See, for example, Brock v. Chicago Zoological Society*, 820 F.2d 909 (7th Cir. 1987) and *NLRB v. Parents & Friends of the Specialized Living Center*, 879 F.2d 1442 (7th Cir. 1989).

[31] Section 1.401–1(a)(2) generally provides that a qualified pension, profit-sharing, or stock bonus plan is a definite written program and arrangement which is communicated to the employees and which is established and maintained by an employer.

[32] See §1.413–1(i)(1) for rules for when an employee is an employee representative.

Pension Plan). After ERISA was enacted in 1974, the widow of a participant who died in 1976 in the LIRR Pension Plan sued the plan under title I of ERISA after being denied survivorship benefits. The *Rose* court concluded that the LIRR Pension Plan was a governmental plan within the meaning of section 3(32) of ERISA because the LIRR was an agency or instrumentality of a political subdivision, the MTA.

The *Rose* court took the position that if a private entity is acquired by a governmental entity which becomes the plan sponsor, the plan can be established by the governmental entity and, thus, be a governmental plan. The court interpreted the "established or maintained" language in section 3(32) literally, but also noted the discrepancy between the "established *or* maintained" language in ERISA section 3(32) and the "established *and* maintained" language in Code section 414(d) and ERISA section 4021(b)(2) (emphasis added). Despite this difference in the three statutory definitions, Congress intended all three definitions to be interpreted in a similar manner. The *Rose* court reasoned that:

> "If a plan is required to have been both established and maintained by a governmental entity in order to qualify for exemption, then a plan which was established by a private entity but subsequently taken over by a governmental body would continue to be subject to ERISA. This outcome conflicts with the federalism-based concerns which led Congress to exempt governmental plans in the first place." *Rose v. Long Island Railroad Pension Plan*, 828 F.2d at 920.

The *Rose* court stated that courts have interpreted the word "and" as meaning "or" if such interpretation would reflect the legislative intent of the statute.[33] The *Rose* court noted that its conclusion was consistent with the approach taken by the PBGC in a similar matter involving an entity's change to governmental status prior to the enactment of ERISA where the PBGC stated that it would not impose the "established" requirement when doing so would frustrate the congressional intent of section 4021(b)(2) of ERISA.[34]

The *Rose* court also noted that the LIRR Pension Plan had been rewritten and substantially funded by the State since its acquisition of the LIRR in 1966, and stated that it would have reached the same conclusion regarding the plan's governmental status even if the definition under section 3(32) of ERISA used the phrase "established and maintained."

> "In any event, even if we agreed with Rose that the correct interpretation of [section 3(32) of ERISA] was established and maintained, we would still not conclude that the LIRR Plan was covered by ERISA, because the Plan was in fact established and maintained by the LIRR."

Rose v. Long Island Railroad Pension Plan, 828 F.2d at 920. *See also Roy v. Teachers Insurance and Annuity Association*, 878 F.2d 47 (2nd Cir. 1989).

The court concluded that a broad reading of the term "established"—whereby a plan not previously established under ERISA may become a plan established under ERISA without the preexisting one having been formally "terminated"—is more consistent with the legislative intent behind the governmental plan exemption.[35]

For reasons similar to those presented by the *Rose* court, but consistent with the "established and maintained" language in section 414(d), the proposed regulations would set forth rules for employers changing status from private to governmental that are consistent with the legislative intent of the exemption of governmental plans. The proposed regulations would provide that if an employer becomes a governmental entity or a governmental entity becomes the employer under the plan (for example, in connection with an asset transfer), the plan will be treated as a governmental plan established by a governmental employer on the date of the change (including all of the plan's assets and liabilities attributable to service before and after the date of the change). Thus, in such a case, under the proposed regulations, the plan would have to comply with all the requirements for a private plan up to the date of the change and then comply with the requirements for a governmental plan after the date of the change. These same rules would also apply if a portion of a private plan was spun off to a plan maintained by a governmental employer: that portion of the plan would cease to be subject to Code rules applicable to nongovernmental employers, and instead would become part of a governmental plan, while the remaining portion of the private plan that was not spun off would continue to be subject to the protection and other rules applicable to private plans. These rules would provide standards for determining when the Code protections and other rules for a private plan cease to apply (and when the substantially different rules for a governmental plan begin to apply).

In the case of a change in status from a private plan to a governmental plan, comments are requested on whether, and if so how, these regulations should address rights and obligations that accrued prior to the conversion to a governmental plan, including the responsibility of the former private plan sponsor (or former private plan) for benefits that accrued prior to the conversion. Any comments that address the potential impact of the proposed regulation's approach on rights and responsibilities under title I and title IV of ERISA will be forwarded to the DOL and the PBGC.

Similarly, the regulations would provide that if a governmental employer ceases to be a governmental entity, the plan will be treated as being established by a private employer thereafter (including all of the plan's assets and liabilities attributable to service before and after the date of the change). Such a change would

[33] See *Rose v. Long Island Railroad Pension Plan*, 828 F.2d at 919.

[34] The *Rose* court said that: "We find the PBGC's approach to be a sensible one; the status of the entity which currently maintains a particular pension plan bears more relation to Congress' goals in enacting ERISA and its various exemptions, than does the status of the entity which established the plan." *Rose v. Long Island Railroad Pension Plan*, 828 F.2d at 920. See PBGC Opinion Letter 75–44 (December 9, 1975).

[35] *But see Hightower v. Texas Hospital Association*, 65 F.3d 443, 448 (5th Cir. 1995), in which the Fifth Circuit held that if the plan was "established or maintained" for its employees by a governmental employer, the plan was exempt from coverage under title I of ERISA, even if it was not exempt from coverage under the title IV "established and maintained" test. The Court of Appeals held that the difference in statutory language between "established or maintained" and "established and maintained" had to be given some meaning, and held that for a plan to be a governmental plan under ERISA section 4021(b)(2), the plan had to be both established *and* maintained by the government. *Id.* at 450–51. The court did not discuss what, if any, actions would be sufficient for an employer assuming sponsorship of an existing plan to be treated as having "established" the plan.

occur either where the employer entity ceases to be a governmental entity (such as a spin-off of a corporation) or where the employees become employees of a different entity (such as in an asset transfer). Thus, for example, the entity in either case would no longer satisfy the requirement that the employer be a governmental entity. If such a change occurs, the plan must comply with the requirements for a governmental plan up to the change and then comply with all the requirements for a private plan for periods after the date of the change. (See also the related discussion under the heading, "Comments and Public Hearing.")

In the case of a formerly governmental plan becoming a private plan, the plan and plan sponsor may secure certain advantages, such as PBGC coverage or ERISA preemption, not available to governmental plans and governmental sponsors. However, nothing in these proposed income tax regulations should be construed to mean that, with respect to a transaction such as an asset sale, in which assets and liabilities of a governmental plan are transferred to a private plan, the assumption of benefit liabilities accrued prior to the transfer to the private plan relieves the former governmental employer (or former governmental plan) from responsibility for those benefits.

As previously stated, the proposed regulations would provide that if a governmental employer ceases to be a governmental entity, the plan will be treated as being established by a private employer on the date of the change. The proposed regulations would provide an exception to this general rule when there is a change in status from a governmental entity to a private entity under certain circumstances. Specifically, if a governmental plan ceases to be maintained by a governmental employer, the plan will nevertheless be treated as continuing to be a governmental plan if the benefits held under the governmental plan are frozen and a governmental entity assumes responsibility for the plan. While the frozen plan would continue to be treated as a governmental plan, the plan would be permitted (but not required) to provide participating employees with credit for service with the new employer for purposes of vesting, final pay adjustments, entitlements to benefits such as early retirement benefits, and similar service credit other than benefit accrual credit.

Further, certain types of plans are limited under the Code to specific types of employers, including limitations that apply differently depending on whether or not the employer is or is not a governmental entity. These limitations on employer eligibility raise special problems for cases in which an entity becomes or ceases to be a governmental employer. For example, because a qualified cash or deferred arrangement under section 401(k) generally cannot be maintained by a State or local government or political subdivision, or any agency or instrumentality thereof, such a plan maintained by a private employer cannot be continued if the employer later becomes part of a State. Other special problems arise if a governmental employer that is not a tax-exempt organization under section 501(c)(3) and that is not a public school attempts to become a sponsoring employer of a section 403(b) plan of a tax-exempt organization under section 501(c)(3). Likewise, a State entity cannot maintain an unfunded section 457(b) plan of a tax-exempt organization described in section 457(e)(1)(B). These proposed regulations would not alter rules relating to the eligibility of an employer to establish or maintain a particular type of retirement plan. An employer that is considering a change in its status should evaluate whether it is eligible to sponsor any plan that it assumes, taking into account the employer eligibility rules. Therefore, sponsors should not assume from these proposed regulations that a change of sponsorship from a private to governmental employer, or *vice versa*, will not result in any adverse tax consequences. As emphasized elsewhere in this preamble, the proposed regulations would provide that the established and maintained rules apply only for purposes of section 414(d).

Proposed Effective Date

It is expected that these proposed regulations would not be applicable earlier than for plan years beginning after the date of the publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**. Generally, amendment of a State or local retirement plan requires enactment of State legislation. The Department of Treasury and IRS intends to take into consideration the time required to complete the State legislative process when determining an effective date for these 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. In addition, because no collection of information is imposed on small entities, the provisions of the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply, and therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the 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 (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The Treasury Department and the IRS specifically 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.

These proposed regulations would provide that a determination of whether an entity is an agency or instrumentality of a State or a political subdivision thereof is based on a facts and circumstances analysis. Under the proposed regulations, the factors to be applied would be ranked into main factors and other factors. [36] Comments are requested on whether the final regulations should eliminate the distinction between main and other factors. Comments are also requested on the ordering

[36] For a list of the factors, see discussion under the heading *Definition of Agency or Instrumentality of a State or a Political Subdivision of a State* in the Explanation of Provisions of this preamble.

and the application of the main and other factors; for example, whether the final regulations should provide a list of factors with a safe harbor standard under which, if an entity satisfies identified factors, the entity will be treated as an agency or instrumentality of a State or political subdivision thereof, for purposes of section 414(d). Comments are also requested on whether the distinction between main and other factors should be retained, in addition to providing a safe harbor standard.

The factors identified in this bright line test might be whether: (1) a majority of the entity's governing board or body are either controlled by a State or political subdivision thereof or elected through periodic, publicly held elections (with the nominees elected by the voters); and (2) a State or political subdivision thereof has the fiscal responsibility for the general debts and other liabilities of the entity, including the entity's employee benefit plans. This standard might be available only if the entity was created by a State government or political subdivision pursuant to a specific enabling statute that prescribes the purposes, powers, and manner in which the entity is to be established and operated.

Apart from the special rules relating to plan coverage for employees of a labor union or plan under section 413(b)(8), these proposed regulations do not include special rules addressing existing practices under which a small number of private employees participate in a plan that would otherwise constitute a governmental plan under section 414(d). Comments are requested on whether an exception should be provided in such cases. Parameters that could be taken into account for such a special rule include the following: (1) whether the private employees were previously employees of the sponsoring governmental entity; (2) whether the private employees were previously participants in the governmental plan; (3) whether the number or percentage of such former employees who participate in the governmental plan is *de minimis* (and, if so, what constitutes a *de minimis* number or percentage); (4) whether the coverage is pursuant to pre-existing plan provisions; (5) whether the private employer performs a governmental function and has been officially designated as a State entity for plan participation purposes; and (6) whether the employer is ineligible to sponsor the particular type of governmental plan (for example, whether a private employer is a tax-exempt organization under section 501(c)(3) that can sponsor a section 403(b) plan, and whether the private employer sponsors or has sponsored plans that cannot be sponsored by a State governmental entity, such as a cash or deferred arrangement under section 401(k) or an unfunded section 457(b) plan of a tax-exempt entity (described in section 457(e)(1)(B)).

If any special rule for such circumstances were to be included in the final regulation, there would be a number of related issues. These issues would include how to address the status of such a plan as a governmental multiple employer plan. Other issues might include how section 414(h) governmental pick-up plans should be treated, differences resulting from the application of federal employment taxes to a private employer participating in a governmental multiple employer plan, the application of the minimum funding rules with respect to a private employer participating in a governmental multiple employer plan, how the prohibited transaction rules of section 4975 would apply with respect to a private employer participating in a governmental multiple employer plan, how the special benefit limitation rules of section 415 would apply to private plan participants in the governmental plan, and what treatment should apply where the plan was previously a funded section 457(b) plan of a State or local government.

If the final regulations do not provide any special rule for cases in which a governmental plan continues to cover private employees who were formerly governmental employees, it is expected that a reasonable transition period following publication of the final regulations will be provided. Comments are requested on what transitional relief should be provided to a governmental plan that covers private employees who were formerly governmental employees and continue to participate in the plan that would otherwise constitute a governmental plan under section 414(d) (such as the governmental plan spinning off a portion of the assets and liabilities of the plan with respect to the former employees as a separate non-governmental plan). Comments are also requested on whether this method of correction might also be appropriate in situations such as described in *Example 5* in paragraph (k)(4) of the proposed regulations.

The final regulations may also provide transitional relief for entities that previously operated as if they were governmental entities eligible to participate or sponsor governmental plans but later were determined to be private entities under the regulations. Comments are requested on what transitional relief should be provided to an entity that is later determined to be a private entity. The Treasury Department and the IRS anticipate that there will be a reasonable transition period following the final regulations for a plan to revise its arrangements in order to avoid the adverse tax consequences of failing to comply with all the requirements of a private retirement plan.

A public hearing has been scheduled for (date to be provided when proposed regulations are published), beginning at 10 a.m. in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington DC. Due to building security procedures, visitors must enter at the main entrance located at 1111 Constitution Avenue, NW. 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" portion of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments must submit written or electronic comments and an outline of the topics to be discussed and time to be devoted to each topic (signed original and eight (8) copies) by (date to be provided when proposed regulations are published). 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 comments has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is Pamela R. Kinard, Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities), Internal Revenue Service. However, personnel from other offices of the IRS and Treasury participated in their development.

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Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Par.2. Section 1.414(d)–1 is added to read as follows:

§1.414(d)–1 Definition of governmental plan.

(a) *Definition of governmental plan*—(1) *In general*. In accordance with section 414(d), for purposes of part I of subchapter D of chapter 1 of the Internal Revenue Code and the regulations, the term *governmental plan* means a plan established and maintained for its employees by the Government of the United States, by the government of any State or political subdivision thereof, or by any agency or instrumentality of the foregoing, as determined pursuant to the requirements of this section. The definitions set forth in this section only apply for purposes of section 414(d) and this section.

(2) *Definition for plans subject to certain statutes*. For purposes of part I of subchapter D of chapter 1 of the Internal Revenue Code and the regulations, the term "governmental plan" also includes any plan to which the Railroad Retirement Act of 1935 or 1937 applies and which is financed by contributions required under that Act and any plan of an international organization which is exempt from taxation by reason of the International Organizations Immunities Act (59 Stat. 669).

(3) *Definition for certain plans of Indian tribal governments*. For purposes of part I of subchapter D of chapter 1 of the Internal Revenue Code and the regulations, the term "governmental plan" also includes a plan which is established and maintained by an Indian tribal government (as defined in section 7701(a)(40)), a subdivision of an Indian tribal government (determined in accordance with section 7871(d)), or an agency or instrumentality of either, and all of the participants of which are employees of such entity substantially all of whose services as such an employee are in the performance of essential governmental functions but not in the performance of commercial activities (whether or not an essential governmental function).

(b) *Definition of United States*. The term *United States* has the meaning set forth in section 7701(a)(9).

(c) *Definition of agency or instrumentality of the United States*—(1) *Agency or instrumentality of the United States*. For purposes of the definition of "governmental plan" in paragraph (a)(3) of this section, the term *agency or instrumentality of the United States* means an entity that satisfies the facts and circumstances test in paragraph (c)(2) of this section.

(2) *Facts and circumstances test*. Whether an entity is an agency or instrumentality of the United States is based on facts and circumstances. In making this determination, the facts to be considered include the following:

(i) The entity performs or assists in the performance of a governmental function.

(ii) There are no private interests involved, or the Government of the United States has all of the powers and interests of an owner. In determining whether an entity that holds stock has a private interest, stock will not be considered a private interest if the stock of the corporation is not acquired for investment purposes or for purposes of control.

(iii) The control and supervision of the entity is vested in the Government of the United States. Control must be more than the government's extensive Federal regulation of an industry.

(iv) The entity is exempt from Federal, State, and Local tax by an Act of Congress.

(v) The entity is created by the United States Government pursuant to a specific enabling statute that prescribes the purposes, powers, and manner in which the entity is to be established and operated.

(vi) The entity receives financial assistance from the Government of the United States. However, an entity is not a governmental entity merely because it receives funds from the Government of the United States under a contract to provide a governmental service.

(vii) The entity is determined to be an agency or instrumentality of the United States by a Federal court.

(viii) Other governmental entities recognize and rely on the entity as an arm of the Government of the United States.

(ix) The entity's employees are treated in the same manner as Federal employees for purposes other than providing employee benefits (for example, the entity's employees are granted civil service protection).

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

Example. (i) *Facts*. Entity A is a Federal credit union, which is created pursuant to the Federal Credit Union Act, and is a tax-exempt organization under section 501(c)(1)(A)(i). Membership in the Federal credit union is not open to the general public but to individuals who share a common bond, current or former employees of specified employers. Entity A is member-owned and is controlled by a board of directors that is elected by its membership. Entity A, along with other Federal credit unions, is subject to regulation by the National Credit Union Administration (NCUA), which is a Federal agency that charters and regulates Federal credit unions.

(ii) *Conclusion*. Based on the facts and circumstances and the factors in paragraph (c)(2) of this section, Entity A is not an agency or instrumentality of the United States because its board of directors is elected by its own members and the directors are not responsible to the United States, except to the limited extent set forth in the Federal Credit Union Act and regulated by the NCUA. Thus, Entity A is not a governmental entity within the meaning of paragraph (c) of this section.

(d) *Definition of State*. The term *State* means any State of the United States and the District of Columbia.

(e) *Definition of political subdivision of a State*. The term *political subdivision of a State* means—

(1) A regional, territorial, or local authority, such as a county or municipality (such as, a municipal corporation), that is created or recognized by State statute to exercise sovereign powers (which generally means the power of taxation, the power of eminent domain, and the police power); and

(2) The governing officers either are appointed by State officials or publicly elected.

(f) *Definition of agency or instrumentality of a State or political subdivision of a State*—(1) *Agency or instrumentality of a State or political subdivision of a State*. The term *agency or instrumentality of a State or political subdivision of a State* means an entity that satisfies the facts and circumstances test in paragraph (f)(2) of this section.

(2) *Facts and circumstances test*—(i) *Factors to be considered*. In making the determination of whether an entity is an agency or instrumentality of a State or political subdivision of a State, the main factors to be considered are—

(A) The entity's governing board or body is controlled by a State (or political subdivision thereof). For example, an entity's governing board or body is controlled by a State (or political subdivision thereof) if the public officials of the State (or political subdivision thereof) have the power to appoint, and to remove and replace, a majority of the entity's governing board or body. This factor is not satisfied if the power to control is materially restricted (for example, if any board member of the entity can be replaced only with an individual chosen from a list of designees selected by the other members of the governing board or body);

(B) The members of the governing board or body are publicly nominated and elected;

(C) A State (or political subdivision thereof) has fiscal responsibility for the general debts and other liabilities of the entity, including responsibility for the funding of benefits under the entity's employee benefit plans;

(D) The entity's employees are treated in the same manner as employees of the State (or political subdivision thereof) for purposes other than providing employee benefits (for example, the entity's employees are granted civil service protection); and

(E) In the case of an entity that is not a political subdivision, the entity is delegated the authority to exercise sovereign powers (which generally means the power of taxation, the power of eminent domain, and police powers) of the State (or political subdivision thereof) and the delegation of authority is pursuant to a statute of a State (or political subdivision thereof).

(ii) *Other factors to be considered*. In making the determination of whether an entity is an agency or instrumentality of a State or a political subdivision of a State, other factors include—

(A) The entity's operations are controlled by a State (or political subdivision thereof);

(B) The entity is directly funded through tax revenues or other public sources. However, this factor is not satisfied if an entity that is not otherwise an agency or instrumentality is paid from public funds under a contract to provide a governmental service or is funded through grants by the State or Federal government;

(C) The entity is created by a State government or political subdivision of a State pursuant to a specific enabling statute that prescribes the purposes, powers, and manners in which the entity is to be established and operated. However, a nonprofit corporation that is incorporated under a State's general corporation laws is not created under a specific enabling statute;

(D) The entity is treated as a governmental entity for Federal employment tax or income tax purposes (such as, the authority to issue tax-exempt bonds under section 103(a)) or under other Federal laws;

(E) The entity is determined to be an agency or instrumentality of a State (or political subdivision thereof) for purposes of State laws. For example, the entity is subject to open meetings laws or the requirement to maintain public records that apply only to governmental entities, or the State attorney general represents the entity in court under a State statute that only permits representation of State entities;

(F) The entity is determined to be an agency or instrumentality of a State (or political subdivision thereof) by a State or Federal court;

(G) A State (or political subdivision thereof) has the ownership interest in the entity and no private interests are involved; and

(H) The entity serves a governmental purpose.

(3) *Examples*. The following examples illustrate the application of this paragraph (f). In each of these examples, unless otherwise stated, only facts that are relevant to the examples are included and it is assumed that no party other than a State or political subdivision thereof has an ownership interest in the entity and that the entity serves a governmental purpose. The examples are as follows:

Example 1. (i) *Facts*. Entity C is a utility company located in County B of State A. Entity C is created pursuant to a State A statute by a petition of 25 private citizens who are landowners, and approved by an order of a judge in County B. Entity C is administered by a board of commissioners named in the original petition, with vacancies to be filled by the incumbents, but with State A having the right to remove a board member for malfeasance. Entity C has the power of eminent domain. In addition, the records of Entity C are public records.

(ii) *Conclusion*. Based on the facts and circumstances, Entity C is not an agency or instrumentality of County B within the meaning of paragraph (f) of this section because it does not satisfy the control factors described in paragraphs (f)(2)(i)(A) and (ii)(A) of this section because Entity C is under the control of a self-perpetuating board of directors and because State A or its officials do not exercise control over the directors.

Example 2. (i) *Facts*. The facts are the same as in *Example 1*, except that Entity C is administered by a board of commissioners which is appointed by the Governor of State A and is subject to removal proceedings by the Governor of State A, the County B prosecutor, or the general public in County B. Vacancies on Entity C's district board are filled by popular election or by appointment of the Governor of State A. Entity C has the power of eminent domain. In addition, the records of Entity C are public records.

(ii) *Conclusion*. Based on the facts and circumstances, Entity C is an agency or instrumentality of County B within the meaning of paragraph (f) of this section.

Example 3. (i) *Facts*. Entity K is a non-profit corporation that operates a zoo in County J. Entity K is organized under the laws of State L. Although Entity K was not created by State law, the legislature of State L authorized the State's forest districts to contract with zoological societies for the creation, operation, and maintenance of zoological parks. County J entered into a contract with Entity K, giving Entity K exclusive control and management authority over the zoo in County J. Entity K, through government contracts, receives over half of its revenues from taxes raised by County J. The remaining revenues are from admission and parking fees, concessions, souvenirs, and private donations. County J maintains a significant amount of control over the budget of Entity K, including overseeing the expenditures of nontax revenues generated by Entity K. The zoo is located on land owned by County J, and vehicles used at the zoo are owned by County J and licensed as municipal vehicles. Entity K is managed by a 35-member board of trustees. Only one member of the board of trustees is a public official. Of the 240 members of Entity K who elect the board of trustees, only 4 members are County J public officials. In addition, County J has no direct role in Entity K's operation and maintenance of the zoo. Employees of Entity K are not treated in the same manner as public employees and, thus, are not covered under the civil service rules, pension plan, or workers' compensation funds of County J or State L.

(ii) *Conclusion*. Based on the facts and circumstances, Entity K is not an agency or instrumentality of County J or State L within the meaning of paragraph (f) of this section. Although Entity K is partly funded by County J, it receives those funds under a contract to provide governmental service and very few members of both the board of trustees and the governing members of Entity K are public officials.

Example 4. (i) *Facts*. Entity P is a non-profit corporation that operates a 24-hour intermediate care facility for mentally challenged adults located in State O. Entity P is licensed and regulated by State O. While not created by statute, Entity P's facility was built pursuant to statutory directives. Entity P is managed by a 9-member board of directors, which consists of parents of the patients at the facility and other volunteers. The directors are elected by Entity P's corporate members. State O has no authority to appoint or remove directors. The facility is managed by an executive director who is hired by the board without State approval. Pursuant to regulations, State O mandates certain personnel requirements, including staffing levels and minimum qualification requirements for staff members at the facility. However, Entity P is responsible for hiring, firing, and other disciplinary decisions. State O prescribes an hourly mean wage for the employees of Entity P, which limits the total amount that Entity P can pay its employees. In addition, State O imposes a ceiling on fringe benefits available to employees of Entity P, but Entity P is responsible for allocating the funds to pay for the fringe benefits.

(ii) *Conclusion*. Based on the facts and circumstances, Entity P is not an agency or instrumentality of State O within the meaning of paragraph (f) of this section. Although Entity P is directly funded by State O, it receives those funds under a contract to provide services to State O. Entity P does not satisfy the control factors described in paragraphs (f)(2)(i)(A) and (ii)(A) of this section because Entity P is controlled by directors who are chosen by Entity P's corporate members. While State O has some oversight control over Entity P's employees, through certification requirements and the imposition of limitations on pay and fringe benefits, Entity P has control over most employment decisions, as well as setting policies for holidays, vacations, insurance, and retirement benefits.

Example 5. (i) *Facts relating to University U*. University U was created by the legislature of State A and is an agency or instrumentality of State A under this paragraph (f). The board of trustees of University U appoints the president of University U. The president of University U appoints the chancellor of the medical school of University U. The chancellor of the medical school is also a vice-president of University U. The chancellor of the medical school appoints the various chairs of the clinical departments of the medical school.

(ii) *Facts relating to the corporate structure of Employer M*. The chairs of the clinical departments of the medical school have incorporated a separate entity, Employer M, under State A's not-for-profit law. Employer M is an integrated group practice for managing the clinical practice activities of the medical school faculty and was established in order to advance the purposes of the medical educational program and related activities of the medical school of University U. Under the by-laws of Employer M, any physician employee of Employer M must be a faculty member of the medical school (and if any physician employee of Employer M leaves the faculty of the medical school, his or her employment with Employer M terminates automatically).

(iii) *Facts relating to the control of Employer M*. Employer M is governed by a board of trustees consisting of the chancellor of the medical school, the clinical department chairs, and full-time faculty members appointed by two-thirds of the clinical department chairs. Performance of services as an employee of Employer M is a condition of employment for all full-time faculty members of the medical school. The faculty members are employees of University U and, in the capacity of their employment at University U, participate in the State A public employees' pension plan. Employer M also employs administrative and non-faculty employees who are not treated in the same manner as employees of State A (or University U). Employer M charges patients for the services provided by Employer M, and a portion of the fees collected are paid to University U. The compensation levels for employees of Employer M are set by faculty members who serve on the board of trustees of Employer M. The compensation paid to faculty members by Employer M is a substantial portion of the total compensation paid to them by University U and Employer M. Audited financial records of Employer M are submitted annually to the president of University U.

(iv) *Conclusion*. Employer M does not satisfy any of the factors listed in paragraphs (f)(2)(i)(B) through (E) of this section (that is, its trustees are not publicly nominated and elected, State A has no fiscal responsibility for Employer M, administrative and non-faculty employees of Employer M are not treated in the same manner as employees of State A, and Employer M has no sovereign powers). Employer M also does not satisfy any of the additional factors listed in paragraphs (f)(2)(ii)(B) through (G) of this section, but does satisfy the governmental purpose factor in paragraph (f)(2)(ii)(H) of this section. With respect to the control factors in paragraphs (f)(2)(i)(A) and (ii)(A) of this section, while all of Employer M's trustees are employees of University U, the majority of the board of trustees is not controlled by University U but by clinical department chairs and full-time faculty members of University U. Their service on the board of trustees of Employer M is in their capacity as representatives of Employer M, not as representatives of University U or State A. Accordingly, based on the facts and circumstances, including the lack of involvement of University U in overseeing the conduct of the board of trustees and the operations of Employer M beyond review of its audited financials, Employer M is not an agency or instrumentality of State A within the meaning of paragraph (f) of this section.

Example 6. (i) *Facts*. Entity W, a private foundation, provides public assistance to the indigent elderly in a residence hall built on land privately donated to Entity W, located in City V. City V contracts with Entity W to provide elder care to residents of City V. Over the years, City V has regularly budgeted for services provided by Entity W to its residents, including maintenance and upkeep of its facilities, and salaries of employees. In 1970, Entity W and City V together incorporated a non-profit organization, Entity X, called "City V Eldercare Residence," through which Entity W would provide its services to the residents of City V. Under Entity X's bylaws, Entity X is governed by a board of directors, six of whom are appointed by the Mayor of City V, and six of whom are appointed by Entity W. Entity X's employees are considered employees of Entity X and are not treated in the same manner as municipal employees of City V.

(ii) *Conclusion*. Although City V is a political subdivision of a State within the meaning of paragraph (e)(1) of this section, Entity X is not an agency or instrumentality of City V within the meaning of paragraph (f) of this section. While Entity X satisfies the governmental purpose factor described in paragraph (f)(2)(ii)(H) of this section, it does not satisfy any other factor, including the control factors described in paragraphs (f)(2)(i)(A) and (ii)(A) of this section or the employee factor described in paragraph (f)(2)(i)(D) of this section (because a majority of the board is not appointed by City V and Entity X's employees are not treated in the same manner as employees of City V).

Example 7. (i) *Facts*. Five States created Commission D as a body corporate of each compacting State and territory. Commission D was created to provide services to the States on issues relating to higher education. Each governor of the five States appoints three persons to the governing board of Commission D, which is subject to the joint control of the five States. Commission D submits yearly reports and budgets to the governors of each of the five States. Commission D's operating costs are apportioned equally among the States. The IRS determined in a ruling that Commission D was exempt from gross income under section 115. The IRS also determined that Commission D was an instrumentality of each of the five States for employment tax purposes.

(ii) *Conclusion*. Based on the facts and circumstances, Commission D is an agency or instrumentality of each of the five States within the meaning of paragraph (f) of this section.

Example 8. (i) *Facts*. Entity S, incorporated under the laws of State T as a non-profit corporation, operates a hospital in City R. City R leases the hospital and its entire operation to Entity S. The lease between City R and Entity S requires Entity S to transfer its assets and liabilities back to the City upon expiration of the lease. City R created the first board of directors for the hospital, but it does not have the power to remove or replace any board member. Only one of the 13 board members of Entity S is a public official, an *ex officio* voting member. In addition, the board of directors is not elected by the general public of City R. To fund a subsequent expansion of the hospital facility, City R issued tax-exempt bonds. Entity S does not have the authority to issue tax-exempt bonds. Entity S does not exercise any sovereign powers. Employees of Entity S are not treated in the same manner as employees of City R. For example, Entity S and City R maintain separate payrolls, health insurance plans, and pension plans.

(ii) *Conclusion*. Based on the facts and circumstances, Entity S is not an agency or instrumentality of City R within the meaning of paragraph (f) of this section. Although City R had the power of the initial appointment of the board members, it cannot subsequently appoint or remove any directors of Entity S, therefore, Entity S does not satisfy the control factor described in paragraph (f)(2)(i)(A) of this section.

(g) *Special rules for plans of Indian tribal governments*. [Reserved].

(h) *Special rules for plans subject to the Railroad Retirement Act of 1935 or 1937*. [Reserved].

(i) [Reserved].

(j) *Special rules for plans subject to the International Organizations Immunities Act*. [Reserved].

(k) *Established and maintained*—(1) *In general*. For purposes of applying this section (and not for any other purpose) with respect to a governmental entity (which is an entity defined in paragraph (b), (c), (d), (e), or (f) of this section), a plan is established and maintained for the employees of a governmental entity if—

(i) The plan is established and maintained for employees by an employer, within the meaning of §1.401–1(a)(2);

(ii) The employer is a governmental entity; and

(iii) The participants covered by the plan are employees of that governmental entity.

(2) *Changes in status*—(i) *Ceasing to be a private entity*. If an employer becomes a governmental entity (for example, as a result of a stock acquisition) or a governmental entity becomes the employer under the plan (for example, in connection with an asset transfer), the plan (including all of the plan's assets and liabilities attributable to service before and after the date of the change) will be treated, for purposes of paragraph (k)(1)(i) of this section, as being established by that governmental entity on the date of that change.

(ii) *Ceasing to be a governmental entity*—(A) *General rule*. Except as provided in paragraph (k)(2)(ii)(B) of this section, if an employer that is a governmental entity ceases to be a governmental entity (for example, as a result of a stock acquisition) or a private entity becomes the employer under the plan (for example, in connection with an asset transfer), the plan (including all of the plan's assets and liabilities attributable to service before and after the date of the change) is treated, for purposes of paragraph (k)(1)(ii) of this section, as being established by the non-governmental employer on the date of that change.

(B) *Exception*. If a plan is established and maintained for the employees of a governmental entity in accordance with paragraph (k)(1) of this section (without regard to this paragraph (k)(2)(ii)) and, at a subsequent date, the employer ceases to be a governmental entity (for example, as a result of an assets transfer), the plan is treated as continuing to be a governmental plan if—

(*1*) A governmental entity continues to be the plan sponsor after the change (for example, a governmental entity assumes the plan on or before the date on which the private entity becomes the employer (including becoming responsible for the employer obligations with respect to the payment of benefits under the plan)); and

(*2*) Benefits under the plan are frozen (with, if provided under the plan, participating employees to receive credit for service with the new employer for purposes of vesting, final pay adjustments, entitlement to benefits such as early retirement benefits, and similar service credit other than benefit accrual credit).

(C) *Governmental liability for spun-off benefits*. In the case of a transaction such as an asset sale in which assets and liabilities of a governmental plan are transferred to a private plan, the private employer would be responsible for satisfying the minimum funding standards of section 412 (including with respect to benefits attributable to service performed before the date of the change). However, nothing in this paragraph (k)(2)(ii) should be construed to mean that, with respect to such a transaction, the assumption of benefit liabilities accrued prior to the transfer to the private plan would relieve the former governmental employer (or former governmental plan) from responsibilities for those benefits.

(3) *Plan coverage for employees of a labor union or plan*. For purposes of paragraph (k)(1)(iii) of this section, employees of employee representatives described in section 413(b)(8) (including employees of a plan) are treated as employees of the plan sponsor. See §1.413–1(i).

(4) *Examples*. The following examples illustrate the application of this paragraph (k):

Example 1. (i) *Facts*. Employer C, a non-profit corporation whose principal place of business is located in City F, is not a governmental entity. Plan B, a retirement plan, is established and maintained by Employer C. In a stock acquisition, City F acquires all the shares of stock of Employer C and, as a result, Employer C becomes a governmental entity.

(ii) *Conclusion*. After the acquisition, Plan B is established and maintained by a governmental entity. In addition, the employees covered by Plan B are employees of a governmental entity. Thus, Plan B, including the assets and liabilities attributable to benefits accrued in Plan B prior to the date of the acquisition, is a governmental plan within the meaning of section 414(d) and this section.

Example 2. (i) *Facts*. Employer G is a hospital that is an agency or instrumentality of State A. Plan J, a retirement plan, is established and maintained by Employer G. Plan J satisfies the requirements of this paragraph (k) and is a governmental plan within the meaning of section 414(d). The assets of Employer G are transferred to a non-profit corporation, Employer M, which is not a governmental entity. All employees of Employer G become employees of Employer M. As part of the transaction, Employer M assumes Plan J, with respect to benefits accrued for service both before and after the transaction.

(ii) *Conclusion*. Plan J is no longer maintained by a governmental entity. In addition, the employees covered by Plan J are no longer employees of a governmental entity. Therefore, Plan J no longer constitutes a governmental plan within the meaning of section 414(d) and this section. In order for Plan J to continue to be a qualified plan, Plan J must satisfy the qualification requirements relating to non-governmental plans, including with respect to the assets and liabilities attributable to benefits accrued in Plan J prior to the date of the sale. The same conclusion would apply if the transfer were a stock transaction.

Example 3. (i) *Facts*. Same facts as in *Example 2*, except that, on the date of the sale, Employer G freezes Plan J, so that participants in Plan J are no longer accruing benefits under the plan and all accrued benefits are limited to service before the sale. In addition, on the date of the acquisition, State A assumes Plan J, including responsibility for the payment of benefits previously accrued to participants in Plan J.

(ii) *Conclusion*. In accordance with paragraph (k)(2)(ii)(B) of this section, Plan J continues to be a governmental plan within the meaning of section 414(d) and this section.

Example 4. (i) *Facts*. Pursuant to a State statute, State L permits local towns and villages to establish recreational facility authorities to build and promote recreational activities. Under Statute K, unincorporated Townships M, N, and O (which are political subdivisions of State L, within the meaning of paragraph (d) of this section) jointly establish a recreational facility authority, Authority R. Financing for Authority F is through local taxes and fees. Authority R operates under a three-person board of directors, one each appointed by townships M, N, and O. Authority R built and operates a skating rink, Facility S, which is located in Township O, but is open to the residents of Townships M, N, and O. Facility S is wholly owned and controlled by Townships M, N, and O. Township O maintains Pension Plan P for its seven employees, which is a governmental plan under section 414(d). Township O amends its plan to permit the three employees of Facility S to participate. The employees of Facility S are not employees of Township O and are not employees of a labor union described in section 413(b)(8).

(ii) *Conclusion*. The governmental plan status of Pension Plan P is not affected by the participation of Facility S's employees because Facility S is a govern-

mental entity within the meaning of section 414(d) and this section.

Example 5. (i) *Facts*. Same facts as *Example 4*, except that Township O amends Plan P to permit participation by 10 employees of candy and soft drink Vendor T, a supplier for Facility S. Vendor T is not a governmental entity.

(ii) *Conclusion*. Plan P is no longer a governmental plan within the meaning of section 414(d) because it provides benefits to employees of a non-governmental employer, Vendor T.

(l) *Employee*. For purposes of this section, the term *employee* means a common law employee of the employer (and the rules in section 401(c) do not apply).

Indian Tribal Governmental Plans

Announcement 2011–79

AGENCY: Internal Revenue Service (IRS), Department of the Treasury.

ACTION: Advance notice of proposed rulemaking.

SUMMARY: The Treasury Department and IRS anticipate issuing regulations under section 414(d) of the Internal Revenue Code (Code) to define the term "governmental plan." This document describes the rules the Treasury Department and IRS are considering proposing relating to the determination of whether a plan of an Indian tribal government is a governmental plan within the meaning of section 414(d) and contains an appendix that includes a draft notice of proposed rulemaking on which the Treasury Department and IRS invite comments from the public. This document applies to sponsors of, and participants and beneficiaries in, employee benefit plans of Indian tribal governments.

DATE: Written or electronic comments must be received by February 6, 2012.

ADDRESSES: Send submissions relating to the section 414(d) draft ITG regulations to: CC:PA:LPD:PR (REG–133223–08), room 5203, Internal Revenue Service, PO Box 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:LPD:PR (REG–133223–08), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC.

Alternately, taxpayers may submit comments relating to the section 414(d) draft ITG regulations located in the Appendix to this ANPRM electronically via the Federal eRulemaking Portal at *www.regulations.gov* (IRS-REG–133223–08).

FOR FURTHER INFORMATION CONTACT: Concerning the ANPRM, Pamela R. Kinard, at (202) 622–6060; concerning submission of comments, Richard Hurst, at (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document describes rules that the Treasury Department and IRS are considering proposing and contains a draft notice of proposed rulemaking (in the Appendix to this ANPRM) under section 414(d) of the Internal Revenue Code (Code). Under the draft notice of proposed rulemaking (in the Appendix to this ANPRM), the rules would provide guidance relating to the determination of whether a plan of an Indian tribal government, a subdivision of an Indian tribal government, or an agency or instrumentality of either (ITG) is a governmental plan within the meaning of section 414(d) of the Code (section 414(d) draft ITG regulations).

Section 414(d) of the Code provides that the term "governmental plan" generally means a plan established and maintained for its employees by the Government of the United States, by the government of any State or political subdivision thereof, or by any agency or instrumentality of any of the foregoing. See sections 3(32) and 4021(b)(2) of the Employee Retirement Income Security Act of 1974 (ERISA) for definitions of the term "governmental plan," which govern respectively for purposes of title I and title IV of ERISA[1].

The term "governmental plan" also includes any plan to which the Railroad Retirement Act of 1935 or 1937 (49 Stat. 967, as amended by 50 Stat. 307) applies and which is financed by contributions required under that Act and any plan of an international organization which is exempt from taxation by reason of the International Organizations Immunities Act (59 Stat. 669). See section 414(d)(2) of the Code.

Section 414(d) was amended by the Pension Protection Act of 2006, Public Law 109–280 (120 Stat. 780) (PPA '06) to include certain plans of Indian tribal governments and related entities.[2] Section 906(a)(1) of PPA '06 provides that the term "governmental plan" includes a plan which is established and maintained by an Indian tribal government (as defined in section 7701(a)(40)), a subdivision of an Indian tribal government (determined in accordance with section 7871(d)), or an agency or instrumentality of either (ITG), and all the participants of which are employees of such entity substantially all of whose services as such an employee are in the performance of essential governmental functions but not in the performance of commercial activities (whether or not an essential governmental function).

Neither section 414(d) of the Code, section 3(32) of ERISA, nor section 4021(b)(2) of ERISA define key terms relating to governmental plans, including the terms "established and maintained," "political subdivision," "agency," and "instrumentality." Currently, there are no regulations interpreting section 414(d). Revenue Ruling 89–49, 1989–1 C.B. 117, see §601.601(d)(2), sets forth a facts and circumstances analysis for determining whether a retirement plan is a governmental plan within the meaning of section 414(d).[3] This analysis is used by the IRS in issuing letter rulings. In connection with this advanced notice of proposed rulemaking, an advance notice of proposed rulemaking is also being issued with respect to the general definition of a

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[1] The three definitions of the term "governmental plan" are essentially the same. The only difference is that, in defining the term "governmental plan," section 3(32) of ERISA uses the phrase "established or maintained," whereas section 414(d) of the Code and section 4021(b) of ERISA use the term "established and maintained."

[2] Section 906(a) of PPA '06 made similar amendments to sections 3(32) and 4021(b)(2) of ERISA.

[3] See also Rev. Rul. 57–128, 1957–1 C.B. 311, see § 601.601(d)(2), which provides guidance on determining when an entity is a governmental instrumentality for purposes of the exemption from employment taxes under section 3121(b)(7) and 3306(c)(7).

governmental plan (REG–157714–06 that is being published elsewhere in this issue of the Bulletin).

Governmental plans are subject to different rules than retirement plans of non-governmental employers. Governmental plans are excluded from the provisions of titles I and IV of ERISA. In addition, governmental plans receive special treatment under the Code. These plans are exempt from certain qualification requirements and they are deemed to satisfy certain other qualification requirements under certain conditions. As a result, the principal qualification requirements for a tax-qualified governmental plan[4] are that the plan—

- Be established and maintained by the employer for the exclusive benefit of the employer's employees or their beneficiaries;
- Provide definitely determinable benefits;
- Be operated pursuant to its terms;
- Satisfy the direct rollover rules of section 401(a)(31);
- Satisfy the section 401(a)(17) limitation on compensation;
- Comply with the statutory minimum required distribution rules under section 401(a)(9);
- Satisfy the pre-ERISA vesting requirements under section 411(e)(2);[5]
- Satisfy the section 415 limitations on benefits, as applicable to governmental plans; and
- Satisfy the prohibited transaction rules in section 503.

State and local governments, political subdivisions thereof, and agencies or instrumentalities thereof are generally not permitted to offer cash or deferred arrangements under section 401(k). However, an ITG is permitted to offer a cash or deferred arrangement under section 401(k).

Notice 2006–89, 2006–2 C.B. 772, and Notice 2007–67, 2007–2 C.B. 467, see §601.601(d)(2), summarize the changes made by section 906(a)(1) of PPA '06 and provide transitional relief to ITGs under a reasonable and good faith standard to comply with such changes. The notices provide that until such guidance is issued, a plan established and maintained by an ITG for its employees is treated as satisfying the requirements of section 906(a)(1) of PPA '06 to be a governmental plan under section 414(d) of the Code if it complies with those requirements based on a reasonable and good faith interpretation of section 414(d). For further background, see the "Background" section of the preamble of the section 414(d) draft ITG regulations in the Appendix to this ANPRM under the headings, "Notices Issued by the IRS Relating to ITG Retirement Plans under PPA '06."

The Treasury Department and the IRS participated in a series of telephone listening meetings with the ITG community following the passage of PPA '06. The attached draft notice of proposed rulemaking in the Appendix to this ANPRM takes into account comments provided through a number of informative and cooperative comments received in response to Notices 2006–89 and 2007–67 and open and direct consultations with the Indian tribal community. Those comments received from Notices 2006–89 and 2007–67 and during the consultations were considered in drafting the proposed rulemaking.

The Treasury Department and the IRS have determined to seek public comment and consult with ITGs on the draft proposed regulations in advance of issuing a notice of proposed rulemaking. In light of the interaction of the governmental plan definitions in the Code and ERISA, a copy of the comments will be forwarded to DOL and PBGC.

Explanation of Provisions

Attached to the Appendix to this ANPRM is a draft notice of proposed rulemaking. These draft regulations include proposed rules, a preamble, and a request for comments. The Treasury Department and IRS invite the public to comment on the rules that the Treasury Department and IRS are considering proposing, which would set forth special rules relating to retirement plans of ITGs.

Section 414(d) Draft ITG regulations

A plan established and maintained by an ITG is a governmental plan under section 414(d), as amended by section 906 of PPA '06, only if all of its participants are employees substantially all of whose services are in the performance of essential governmental functions (but not in the performance of commercial activities whether or not an essential governmental function). Therefore, the rules under the section 414(d) draft general regulations (in the Appendix to the ANPRM that is being published elsewhere in this issue of the Bulletin) would apply to ITG governmental plans, as well as the special rules under the attached section 414(d) draft ITG regulations. The anticipated proposed regulations would use the broader concepts of governmental activity and commercial activity, instead of the terms essential governmental function and commercial activity. See the "Explanation of Provisions" section in the section 414(d) draft ITG regulations in the Appendix to this ANPRM under the heading, "Determination of Governmental and Commercial Activities."

Under the section 414(d) draft ITG regulations (in the Appendix to this ANPRM), whether a plan of an ITG is a governmental plan or a nongovernmental plan within the meaning of section 414(d) would be based, in part, on: (1) a determination of which activities are commercial activities and (2) a determination of whether employees of the ITG covered by the plan are employees who perform substantial services in commercial activities of the ITG (and are thus commercial employees).

The anticipated proposed regulations would provide that certain specific activities are deemed to be governmental or commercial for purposes of section 414(d). Under the anticipated proposed regulations, commercial activities would be operations involving a hotel, casino, service station, convenience store, or marina. These activities are examples that were identified as commercial activities in Notices 2006–89 and 2007–67, as well as in the Joint Committee on Taxation

[4] A special rule applies to contributory plans of certain governmental entities. Section 414(h)(2) provides that, for a qualified plan established by a State government or political subdivision thereof, or by any agency or instrumentality of the foregoing, where the contributions of the governmental employer are designated as employee contributions under section 414(h)(1) but the governmental employer picks up the contributions, the contributions picked up will be treated as employer contributions.

[5] Section 411(e)(2) states that a plan described in section 411(e)(1) is treated as meeting the requirements of section 411 if the plan meets the vesting requirements resulting from the application of section 401(a)(4) and (a)(7) as in effect on September 1, 1974.

Technical Explanation to section 906 of PPA '06. The section 414(d) draft ITG regulations in the Appendix to this ANPRM would provide that governmental activities include activities related to the building and maintenance of public roads, sidewalks, and buildings, activities related to public works projects (such as schools and government buildings), and activities that are subject to a treaty or special rules that pertain to trust land ownership and use. See §601.601(d)(2).

In addition to listing certain specified activities, the anticipated proposed regulations would provide a facts and circumstances test for determining whether an activity is a governmental or commercial activity. See the "Explanation of Provisions" section in the section 414(d) draft ITG regulations in the Appendix to this ANPRM under the heading, "Governmental and Commercial Activities." The anticipated proposed regulations would also provide examples illustrating the application of the facts and circumstances tests to particular activities.

The anticipated proposed regulations would also provide rules for determining whether employees covered by an ITG plan are employees who perform substantial services in activities that are governmental. For this purpose, the determination of whether an employee's services are for governmental or commercial activities would generally be based on the employee's assigned duties and responsibilities. See the "Explanation of Provisions" section in the section 414(d) draft ITG regulations in the Appendix to this ANPRM under the headings, "Determination of Governmental ITG Employees" and "Determination of Commercial ITG Employees."

The anticipated proposed regulations do not address the broader issue of whether a retirement plan is a governmental plan within the meaning of section 414(d). That topic is addressed in the advance notice of proposed rulemaking relating generally to the definition of governmental plan that is being published elsewhere in this issue of the Bulletin.

Request for Comments

Before a notice of proposed rulemaking is issued, 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. Copies of the comments will be provided to the DOL and PBGC.

Comments are also requested on whether, as an alternative to issuing proposed regulations, the Department of Treasury and IRS should publish a notice that reflects some or all of the rules in the draft proposed regulations and that also modifies the rule in Notice 2007–67 concerning when a mixed ITG is required to be amended to be two different plans, one for governmental employees and another for commercial employees. If so, the notice would include a significant transitional period for compliance similar to the transition period that would be expected to apply for regulations (such as not being effective until plan years that begin at least 18 months after publication of the notice). The Department of Treasury and IRS invite comments on whether this method of guidance would be preferable to the issuance of regulations.

The IRS and Department of Treasury plan to schedule a public hearing on the ANPRM. That hearing will be scheduled and announced at a later date. In addition to a public hearing, the Treasury Department and IRS anticipate scheduling consultation listening meetings in order to obtain comments from tribal governments on the section 414(d) draft ITG regulations. It is expected that these meetings will take place in different locations across the country. Participants will be encouraged to pre-register for the meetings. Information relating to these meetings, including dates, times, locations, registration, and the procedures for submitting written and oral comments, will be available on the IRS website relating to governmental plans at *http://www.irs.gov/retirement/article/0,,id=181779,00.html.*

EO 13175, Consultation and Coordination with Indian Tribal Governments

In the Appendix to this ANPRM is a draft notice of proposed rulemaking. These draft regulations include proposed rules, a preamble, and a request for comments. The Treasury Department and the IRS invite the public to comment on the rules under consideration, which would set forth special rules relating to retirement plans of ITGs. This solicitation of comments is in furtherance of the objective of Executive Order 13175 under which Treasury consults with tribal officials in the development of Federal policies that may have tribal implications. The IRS and Treasury Department will consult with Indian tribes through the normal comment process in the **Federal Register**, issuing this advance notice of public rulemaking, and reaching out to Indian tribes through a series of consultation listening meetings.

Drafting Information

The principal author of this advance notice of proposed rulemaking is Pamela R. Kinard, Office of the Chief Counsel (Tax-exempt and Government Entities), however, other personnel from the IRS and Treasury Department participated in its development.

Steven T. Miller,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on November 7, 2011, 8:45 a.m., and published in the issue of the Federal Register for November 8, 2011, 76 F.R. 69188)

APPENDIX

The following is draft language for a notice of proposed rulemaking that would set forth rules relating to the determination of whether a plan of an Indian tribal government is a governmental plan within the meaning of section 414(d). The IRS and Treasury release this draft language in order to solicit comments from the governmental plans community:

Background

This document contains proposed regulations under section 414(d) of the Internal Revenue Code (Code). These regulations, when finalized, would provide guidance relating to the determination of whether a plan of an Indian tribal government or other entities related to an Indian tribal government is a governmental plan within the meaning of section 414(d). The definition of a governmental plan under section 414(d) applies for purposes of Part I of Subchapter D of Chapter 1 of Subtitle A (Income Taxes) of the Code (sections 401 through 420) and certain other Code

provisions that refer to section 414(d) (such as sections 72(t)(10), 501(c)(25)(C), 4975(g)(2), 4980B(d)(2), 9831(a)(1), and 9832(d)(1) of the Code).

Statutory Definition of Governmental Plan

Both the Code and the Employee Retirement Income Security Act of 1974 (ERISA) define the term "governmental plan." Prior to the Pension Protection Act of 2006, Public Law 109–280 (120 Stat. 780) (PPA '06), section 414(d) of the Code provides that the term "governmental plan" means a plan established and maintained for its employees by the Government of the United States, by the government of any State or political subdivision thereof, or by any agency or instrumentality of any of the foregoing. Sections 3(32) and 4021(b)(2) of ERISA have parallel definitions of the term "governmental plan." The term "governmental plan" also includes any plan to which the Railroad Retirement Act of 1935 or 1937 (49 Stat. 967, as amended by 50 Stat. 307) applies and which is financed by contributions required under that Act and any plan of an international organization which is exempt from taxation by reason of the International Organizations Immunities Act Public Law 79–291 (59 Stat. 669).

Section 906 of PPA '06

Section 906(a) of PPA '06 amended section 414(d) of the Code (and the parallel provisions in sections 3(32) and 4021(b)(2) of ERISA) to include in the definition of "governmental plan" certain plans of an Indian tribal government, a subdivision of an Indian tribal government, or an agency or instrumentality thereof. Specifically, under section 906(a)(1) of PPA '06, the term "governmental plan" includes a plan which is established and maintained for its employees by an Indian tribal government (as defined in section 7701(a)(40)), a subdivision of an Indian tribal government (determined in accordance with section 7871(d)), or an agency or instrumentality of either (ITG), and all of the participants of which are employees of such entity substantially all of whose services as such an employee are in the performance of essential governmental functions but not in the performance of commercial activities (whether or not an essential governmental function). Section 906(c) of PPA '06 provides that the amendments made by section 906 of PPA '06 apply to any year beginning on or after the date of enactment, which is August 17, 2006.

In its Technical Explanation[6] to section 906 of PPA '06, the Joint Committee on Taxation refers to an employee substantially all of whose services for an ITG are in the performance of essential governmental services and not in the performance of commercial activities (whether or not such activities are an essential governmental function) as a qualified employee who is eligible to participate in a governmental plan as described in section 414(d). The Technical Explanation states, for example, that a governmental plan includes a plan of an ITG, all of the participants of which are teachers in tribal schools. However, the Technical Explanation also states that a governmental plan does not include a plan covering tribal employees who are employed by a hotel, casino, service station, convenience store, or marina operated by a tribal government.

Exemption of Governmental ITG Plans from Certain Qualified Plan Rules

Governmental plans under Code section 414(d), including governmental ITG plans, receive special treatment with respect to certain qualification rules. Such plans are exempt from certain qualification requirements and are deemed to satisfy certain other qualification requirements under certain conditions. For example, the nondiscrimination and minimum participation rules do not apply to governmental plans.[7] In addition, the Code provides other exemptions for section 414(d) governmental plans:

- Section 401(a)(10)(B)(iii), which provides that the top-heavy requirements of section 416 do not apply to a governmental plan.
- Section 410(c)(1)(A), which provides that the minimum participation provisions of section 410 do not apply to a governmental plan.
- Section 411(e), which provides that a governmental plan is treated as satisfying the requirements of section 411 if the plan meets the pre-ERISA vesting requirements.
- Section 412(e)(2)(C), which provides that the minimum funding standards of section 412 do not apply to a governmental plan.
- Section 417, which provides rules relating to qualified joint and survivor annuities and qualified preretirement survivor annuities.

Section 415 also provides a number of special rules for governmental plans. The special rules include section 415(b)(11) (under which governmental pensions are not limited to 100% of a participant's average high 3 compensation), section 415(b)(2)(I) (the reduced limitation to the annual benefit payable beginning before age 62 and the reduction in the dollar limitation to the annual benefit payable for participation or services of less than 10 years do not apply to disability or survivor benefits received from a governmental plan), section 415(m) (benefits provided under a qualified governmental excess benefit arrangement are not taken into account in determining the section 415 benefit limitations under a section 414(d) governmental plan), and section 415(n) (permissive service credit).

As a result, the principal qualification requirements for a tax-qualified governmental plan[8] are that the plan—

- Be established and maintained by the employer for the exclusive benefit of

[6] Joint Committee on Taxation, Technical Explanation of H.R. 4, the "Pension Protection Act of 2006" as passed by the House on July 28, 2006, and considered by the Senate on August 3, 2006 (JCX–38–06), August 3, 2006, 109th Cong., 2nd Sess. 244 (2006).

[7] Section 861 of PPA '06 amended sections 401(a)(5)(G) and 401(a)(26)(G) of the Code to provide that the minimum participation standards and nondiscrimination requirements of section 410 and the additional participation requirements under section 401(a)(26) do not apply to governmental plans within the meaning of section 414(d) of the Code. Section 861 of PPA '06 also exempts governmental plans from the nondiscrimination and participation requirements applicable to qualified cash or deferred arrangements under section 401(k)(3) of the Code.

[8] A special rule applies to contributory plans of certain governmental entities. Section 414(h)(2) provides that, for a qualified plan established by a State government or political subdivision thereof, or by any agency or instrumentality of the foregoing, where the contributions of the governmental employer are designated as employee contributions under section 414(h)(1) but the governmental employer picks up the contributions, the contributions picked up will be treated as employer contributions.

the employer's employees or their beneficiaries;
- Provide definitely determinable benefits;
- Be operated pursuant to its terms;
- Satisfy the direct rollover rules of sections 401(a)(31) and 402(f);
- Satisfy the section 401(a)(17) limitation on compensation;
- Comply with the statutory minimum required distribution rules under section 401(a)(9);
- Satisfy the pre-ERISA vesting requirements under section 411(e)(2);[9]
- Satisfy the section 415 limitations on benefits, as applicable to governmental plans; and
- Satisfy the prohibited transaction rules in section 503.

State and local governments, political subdivisions thereof, and agencies or instrumentalities thereof are generally not permitted to offer cash or deferred arrangements under section 401(k).[10] However, Indian tribal governments and their related entities are permitted to offer cash or deferred arrangements as part of a plan maintained by an ITG.[11]

Rules Treating Indian Tribal Governments as States for Purposes of Issuing Tax-Exempt Bonds

Section 7871 provides special rules for Indian tribal governments. Section 7871(a)(4) provides that an Indian tribal government is to be treated as a State for purposes of section 103, relating to tax-exempt bonds.[12] Section 7871(c)(1) generally provides that section 103(a) applies to an obligation issued by an Indian tribal government only if such obligation is part of an issue substantially all of the proceeds of which are to be used in the exercise of any essential governmental function.

On August 9, 2006, an advance notice of proposed rulemaking under section 7871 was published in the **Federal Register** (71 FR 45474). The ANPRM describes the rules that the Treasury Department and the IRS anticipate proposing on the definition of essential governmental function under section 7871(e). The rules would provide that an activity is considered an essential governmental function that is customarily performed by State and local governments if: (1) there are numerous State and local governments with general taxing powers that have been conducting the activity and financing it with tax-exempt governmental bonds; (2) State and local governments with general taxing powers have been conducting the activity and financing it with tax-exempt governmental bonds for many years; and (3) the activity is not a commercial or industrial activity. The ANPRM provides examples of activities customarily performed by State and local governments, including public works projects such as roads, schools, and government buildings.

Notices Issued by the IRS Relating to ITG Retirement Plans under PPA '06

Notice 2006–89, 2006–2 C.B. 772, and Notice 2007–67, 2007–2 C.B. 467, see §601.601(d)(2), summarize the changes made by section 906(a)(1) of PPA '06 and provide transitional relief to ITGs under a reasonable and good faith standard to comply with such changes. The notices provide that, until such guidance is issued, a plan established and maintained by an ITG for its employees is treated as satisfying the requirements of section 906(a)(1) of PPA '06 to be a governmental plan under section 414(d) of the Code if it complies with those requirements based on a reasonable and good faith interpretation of section 414(d). The notices further provide that it is not a reasonable and good faith interpretation of section 414(d) for an ITG plan to claim to be a governmental plan within the meaning of section 414(d) if employees participating in the plan perform services for a hotel, casino, service station, convenience store, or marina operated by an ITG.

In Notices 2006–89 and 2007–67, the Treasury Department and IRS announced that regulations would be proposed to provide guidance on section 414(d), including changes made to section 414(d) by section 906 of PPA '06, and to provide transitional relief pending the issuance of these regulations. Comments were requested on issues relating to section 906 of PPA '06, including transitional issues not addressed in the notice.

The transitional relief provided to plans of ITGs under Notices 2006–89 and 2007–67 continues up to the date that is six months after the date that guidance is issued under section 414(d) of the Code, as amended by section 906 of PPA '06 (extended date). For ITG plans that provide benefits both to employees substantially all of whose work is in essential governmental functions that are not commercial activities (governmental ITG employees) and to employees who perform services substantially in the performance of commercial activities (commercial ITG employees), the Notices provide that the ITG plan will be treated as satisfying the reasonable, good faith standard if certain steps are taken, which include adopting a separate plan covering commercial ITG employees effective as of the beginning of the first plan year beginning on or after August 17, 2006, the enactment of PPA '06. The commercial ITG plan, beginning on the same effective date, must comply with the qualification requirements for plans that are not governmental plans.

These proposed regulations would provide guidance relating to ITG plans under section 414(d). The transitional relief provided under Notices 2006–89 and 2007–67 would end six months after the effective date of the final regulations published in the **Federal Register**.

The transitional relief in Notices 2006–89 and 2007–67 is conditioned on the ITG plans involved not being amended, for periods before the extended date, to reduce benefits unless the reduction does not distinguish between reductions for

[9] Section 411(e)(2) states that a plan described in section 411(e)(1) is treated as meeting the requirements of section 411 if the plan meets the vesting requirements resulting from the application of section 401(a)(4) and (a)(7) as in effect on September 1, 1974.

[10] Section 401(k)(4)(B)(ii) provides that a cash or deferred arrangement shall not be treated as a qualified cash or deferred arrangement if it is part of a plan maintained by a State or local government or political subdivision thereof, or any or agency or instrumentality thereof.

[11] See section 401(k)(4)(B)(iii). For a general overview of the special rules relating to plans of ITGs, see the Joint Committee on Taxation, *Overview of Federal Tax Provisions Relating to Native American Tribes and Their Members* (JCX 61–08), July 18, 2008.

[12] An Indian tribal government is treated in the same manner as a State for certain specified purposes under the Code, but not for purposes of section 414(d) (or any provision in sections 401 through 424, other than sections 403(b)(1)(A)(ii)).

commercial ITG employees and governmental ITG employees or the reduction for commercial ITG employees is the minimum amount necessary to satisfy any requirement under the Code. If any reduction occurs that does not satisfy these conditions, the transitional relief provided under Notices 2006–89 and 2007–67 ends on the date that the reduction goes into effect.

Executive Order 13175

Executive Order 13175 requires that Federal departments and agencies engage in consultation procedures in certain circumstances where regulations are issued which have substantial direct effects with respect to the Federal government and Indian tribes. While these regulations when issued as final regulations would not have such substantial direct effects, the IRS and Treasury Department have followed similar procedures. Further, the Treasury Department and the IRS participated in a series of telephone listening meetings with the ITG community following the passage of PPA '06 and these proposed regulations also take into account the comments that were provided in response to Notices 2006–89 and 2007–67, including the related open and direct consultations with the Indian tribal community.

Judicial Determinations

The few court cases that discuss section 906 of PPA '06 primarily relate to welfare benefit plans. One reason for the legislative change to section 414(d) of the Code and section 3(32) of ERISA is "to clarify the legal ambiguity regarding the status of employee benefit plans established and maintained by tribal governments."[13] In *Bolssen v. Unum Life Insurance Company of America*, 629 F.Supp. 2d 878 (E.D. Wis. 2009), Mr. Bolssen sued the Unum Life Insurance Company for failing to provide disability insurance benefits. He argued that the case should be remanded to state court because the insurance plan sponsored by his employer, an Indian tribal casino, was a governmental plan within the meaning of section 3(32) of ERISA. In analyzing whether the welfare benefit plan was a governmental plan, the *Bolssen* court looked to another case involving an Indian tribal casino, *San Manuel Indian Bingo & Casino v. NLRB*, 475 F.3d 1306 (D.C. Cir. 2007). In *San Manuel Indian Bingo & Casino*, the court held that the National Labor Relations Act applied to an Indian tribal casino because the operation of the casino was a commercial function. The court reasoned that "it can be argued any activity of a tribal government is by definition 'governmental,' and even more so an activity aimed at raising revenue that will fund governmental functions. Here, though, we use the term 'governmental' in a restrictive sense to distinguish between the traditional acts governments perform and collateral acts that, though perhaps in some way related to the foregoing, lie outside their scope."[14]

The court, in *San Manuel Indian Bingo & Casino*, held that operating a casino is not a traditional act of government, but is commercial in nature.[15] The court in *Bolssen* applied the same reasoning to conclude that disability plan of the casino was not a governmental plan within the meaning of section 3(32) of ERISA.

Explanation of Provisions

These proposed regulations would provide special rules for purposes of the definition of a "governmental plan" under section 414(d) of the Code, as it relates to plans of ITGs. The Treasury Department and IRS also expect to issue separate proposed regulations under section 414(d) to define a governmental plan for purposes other than the special rules applicable to ITGs. However, these proposed regulations relating to ITGs would provide Indian tribal governments with guidance in determining whether an ITG plan is a governmental ITG plan or a commercial ITG plan. As discussed in the background of this preamble, under the heading "Exemption of Governmental ITG Plans from Certain Qualified Plan Rules," governmental plans receive special treatment with respect to certain qualification rules. Thus, the determination of whether an ITG plan is a governmental ITG plan is essential in ensuring compliance with the qualified plan rules because an ITG must be able to ascertain which of its plans are governmental plans under section 414(d) and which of its plans must comply with the requirements for a plan that is not a governmental plan. These proposed regulations take into account comments received in response to Notices 2006–89 and 2007–67 and a number of open and direct consultations with the Indian tribal community. Those comments received from Notices 2006–89 and 2007–67 and during the consultations were considered in drafting these proposed regulations.

Determination of Governmental and Commercial Activities

As discussed earlier in the background section of this preamble, a governmental plan, as it relates to ITGs, may include a plan established and maintained by an ITG, but such a plan is a governmental plan under section 414(d) only if all of its participants are employees substantially all of whose services are in the performance of essential governmental functions (but not in the performance of commercial activities whether or not an essential governmental function). Key to determining whether a plan of an ITG is a governmental plan within the meaning of section 414(d) is the determination of the terms "essential governmental function" and "commercial activity."

These proposed regulations would use the concepts of "governmental activity" and "commercial activity," instead of the terms "essential governmental function" and "commercial activity." The terms "governmental activity" and "commercial activity" would apply only for purposes of the governmental plan rules under section 414(d) and not for any other purpose under the Code, including section 7871. The use of these terms is meant to provide guidance on the requirements of section 414(d) with respect to ITG plans, while maintaining flexibility and without directly impacting future guidance on section 7871.

These proposed regulations would define a governmental ITG plan as any plan that is established and maintained by an In-

[13] See *Dobbs v. Anthem Blue Cross & Blue Shield*, 475 F.3d 1176, 1178 (10th Cir. 2007) (citing 150 Cong. Rec. S9526, 9533), *rev'd in part* 600 F.3d 1275 (2010). See also *Bolssen v. Unum Life Insurance Company of America*, 629 F.Supp. 2d 878, 881 (E.D. Wis. 2009).

[14] *San Manuel Indian Bingo & Casino*, 475 F.3d at 1313.

[15] Id. at 1315.

dian tribal government, a subdivision of an Indian tribal government, or an agency or instrumentality of either, and all of its participants are employees substantially all of whose services are in the performance of governmental activities. The regulations would define a commercial ITG plan as a plan covering any ITG employees who perform substantial services in a commercial activity, such as a hotel, casino, service station, convenience store, or marina, which are examples of commercial activities that are listed in the Joint Committee on Taxation Technical Explanation to section 906 of PPA '06.[16] A plan would also be a commercial plan if it covers any individual who is not an employee of an ITG.

Governmental and Commercial Activities

Under the proposed regulations, whether a plan of an ITG is a commercial plan or a governmental plan within the meaning of section 414(d) is based in part on (1) a determination of which activities are commercial activities and (2) a determination of whether employees of the Indian tribal government covered by the plan are employees who perform substantial services in commercial activities (and are thus commercial employees).

Under the first step, the proposed regulations would provide guidance for determining whether an activity operated by an ITG is a governmental activity or a commercial activity for purposes of section 414(d). This is achieved by listing certain specific activities that are deemed to be governmental or commercial for purposes of section 414(d). Specific governmental activities would include the following: (1) activities that are related to public infrastructure, such as the building and maintaining of public roads and buildings; (2) activities that involve providing criminal protection services to the public (such as police and fire departments) or providing civil or public administrative service (such as providing public housing and operating public schools and hospitals, as well as managing the ITG's civil service system); and (3) activities subject to a treaty or special rules that pertain to trust land ownership and use. Under the regulations, operations involving a hotel, casino, service station, convenience store, and marina would be commercial activities. As discussed above, these activities are examples that are identified as commercial activities in Notices 2006–89 and 2007–67, as well as in the Joint Committee on Taxation Technical Explanation to section 906 of PPA '06.

In addition to listing certain specified activities, the proposed regulations would provide a facts and circumstances test for determining whether an activity is a governmental or commercial activity. The proposed regulations provide that, in making a determination of whether an activity is a governmental activity, the factors to be considered include whether—

- The activity provides a public benefit to members of the Indian tribal government (not treating the generation of profits from commercial acts as providing a public benefit); and
- The absence of one or more of the relevant factors listed for a commercial activity as provided in these proposed regulations.

The proposed regulations also provide that, in making a determination of whether an activity is a commercial activity, the factors to be considered include whether—

- The activity is a type of activity that is operated to earn a profit;
- The activity is a type of activity that is typically performed by private businesses; and
- The activity is a type of activity where the customers are substantially from outside of the Indian tribal community, including whether the activity is located or conducted outside of Indian tribal land.

These proposed regulations also provide examples illustrating the application of the facts and circumstances tests to particular activities. Some examples of activities of an Indian tribal government that are commercial might include: (1) operating a bank for a profit, serving tribal and non-tribal customers; (2) operating a trucking business for a profit; and (3) operating a factory producing goods for sale primarily to non-tribal customers. Conversely, examples of activities of an Indian tribal government that are governmental could include: (1) a community swimming pool on tribal land used primarily by tribal members; and (2) the operation of a cultural center and a museum on tribal land.

The proposed regulations would also delegate to the Commissioner of Internal Revenue the authority to publish guidance under section 414(d) that the Commissioner determines to be necessary or appropriate with respect to determining whether a plan of an Indian tribal government is a commercial ITG plan because the tribe's employees are performing services in an activity that the Commissioner determines to be a commercial activity. Any such guidance would be published in the form of revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2)).

Determination of Governmental ITG Employees

These proposed regulations would also provide rules for the second step, namely determining whether employees covered by an ITG plan are employees who perform substantially all of their services in activities that are governmental. For this purpose, the determination of whether an employee's services are for governmental or commercial activities would generally be based on the employee's assigned duties and responsibilities. In making this determination, the rules in these regulations would not require that a plan keep track of the individual hours worked by any employee or that the compensation of any particular employee be traced through the hours worked by that employee. The proposed regulations would provide that an employee whose assigned duties and responsibilities are in the performance of a governmental activity is treated as performing substantially all of his or her services in a governmental activity, and not treated as performing services for a commercial activity, even though the performance of those services for the governmental activity may temporarily involve significant time working in the commercial activity. For example, the chief financial officer (CFO) for an ITG may be expected to spend a substantial amount of time working on the financing for any

[16] Joint Committee on Taxation, *Technical Explanation of H.R. 4, the "Pension Protection Act of 2006" as passed by the House on July 28, 2006, and considered by the Senate on August 3, 2006* (JCX–38–06), August 3, 2006, 109th Cong., 2nd Sess. 244 (2006).

casino, marina, or hotel to be built on the ITG's tribal lands, but, despite temporarily working in a commercial activity, the proposed regulations would provide that the CFO is a governmental employee of the ITG all of whose services are in that capacity.

Determination of Commercial ITG Employees

The proposed regulations set forth rules for determining an employee's assigned duties and responsibilities, and thus when his or her services are substantially in the performance of a governmental or commercial activity. The analysis would start with the location of the employee's services in relation to the activity. The regulations provide that if a commercial activity has a specific location that is identifiable and is not associated with a governmental activity, any employee performing services at the location of activity is a commercial employee. One example is a security guard whose work is providing security services at a location which is an Indian tribal casino. In the case of an employee who works at a location other than a location where a commercial activity is being performed, the result would depend on the employee's assigned duties and responsibilities.

Another key part of the analysis is who pays the employee. If an employee is on the payroll of an ITG entity that is engaged in a commercial activity, the employee's assigned duties and responsibilities are treated as being for a commercial activity and, thus, the employee is a commercial ITG employee. For example, if a cashier is on the payroll of a convenience store (which is a commercial activity) owned by an ITG, the cashier is a commercial ITG employee. However, in the case of an employee who is not on a payroll of an ITG that engages in a commercial activity, the result would depend on the employee's assigned duties and responsibilities.

Where an employee neither works at a location where a commercial activity is being performed nor is on the payroll of a commercial entity, the result would depend on the employee's assigned duties and responsibilities, taking into account the facts and circumstances. Thus, for example, a bookkeeper located in a governmental building and paid through the general payroll of the ITG would nevertheless be a commercial employee if the facts and circumstances indicate that his or her assigned duties and responsibilities are to maintain the books and records for a hotel owned and operated by an ITG.

The statutory language in section 414(d) makes it clear that a plan is not a governmental ITG plan if it covers any employee who is a commercial ITG employee. There is no *de minimis* exception relating to this rule under section 414(d). In light of these circumstances, an ITG may choose to use caution when covering employees in a governmental plan. If, after applying the rules, an ITG plan sponsor is not certain whether an employee is a governmental ITG or commercial ITG employee, the ITG may choose to provide coverage for the employee in its commercial ITG plan in order to ensure the preservation of the status of the governmental ITG plan. Coverage of a governmental employee in a commercial plan would not adversely affect the qualified status of the commercial plan.

Reasonable, Good Faith Interpretation

The proposed regulations provide that, in general, an ITG plan will not be treated as failing to satisfy the assignment of employee rules if the plan complies with those rules under a standard that constitutes a reasonable, good faith interpretation of the statute, taking into account the final regulations and any other published guidance that relates to the application of section 414(d) to ITGs. The reasonable, good faith interpretation standard for the assignment of employees to governmental and commercial plans would only apply if the benefit levels between the separate governmental and commercial plans are uniform. Thus, this reasonable, good faith interpretation standard would not apply if the benefit level for employees under a plan purporting to be a governmental plan is higher than that of the benefit level under a separate plan covering employees who include commercial employees.

Assignment of Shared Employees

Under these rules, there may be cases in which an employee is transferred from one ITG employer to another. An employee may also perform substantially all of his or her services in the performance of a governmental activity and later the employee's assigned duties and responsibilities may change, so that the employee is subsequently performing substantially all of his or her duties in the performance of a commercial activity. In addition, an employee may work two separate and distinct jobs, one in a commercial activity of an ITG and another in a governmental activity of an ITG (for example, an ITG employee who works as a full-time police officer and also works at the front desk in the lobby of a hotel over the weekends). For all of these scenarios, assuming the ITG maintains separate plans for its governmental and commercial employees, the ITG should assign the employee to either plan based on prorating service credits and allocating compensation between the governmental and commercial activities.

Application of the Controlled Group Rules to ITG Plans

These proposed regulations do not address the rules under which, for purposes of sections 401, 408(k), 408(p), 410, 411, 415, and 416, all employees of all corporations that are members of a controlled group of corporations are treated as employed by a single employer for purposes of these controlled group rules. Note that, under current guidance, a reasonable, good faith interpretation standard applies with respect to governments. See Notice 89–23, 1989–1 C.B. 654, and Notice 96–64, 1996–2 C.B. 229, see §601.601(d)(2) of this chapter.

Proposed Effective Date

The proposed regulations would apply to plan years beginning 6 months after publication of these regulations as final regulations. For plan years after the statutory effective date of the PPA '06 amendment of section 414(d) and prior to the effective date of these regulations as final regulations, a plan of an ITG would be treated as a governmental plan for purposes of section 414(d), providing that a reasonable, good faith effort is made to ensure that the plan satisfy the conditions for being a governmental plan under section 414(d), taking into account relevant guidance, including Notices 2006–89 and 2007–67. To the extent that a plan of an Indian tribal government complies with the

requirements under either the notices or the proposed regulations, the plan will be treated as making a reasonable, good faith effort to satisfy the requirements of section 414(d).

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. In addition, because no collection of information is imposed on small entities, the provisions of the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply, and therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the 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 (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The Treasury Department and the IRS specifically request comments on the clarity of the proposed rules and how they can be made easier to understand. Comments are specifically requested on whether a correction mechanism under the Employee Plans Compliance Resolution System (EPCRS), as set forth in Rev. Proc. 2008–50, 2008–35 I.R.B. 464, see §601.601(d)(2), might be helpful for cases in which an employee substantially all of whose services are not in the performance of a governmental activity has nevertheless inadvertently become a participant in a plan purporting to be a governmental plan. For example, assuming the various conditions for self correction have been satisfied (see section 4.09 of Rev. Proc. 2008–50, which provides that the failure must be an operational failure which occurred by mistake or oversight, even though the plan had established practices and procedure to ensure qualification, and which is promptly corrected), the plan's assets and liabilities with respect to the employee might be transferred to a similar plan covering commercial employees under which the employee would accrue benefits up to the level that would have applied if he or she had participated in that commercial plan during the period when he or she was a commercial employee. All comments will be available for public inspection and copying.

A public hearing has been scheduled for (date to be provided when proposed regulations are published), beginning at 10 a.m. in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington DC. Due to building security procedures, visitors must enter at the main entrance, located at 1111 Constitution Avenue, NW. 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" portion of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments must submit written or electronic comments and an outline of the topics to be discussed and time to be devoted to each topic (signed original and eight (8) copies) by (date to be provided when proposed regulations are published). 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 comments has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is Pamela R. Kinard, Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities), Internal Revenue Service. However, personnel from other offices of 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:

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

Par. 2. Section 1.414(d)–1 is amended by adding paragraph (g) to read as follows:

§1.414(d)–1 Definition of governmental plan.

* * * * *

(g) *Special rules for plans of Indian tribal governments*—(1) *Definition of governmental plan as it relates to Indian tribal governments*. For purposes of applying paragraph (a)(3) of this section, a governmental plan as it relates to an Indian tribal government is a plan that is established and maintained for its employees by an Indian tribal government, a subdivision of an Indian tribal government, or an agency or instrumentality of either (ITG), provided that the employees covered under the plan provide substantially all of their services in the performance of governmental activities as determined in paragraph (g)(6) of this section.

(2) *Definition of commercial ITG plans*. For purposes of paragraph (g) of this section, the term *commercial ITG plan* means a plan of an ITG that covers any ITG employee who is not a governmental ITG employee under paragraph (g)(8) of this section or that covers any individual who is not an employee of an ITG.

(3) *Definition of an Indian tribal government*. For purposes of this paragraph (g), the term *Indian tribal government* has the meaning set forth in section 7701(a)(40).

(4) *Definition of subdivision of an Indian tribal government*. For purposes of this paragraph (g), the term *subdivision of an Indian tribal government* has the meaning set forth in section 7871(d).

(5) *Definition of agency or instrumentality of an Indian tribal government or subdivision of an Indian tribal government*. For purposes of this paragraph (g), the term *agency or instrumentality of an Indian tribal government or subdivision*

of an Indian tribal government means an entity that would be treated as an "agency or instrumentality of a State or political subdivision of a State" under paragraph (f) of this section if the related Indian tribal government or subdivision of an Indian tribal government were treated as a State or political subdivision of a State, respectively.

(6) *Definition of governmental activities*—(i) *In general*. The following activities are governmental activities for purposes of paragraph (g)(1) of this section:

(A) Activities that are related to the building and maintaining of public roads; public sidewalks, public buildings, and related areas, such as parking lots.

(B) Activities that are related to public sewer and drainage facilities, and related facilities such as a waste-water treatment plant.

(C) Activities relating to public works projects, such as schools and government buildings.

(D) Activities relating to public utilities, such as electricity and other power sources, including the development of newer and emerging technologies.

(E) Activities related to providing criminal protection services, such as police and fire departments, providing civil and public administrative services, such as operating and managing public housing, libraries, judiciary buildings, and administrative buildings, teaching in and managing public schools, managing and providing services at public hospitals and health clinics, operating the government's civil service system, and other related public services.

(F) Activities subject to a treaty or special rules that pertain to trust land ownership and use.

(ii) *Facts and circumstances test*. Whether any other activity is a governmental activity for purposes of section 414(d) is based on facts and circumstances. In making this determination, the facts to be considered include the following:

(A) Whether the activity provides a public benefit to members of the Indian tribal government; and

(B) Whether there is the absence of one or more of the relevant factors listed for a commercial activity as provided in paragraph (g)(7) of this section.

(iii) *Examples*. The following examples illustrate the application of this paragraph (g)(6):

Example 1. (i) *Facts*. Indian tribal government C owns and operates a community swimming pool on tribal land. Indian tribal members of Indian tribal government C may use the pool for free. Other local community members pay a fee to use the pool. Due to its location, this pool is used primarily by tribal members of Indian tribal government C.

(ii) *Conclusion*. Based on the facts and circumstances and the factors in paragraph (g)(6)(ii) of this section, the operation of the community swimming pool is a governmental activity of Indian tribal government C because it is a type of activity that is operated on a nonprofit basis and is similar to an activity that other non-tribal local governments operate for their communities. In addition, the pool is located inside tribal land and provides recreational benefits to tribal members.

Example 2. (i) *Facts*. Indian tribal government D owns and operates a cultural center and a museum on tribal land. The purpose of the cultural center and museum is to preserve and showcase items related to the culture of Indian tribal government D, including crafts and artistry. The center contains an exhibit area, a lobby and reception area, a small gift shop, a theater and various activity rooms. A variety of civic functions are held in the activity rooms. The other areas display and sell local handicraft items produced locally by members of Indian tribal government D.

(ii) *Conclusion*. Based on the facts and circumstances and the factors in paragraph (g)(6)(ii) of this section, the operation of the cultural center and museum is a governmental activity of Indian tribal government D even though the majority of its visitors are individuals who are not members of the tribe. Its purpose is to promote and display the culture of Indian tribal government D, which is a type of activity that is generally operated on a nonprofit basis (similar to municipal museums operated by public authorities) and not by private businesses. In addition, the center and museum are located inside tribal land and provide a public benefit by educating the public and preserving and highlighting the culture of the tribe.

(7) *Definition of commercial activities*—(i) *In general*. The following activities are commercial activities for purposes of paragraph (g)(2) of this section:

(A) Activities relating to the operation of a hotel.

(B) Activities relating to the operation of a casino.

(C) Activities relating to the operation of a service station.

(D) Activities relating to the operation of a convenience store.

(E) Activities relating to the operation of a marina.

(ii) *Facts and circumstances test*. Whether any other activity is a commercial activity for purposes of section 414(d) is based on facts and circumstances. In making this determination, the facts to be considered include the following:

(A) Whether the activity is a type of activity that is operated to earn a profit.

(B) Whether the activity is a type of activity that is typically performed by private businesses.

(C) Whether the activity is a type of activity where the customers are substantially from outside of the Indian tribal community, including whether the activity is located or conducted outside of Indian tribal land.

(iii) *Delegation of authority to the Commissioner*. Any activity that the Commissioner of the Internal Revenue Service determines is a commercial activity under section 414(d), in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter).

(iv) *Examples*. The following examples illustrate the application of this paragraph (g)(7)(ii):

Example 1. (i) *Facts*. Indian tribal government A owns and operates a recreational RV park and campground facility, serving transient non-tribal customers, primarily tourists. Other RV parks and campgrounds in the area operated by non-tribal private entities also attract the same type of customers. Very few, if any, tribal members of Indian tribal government A use this RV park and campground facility. Indian tribal government A charges a fee to customers to use the RV park and campground.

(ii) *Conclusion*. Based on the facts and circumstances and the factors in paragraph (g)(7)(ii) of this section, the operation of the recreational RV park and campground facility is a commercial activity of Indian tribal government A because it is the type of activity that is operated to earn a profit and is the type of activity that is performed by other private businesses. In addition, the facility includes customers who are substantially from outside of the Indian tribal community.

Example 2. (i) *Facts*. Indian tribal government B owns and operates a bank. This bank serves both tribal and non-tribal customers primarily living in the local area (either on or off the tribal land). No distinction is made between the services and fees provided to any customer based on whether or not he or she is a tribal member of Indian tribal government B.

(ii) *Conclusion*. Based on the facts and circumstances and the factors in paragraph (g)(7)(ii) of this section, the operation of a bank is a commercial activity of Indian tribal government B because it is the type of activity that is operated to earn a profit and is the type of activity that is performed by other private businesses.

Example 3. (i) *Facts*. Indian tribal government E entered into a lease with Company X, which is in the trucking business. The lease provides that Indian tribal government E will purchase tractors, trailers and other equipment and lease such equipment to Company X on a long-term basis.

(ii) *Conclusion*. Based on the facts and circumstances and the factors in paragraph (g)(7)(ii) of this section, the leasing transactions relate to a commer-

cial activity of Indian tribal government E because it is the type of activity that is operated to earn a profit and is the type of activity that is performed by other private businesses.

Example 4. (i) *Facts*. Indian tribal government G operates a factory on tribal land that produces goods for sale primarily to non-tribal customers, intended to earn a profit.

(ii) *Conclusion*. Based on the facts and circumstances and the factors in paragraph (g)(7)(ii) of this section, this is a commercial activity of Indian tribal government G because the activity is operated to earn a profit and is the type of activity that is performed by private businesses. In addition, the customers are substantially from outside of the Indian tribal community. The result could be different if the factory produced goods to promote and display the culture of Indian tribal government G, even if non-tribal customers primarily purchase the goods. This could be a governmental activity, depending on the factors.

(8) *Determination of ITG employees*—(i) *Governmental and commercial ITG employees*. This paragraph (g)(8) applies to determine whether an employee is an employee substantially all of whose services are in the performance of a governmental activity of an ITG (a governmental ITG employee), or is instead an employee who renders a significant portion of his or her services in the performance of a commercial activity of an ITG (a commercial ITG employee), for purposes of this paragraph (g). As provided in paragraph (g)(8)(iv) of this section, this determination is based on the employee's assigned duties and responsibilities.

(ii) *Location of the activity*. If a commercial activity (within the meaning of paragraph (g)(7) of this section) of an ITG has a specific location that is readily identifiable and is not associated with a governmental activity, an employee performing substantial services at such a location is treated as having assigned duties and responsibilities for that commercial activity and, thus, the employee is a commercial ITG employee within the meaning of paragraph (g)(8) of this section. For example, a guard who is assigned to provide security services for an Indian tribal government at an Indian tribal casino (which is a commercial activity under paragraph (g)(7)(i)(B) of this section) is a commercial ITG employee within the meaning of paragraph (g)(8) of this section. However, where an employee is not on a payroll of an ITG that engages in a commercial activity, the result would depend on the other rules in this paragraph (g)(8).

(iii) *Payroll records*. If an employee is on the payroll of an ITG entity that is engaged in a commercial activity (within the meaning of paragraph (g)(7) of this section), the employee's assigned duties and responsibilities are being treated as for the commercial activity and, thus, the employee is a commercial ITG employee. For example, if a cashier is on the payroll of a convenience store (which is a commercial activity under paragraph (g)(7)(i)(D) of this section) owned by an ITG, the cashier is a commercial ITG employee within the meaning of paragraph (g)(8) of this section.

(iv) *Duties and responsibilities*. Subject to the specific rules in paragraph (g)(8)(ii) or (iii) of this section, whether an employee is a governmental or commercial ITG employee within the meaning of this paragraph (g)(8) is based on the employee's assigned duties and responsibilities, taking into account facts and circumstances. Thus, whether an employee is a governmental or commercial ITG employee depends on whether the facts and circumstances indicate that the employee's assigned duties and responsibilities are substantially in the performance of a governmental or commercial activity. Thus, for example, a bookkeeper located in a governmental building and on the payroll of the general ITG government would nevertheless be a commercial employee if the facts and circumstances indicate that his or her assigned duties and responsibilities are to maintain the books and records for the hotel owned and operated by an ITG. However, an employee whose assigned duties and responsibilities are in the performance of a governmental activity, based on all the facts and circumstances, in accordance with the standards set forth in this paragraph (g)(8), is not treated as performing services for a commercial activity, even if the performance of services for the governmental activity may temporarily involve significant time working in a commercial activity in furtherance of the employee's duties and responsibilities for the governmental activity. For example, although, over a six-month period, the chief financial officer (CFO) for an ITG may spend a substantial amount of time working on the financing for a casino to be built on the ITG's tribal lands, the CFO would not be a commercial employee within the meaning of this paragraph (g)(8) because the CFO's duties and responsibilities are for a governmental activity.

(v) *Reasonable, good faith interpretation*. Except as provided in paragraph (g)(8)(ii) and (iii) of this section, an ITG plan will not be treated as failing to satisfy the rules in this paragraph (g)(8) if it complies with those rules under a standard that constitutes a reasonable, good faith interpretation of the statute, taking into account the rules in this paragraph (g) and any other published guidance that relates to the application of section 414(d) to ITGs. However, this paragraph (g)(8)(v) applies with respect to the assignment of employees to governmental and commercial plans only if the benefit levels provided by the separate governmental and commercial plans are uniform. Thus, this paragraph (g)(8)(v) would not apply if the benefit level for employees under a plan purported to be a governmental plan is higher than that provided under a separate plan which covers commercial ITG employees.

(vi) *Examples*. The following examples further illustrate the application of this paragraph (g)(8):

Example 1. (i) *Facts*. Employee A, who is an attorney, works at the Attorney General's office of Indian tribal government B. Employee A's job location is in a government office building on tribal lands. The assigned duties and responsibilities of Employee A are principally to review the operations of marina boat operators to ensure that they comply with tribal rules and regulations as applicable to marina boat operators. Employee A provides some services for the marina, such as speaking at conferences or meetings with marina boat operators. Employee A's area of expertise is contract law.

(ii) *Conclusion*. Based on the facts and circumstances and the factors in paragraph (g)(8)(ii) through (iv) of this section, Employee A is a governmental ITG employee within the meaning of this paragraph (g)(8). Employee A primarily performs services for Indian tribal government B at a government building which is a governmental location and Employee A is on the payroll of Indian tribal government B. In addition, Employee A's assigned duties and responsibilities are primarily to provide government oversight services for Indian tribal government B.

Example 2. (i) *Facts*. Employee C is a police officer providing services for Indian tribal government D. Employee C's job location is the tribal police station located in a government building on tribal lands. The assigned duties and responsibilities of Employee C indicate that Employee C is expected to maintain public order, detect crime, and apprehend offenders on tribal lands of Indian tribal government D. Occasionally, while on patrol, Employee C must go to the casino operated by Indian tribal government D to restore order relating to a disturbance. Employee C's area of expertise is in general law enforcement.

(ii) *Conclusion*. Based on the facts and circumstances and the factors in paragraph (g)(8)(ii) through

(iv) of this section, Employee C is a governmental ITG employee within the meaning of this paragraph (g)(8). Employee C primarily performs services for Indian tribal government D at either a government building or while on patrol, even though Employee C's patrol duties include providing law enforcement services at the casino, which is a commercial activity under paragraph (g)(7)(i)(B) of this section. In addition, the assigned duties and responsibilities of Employee C, as well as Employee C's area of expertise, relate to general law enforcement and do not substantially relate to a commercial activity.

Extending Religious and Family Member FICA and FUTA Exceptions to Disregarded Entities; Correction

Announcement 2011–80

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Correcting amendment.

SUMMARY: This document describes a correction to final and temporary regulations (T.D. 9554, 2011–50 I.R.B. 843) extending the exceptions from taxes under the Federal Insurance Contributions Act ("FICA") and the Federal Unemployment Tax Act ("FUTA") under sections 3121(b)(3) (concerning individuals who work for certain family members), 3127 (concerning members of religious faiths), and 3306(c)(5) (concerning persons employed by children and spouses and children under 21 employed by their parents) of the Internal Revenue Code ("Code") to entities that are disregarded as separate from their owners for Federal tax purposes. The temporary regulations also clarify the existing rule that the owners of disregarded entities, except for qualified subchapter S subsidiaries, are responsible for backup withholding and related information reporting requirements under section 3406. These regulations were published in the **Federal Register** on Tuesday, November 1, 2011 (76 FR 67363).

DATES: This correction is effective on December 6, 2011, and is applicable on November 1, 2011.

FOR FURTHER INFORMATION CONTACT: Joseph Perera, (202) 622–6040 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

The final and temporary regulations that are the subject of this document are under section 7701 of the Internal Revenue Code.

Need for Correction

As published, final and temporary regulations (T.D. 9554) contain an error that may prove to be misleading and is in need of clarification.

* * * * *

Correction of Publication

Accordingly, 26 CFR 301 is corrected by making the following correcting amendment:

PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 continues to read in part as follows:

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

Par. 2. Section 301.7701–2T is revised to read as follows:

§301.7701–2T Business entities; definitions (temporary).

(a) through (c)(2)(iv) [Reserved]. For further guidance, see §301.7701–2(a) through (c)(2)(iv).

(A) *In general*. Section §301.7701–2(c)(2)(i) (relating to certain wholly owned entities) does not apply to taxes imposed under Subtitle C—Employment Taxes and Collection of Income Tax (Chapters 21, 22, 23, 23A, 24 and 25 of the Internal Revenue Code). However, §301.7701–2(c)(2)(i) does apply to withholding requirements imposed under section 3406 (backup withholding). The owner of a business entity that is disregarded under §301.7701–2 is subject to the withholding requirements imposed under section 3406 (backup withholding). Section 301.7701–2(c)(2)(i) also applies to taxes imposed under Subtitle A, including Chapter 2—Tax on Self Employment Income. The owner of an entity that is treated in the same manner as a sole proprietorship under §301.7701–2(a) will be subject to tax on self-employment income.

(B) [Reserved]. For further guidance, see §301.7701–2(c)(2)(iv)(B).

(C) *Exceptions*. For exceptions to the rule in §301.7701–2(c)(2)(iv)(B), see sections 31.3121(b)(3)–1(d), 31.3127–1(c), and 31.3306(c)(5)–1(d).

(D) through (e)(4) [Reserved]. For further guidance, see §301.7701–2(c)(2)(iv)(D) through (e)(4).

(5) Paragraphs (c)(2)(iv)(A) and (c)(2)(iv)(C) of this section apply to wages paid on or after December 6, 2011. For rules that apply to paragraph (c)(2)(iv)(A) of this section before December 6, 2011, see 26 CFR part 301 revised as of April 1, 2009. However, taxpayers may apply paragraphs (c)(2)(iv)(A) and (c)(2)(iv)(C) of this section to wages paid on or after January 1, 2009.

(e)(6) through (e)(7) [Reserved]. For further guidance, see §301.7701–2(e)(6) through (e)(7).

(8) *Expiration Date*. The applicability of paragraphs (c)(2)(iv)(A) and (c)(2)(iv)(C) of this section expires on or before December 5, 2014.

LaNita Van Dyke,
Chief, Publications and Regulations Branch,
Legal Processing Division,
Associate Chief Counsel
(Procedure and Administration).

(Filed by the Office of the Federal Register on December 5, 2011, 8:45 a.m., and published in the issue of the Federal Register for December 6, 2011, 76 F.R. 76037)

Definition of Terms

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

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

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

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

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

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

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

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

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

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

Abbreviations

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

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

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