Internal Revenue
bulletin

Bulletin No. 2013-13
March 25, 2013

HIGHLIGHTS OF THIS ISSUE

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

INCOME TAX

Rev. Rul. 2013–6, page 701.

Interest rates: underpayment and overpayments. The rates for interest determined under section 6621 of the Code for the calendar quarter beginning April 1, 2013, will be 3 percent for overpayments (2 percent in the case of a corporation), 3 percent for the underpayments, and 5 percent for large corporate underpayments. The rate of interest paid on the portion of a corporate overpayment exceeding $10,000 will be 0.5 percent.

T.D. 9611, page 699.

Final regulations under section 36B of the Code relate to whether health coverage under an employer-sponsored plan is affordable for individuals who are eligible to enroll in the plan by reason of their relationship to an employee (related individuals).

T.D. 9612, page 678.

Final regulations under sections 704, 721, and 761 of the Code relate to the tax treatment of noncompensatory options and convertible instruments issued by a partnership. The final regulations generally provide that the exercise of a noncompensatory option does not cause the recognition of immediate income or loss by either the issuing partnership or the option holder. The final regulations also modify the regulations under section 704(b) regarding the maintenance of the partners' capital accounts and the determination of the partners' distributive shares of partnership items. The final regulations also contain a characterization rule providing that the holder of a noncompensatory option is treated as a partner under certain circumstances. The final regulations will affect partnerships that issue noncompensatory options, the partners of such partnerships, and the holders of such options.

REG–106918–08, page 714.

Proposed regulations under sections 761 and 1234 of the Code relate to the tax treatment of noncompensatory options and convertible instruments issued by a partnership. Specifically, the proposed regulations expand the characterization rule measurement events to include certain transfers of interests in the issuing partnership and other look-through entities, and provide additional guidance in determining the character of the grantor's gain or loss as a result of a closing transaction with respect to, or a lapse of, an option on a partnership interest. The proposed regulations will affect partnerships that issue noncompensatory options, the partnerships, and the holders of such options.

REG–148500–12, page 716.

Proposed regulations relate to the shared responsibility payment for not maintaining minimum essential coverage under section 5000A of the Code, which was added by the Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act of 2010, as amended by the TRICARE Affirmation Act and Public Law 111–173. A public hearing is scheduled for May 29, 2013.

Notice 2013–14, page 712.

This notice provides guidance on section 309 of the American Taxpayer Relief Act of 2012, Pub. L. No. 112–240, enacted on January 2, 2013, which amends section 51 of the Code to extend the Work Opportunity Tax Credit through December 31, 2013. The notice also provides employers additional time beyond the 28-day deadline in section 51(d)(13) for submitting Form 8850, *Pre-Screening Notice and Certification Request for the Work Opportunity Credit*, to Designated Local Agencies.

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Finding Lists begin on page ii.
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Department of the Treasury
Internal Revenue Service

EMPLOYMENT TAX

Notice 2013–14, page 712.
This notice provides guidance on section 309 of the American Taxpayer Relief Act of 2012, Pub. L. No. 112–240, enacted on January 2, 2013, which amends section 51 of the Code to extend the Work Opportunity Tax Credit through December 31, 2013. The notice also provides employers additional time beyond the 28-day deadline in section 51(d)(13) for submitting Form 8850, *Pre-Screening Notice and Certification Request for the Work Opportunity Credit*, to Designated Local Agencies.

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.

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.

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

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

Section 704.—Partner's Distributive Share

26 CFR 1.171–1: Bond premium.

T.D. 9612

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Noncompensatory Partnership Options

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

ACTION: Final Regulations.

SUMMARY: This document contains final regulations relating to the tax treatment of noncompensatory options and convertible instruments issued by a partnership. The final regulations generally provide that the exercise of a noncompensatory option does not cause the recognition of immediate income or loss by either the issuing partnership or the option holder. The final regulations also modify the regulations under section 704(b) regarding the maintenance of the partners' capital accounts and the determination of the partners' distributive shares of partnership items. The final regulations also contain a characterization rule providing that the holder of a noncompensatory option is treated as a partner under certain circumstances. The final regulations will affect partnerships that issue noncompensatory options, the partners of such partnerships, and the holders of such options.

DATES: Effective Date: These regulations are effective on February 5, 2013.

Applicability Date: These regulations apply to noncompensatory options (as defined in §1.721–2(f)) that are issued on or after February 5, 2013.

FOR FURTHER INFORMATION CONTACT: Benjamin Weaver at (202) 622–3050 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to 26 CFR part 1 under sections 171, 704, 721, 761, 1272, 1273, and 1275 of the Internal Revenue Code (Code). On January 22, 2003, proposed regulations (REG–103580–02, 2009–9 I.R.B. 543) relating to the tax treatment of noncompensatory options and convertible instruments issued by a partnership were published in the **Federal Register** (68 FR 2930). On March 28, 2003, corrections to the proposed regulations were published in the **Federal Register** (68 FR 15118). Because no requests to speak were submitted by April 29, 2003, the public hearing scheduled for Tuesday, May 20, 2003, was cancelled (see 68 FR 24903). The Treasury Department and the IRS received a number of comments in response to the proposed regulations. After consideration of the comments, the proposed regulations are adopted as revised by this Treasury decision. The final regulations apply to certain call options, warrants, convertible debt, and convertible equity that are not issued in connection with the performance of services (noncompensatory options). All comments are available at *www.regulations.gov* or upon request.

Summary of Comments and Explanation of Provisions

The final regulations describe certain of the income tax consequences of issuing, transferring, and exercising noncompensatory partnership options. The final regulations apply only if the call option, warrant, or conversion right grants the holder the right to acquire an interest in the issuer (or cash measured by the value of the interest). The final regulations generally provide that the exercise of a noncompensatory option does not cause recognition of gain or loss to either the issuing partnership or the option holder. In addition, the final regulations modify the regulations under section 704(b) regarding the maintenance of the partners' capital accounts and the determination of the partners' distributive shares of partnership items. Finally, the final regulations contain a characterization rule providing that the holder of a call option, warrant, convertible debt, or convertible equity issued by a partnership (or an eligible entity, as defined in §301.7701–3(a), that would become a partnership if the option holder were treated as a partner) is treated as a partner under certain circumstances.

A number of comments were received regarding the proposed regulations. The comments included requests for clarification and recommendations relating to (1) the issuance and exercise of noncompensatory options; (2) accounting for noncompensatory options; (3) the characterization rule; (4) the convertible bond provision; and (5) the application of the original issue discount provisions. Significant comments are further discussed in this preamble.

1. *Issuance, Exercise, Lapse, Repurchase, and other Terminations of a Noncompensatory Option*

Like the proposed regulations, the final regulations under section 721 define a noncompensatory option as an option issued by a partnership, other than an option issued in connection with the performance of services. For this purpose, an option is defined as a call option or warrant to acquire an interest in the issuing partnership, the conversion feature of convertible debt, or the conversion feature of convertible equity.

A. *Application of section 721 on issuance of a noncompensatory option*

The proposed regulations provide that section 721 does not apply to a transfer of property to a partnership in exchange for a noncompensatory option. Several commenters observed that the proposed regulations do not exclude options issued in satisfaction of interest or similar items, such as unpaid rent or royalties. Accordingly, the final regulations provide that section 721 does not apply to the transfer of property to a partnership in exchange for a noncompensatory option, or to the satisfaction of a

partnership obligation with a noncompensatory option. The final regulations contain an example illustrating that a transfer of appreciated or depreciated property to a partnership in exchange for a noncompensatory option generally will result in the recognition of gain or loss by the option recipient. Under open transaction principles applicable to noncompensatory options, the partnership will not recognize income for receipt of the property while the option is outstanding. Notwithstanding the general rule, the Treasury Department and IRS believe it is appropriate to take into account the conversion right embedded in convertible equity as part of the underlying partnership interest. Accordingly, the final regulations provide that section 721 does apply to a contribution of property to a partnership in exchange for convertible equity in a partnership.

B. *Application of section 721 on exercise of a noncompensatory option*

i. Payment of the Exercise Price with Property or Cash

The proposed regulations provide that section 721 applies to the holder and the partnership upon the exercise of a noncompensatory option issued by the partnership. The final regulations generally adopt this rule. However, in response to comments requesting clarification, the final regulations also provide that section 721 generally applies to the exercise of a noncompensatory option when the exercise price is satisfied with property or cash contributed to the partnership, regardless of whether the terms of the option require or permit a cash payment.

ii. Exercise of a Noncompensatory Option in Satisfaction of a Partnership Obligation

The proposed regulations under section 721 do not apply to any interest on convertible debt that has been accrued by the partnership (including accrued original issue discount). A number of comments were received requesting clarification on the proper treatment of accrued but unpaid interest. Since the proposed regulations were issued and the comments received, final regulations under section 721 were published on November 17, 2011 (T.D. 9557, 2011–50 I.R.B. 838) addressing certain partnership debt-for-equity exchanges. Section 1.721–1(d)(2) provides:

> 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).

The preamble to T.D. 9557 explains this provision as follows: "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 Treasury Department and the IRS believe that similar considerations arise in the context of the exercise of noncompensatory options. Accordingly, the final regulations provide that section 721 does not apply to the transfer of a partnership interest to a noncompensatory option holder upon conversion of convertible debt in the partnership to the extent that the transfer is in satisfaction of the partnership's indebtedness for unpaid interest (including accrued original issue discount) on convertible debt that accrued on or after the beginning of the convertible debt holder's holding period for the indebtedness. Additionally, the final regulations provide that section 721 does not apply to the extent that the exercise price is satisfied with the partnership's obligation to the option holder for unpaid rent, royalties, or interest (including accrued original issue discount) that accrued on or after the beginning of the option holder's holding period for the obligation.

The proposed regulations do not specify whether, upon conversion of convertible debt in the partnership, the partnership is treated as satisfying its obligation for unpaid interest with a fractional interest in each partnership property. Under this "vertical slice" approach, the partnership could recognize gain or loss equal to the difference between the fair market value of each partial property deemed transferred to the creditor and the partnership's adjusted basis in that partial property. The Treasury Department and the IRS believe that approach would be difficult to administer and may inappropriately accelerate gain or loss recognition. Therefore, the final regulations provide that the partnership will not recognize gain or loss upon the transfer of a partnership interest to a noncompensatory option holder upon conversion of convertible debt in the partnership to the extent that the transfer is in satisfaction of the partnership's indebtedness for unpaid interest (including accrued original issue discount) on convertible debt that accrued on or after the beginning of the convertible debt holder's holding period for the indebtedness. Additionally, the final regulations also provide that the issuing partnership will not recognize gain or loss upon the transfer of a partnership interest to an exercising option holder in satisfaction of the partnership's obligation to the option holder for unpaid rent, royalties, or interest (including accrued original issue discount) that accrued on or after the beginning of the option holder's holding period for the obligation. This treatment is consistent with the rules under §1.721–1(d)(2).

iii. Options Issued by Disregarded Entities

The rule in the proposed regulations providing for nonrecognition of gain or loss on the exercise of a noncompensatory option does not apply to any call option, warrant, or convertible debt issued by an eligible entity, as defined in §301.7701–3(a), that would become a partnership under §301.7701–3(f)(2) if the option, warrant, or conversion right were exercised. The Treasury Department and the IRS requested and received comments on whether the nonrecognition rule should be extended to such instruments. Commenters recommended that the nonrecognition rule should be extended to such instruments. However, some commenters noted that the extension of the proposed regulations to include a noncompensatory option issued by an eligible entity that would become a partnership under §301.7701–3(f)(2) upon exercise of the option would necessitate adjustments to the capital accounting requirements of the regulations, as applied to these entities. Without these adjustments, upon exercise of the option, the owner of the eligible entity would be treated as contributing all

property owned by the eligible entity prior to exercise of the option to the new partnership, while the option holder would be treated as contributing only the exercise price and premium to the new partnership. The new partnership would have no unbooked unrealized gain in its property that it could allocate to the exercising option holder. Accordingly, the Treasury Department and the IRS have decided not to apply the rules of the final regulations to these instruments.

iv. Application of Section 721(b)

One commenter requested clarification of whether section 721(b) could apply to the exercise of a noncompensatory option under the regulations. Section 721(b) provides that section 721(a) does not apply to gain realized on a transfer of property to a partnership that would be treated as an investment company (within the meaning of section 351) if the partnership were incorporated. The Treasury Department and the IRS believe that section 721, including the provisions of section 721(b) and §1.721–1(a), applies to the exercise of noncompensatory options.

v. Cash Settled Options

Several commenters requested guidance on the treatment of cash-settled options, particularly regarding whether the cash settlement of an option is treated as a sale or exchange of the option or as an exercise of the option followed by an immediate redemption of the newly-issued partnership interest. The Treasury Department and the IRS believe that the cash settlement of a noncompensatory option should be treated as a sale or exchange of the option and taxed under the rules of section 1234, rather than as a contribution to the partnership under section 721, followed by an immediate redemption (although the latter may, in certain instances, be treated as a sale of the option under the disguised sale rules). The final regulations provide that the settlement of a noncompensatory option in cash or property other than an interest in the issuing partnership is not a transaction to which section 721 applies.

C. *Lapse, repurchase, sale, or exchange of a noncompensatory option*

The proposed regulations provide that section 721 does not apply to the lapse of a noncompensatory option. Accordingly, the lapse of a noncompensatory option generally results in the recognition of income by the partnership and loss by the holder of the lapsed option in an amount equal to the option premium. However, the proposed regulations do not address the character of the gain or loss recognized upon lapse, repurchase, sale, or exchange of the option.

While section 1234(b) provides that gain or loss from any closing transaction generally is treated as short term capital gain or loss to the grantor of an option, commenters were uncertain whether section 1234(b) applies to partnership interests because it is unclear whether partnership interests qualified as "securities" for purposes of section 1234(b). To eliminate this uncertainty, proposed regulations under section 1234(b) (REG–106918–08) are being published concurrently with these final regulations, which treat partnership interests as securities for this purpose. The preamble to those proposed regulations also addresses, and seeks comments on, the character of gain or loss to the option holder on the sale or exchange of, or loss on failure to exercise, an option.

D. *Application of general tax principles in certain situations*

In the event that the exercise of a noncompensatory option is followed by a redemption of the exercising option holder's partnership interest, general tax principles, including the disguised sale rules of section 707(a)(2)(B), will apply in determining whether the transaction is actually a cash settlement of the noncompensatory option by the partnership.

The proposed regulations provide that if the exercise price of a noncompensatory option exceeds the capital account received by the option holder on the exercise of the noncompensatory option, the transaction will be given tax effect in accordance with its true nature. Similarly, the final regulations provide that, if the exercise price of a noncompensatory option exceeds the capital account received by the option holder on the exercise of the option, then general tax principles will apply to determine the tax consequences of the transaction. The final regulations are based on the premise that the partnership and the option holder will act in an economically rational way, such that an option holder generally will not exercise the option unless the capital account received will equal or exceed the exercise price. It should be noted that a noncompensatory option could be economically viable to exercise when the option holder receives a right to share in partnership capital that is less than the sum of the premium paid for the option and the exercise price of the option, provided that the exercise price alone does not exceed the capital account received. This simply reflects the fact that the premium is a sunk cost at the time the option holder exercises the option.

2. *Accounting for Noncompensatory Options*

A. *Accounting for the issuance of a noncompensatory option*

Under the proposed regulations, issuance of a noncompensatory option is not a permissive or mandatory revaluation event under Treas. Reg. §1.704–1(b)(2)(iv). One commenter noted that, as a result, unrealized gain in partnership property arising prior to the issuance of the option could be inappropriately shifted to the option holder upon exercise. The Treasury Department and the IRS agree. Therefore, the final regulations provide that the issuance by a partnership of a noncompensatory option (other than an option for a *de minimis* partnership interest) is a permissible revaluation event.

B. *Revaluations while a noncompensatory option is outstanding*

Under the proposed regulations, any revaluation during the period in which there are outstanding noncompensatory options generally must take into account the fair market value of any outstanding noncompensatory options. If the fair market value of outstanding noncompensatory options as of the date of the adjustment exceeds the consideration paid by the option holders to acquire the options, then the value of partnership property reflected on the partnership's books must be reduced by that excess to the extent of the

unrealized income or gain in partnership property (that has not been reflected in the capital accounts previously). This reduction is allocated only to properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation. Conversely, if the price paid by the option holders to acquire the outstanding noncompensatory options exceeds the fair market value of the options as of the date of the adjustment, then the value of partnership property reflected on the partnership's books must be increased by that excess to the extent of the unrealized deduction or loss in partnership property (that has not been reflected in the capital accounts previously). This increase is allocated only to properties with unrealized depreciation in proportion to their respective amounts of unrealized depreciation.

The Treasury Department and the IRS have decided to retain these rules with certain modifications. The final regulations continue to provide that the adjustments to the value of partnership property reflected on the partnership's books should generally be made to partnership properties on a *pro rata* basis. Several comments were received requesting additional guidance when certain properties are subject to special allocations to existing partners. The Treasury Department and the IRS agree that the final regulations should take into account the economic arrangement of the parties. Therefore, the final regulations provide that the adjustments must take into account the economic arrangement of the partners with respect to the property.

One commenter noted that, while the proposed regulations do not state how the fair market value of the outstanding option should be computed, the value that is consistently used in the examples in the proposed regulations is the liquidation value of the option assuming exercise. The commenter requested additional guidance on the determination of the fair market value of outstanding options. The Treasury Department and the IRS believe that additional guidance on the determination of fair market value is unnecessary and believe that the examples sufficiently illustrate that the fair market value of an outstanding option may be based on the liquidation value of the option assuming exercise.

C. *Accounting for the exercise of a noncompensatory option*

The proposed regulations provide that an exercising noncompensatory option holder's initial capital account is equal to the consideration paid to the partnership to acquire the noncompensatory option and the fair market value of any property (other than the option) contributed to the partnership upon the exercise of the noncompensatory option. The proposed regulations provide that upon the conversion of convertible equity, the fair market value of property contributed to the partnership includes the converting partner's capital account immediately before the conversion. Because the converting partner's pre-conversion capital account will not be eliminated because of the conversion, the Treasury Department and the IRS believe that this provision from the proposed regulations is unnecessary and could cause confusion. Therefore, the Treasury Department and the IRS have decided to remove this provision to eliminate confusion; no substantive change is intended by this revision.

Additionally, the proposed regulations provide that the capital account of a holder of convertible debt is credited with the adjusted basis of the debt and the accrued but unpaid qualified stated interest on the debt immediately before the conversion of the debt. One commenter noted that the regulations should credit the debt holder's capital account with the adjusted issue price rather than the adjusted basis of the debt. Using adjusted issue price avoids creating a different tax result in cases in which the debt is converted by the original debt holder versus cases in which the debt is converted after a transfer of the debt at a price that reflected unrealized gain or loss attributable to the conversion right and/or changes in market interest rates. The Treasury Department and the IRS agree with this comment and, therefore, the final regulations credit the capital account of a convertible debt holder with the adjusted issue price of the debt and the accrued but unpaid qualified stated interest on the debt immediately before the conversion of the debt.

The proposed regulations require a partnership to revalue its property immediately following the exercise of a noncompensatory option, after the option holder has become a partner. The partnership must allocate the unrealized income, gain, loss, and deduction from this revaluation, first, to the noncompensatory option holder on exercise to the extent necessary to reflect the option holder's right to share in partnership capital under the partnership agreement and, then, to the historic partners, to reflect the manner in which the unrealized income, gain, loss, or deduction in partnership property would be allocated among those partners if there were a taxable disposition of the property for its fair market value on that date. To the extent that unrealized appreciation or depreciation in the partnership's property has been allocated to the capital account of the noncompensatory option holder on exercise, the holder will, under section 704(c) principles, recognize any income or loss attributable to that appreciation or depreciation as the underlying properties are sold, depreciated, or amortized. The final regulations adopt these provisions with some modifications.

Under the current section 704(b) regulations, a revaluation of partnership property pursuant to §1.704–1(b)(2)(iv)(*f*) is based on the fair market value of partnership property as of the date of the revaluation, as determined under §1.704–1(b)(2)(iv)(*h*). Several commenters to the proposed regulations recommended that the section 704(b) regulations be revised to permit revaluations of partnership property based on the fair market value of the partnership interest, rather than the fair market value of the partnership's property. These values may differ because of restrictions on the transferability or liquidity of the partnership interest or other factors. The Treasury Department and the IRS have decided to continue requiring that revaluations be based on the fair market value of the partnership's property. The Treasury Department and the IRS believe that changing the rules for all revaluations is beyond the scope of these final regulations.

Several comments were received requesting additional guidance on adjusting capital accounts upon exercise of an option when certain partnership properties are subject to special allocations to existing partners. The final regulations clarify that the allocations must take into account the economic arrangement of the partners with respect to the property.

Furthermore, several commenters requested additional guidance on how to adjust capital accounts upon exercise when the partnership owns multiple properties with unrealized income, gain, loss, or deduction. The final regulations clarify that allocations should be made on a *pro rata* basis from partnership property, subject to the requirement that the allocations take into account the economic arrangement of the partners. Thus, if the exercising partner's right to share in partnership capital under the partnership agreement exceeds the sum of the premium and exercise price, then only income or gain may be allocated to the exercising partner from partnership properties with unrealized appreciation, in proportion to their respective amounts of unrealized appreciation (subject to the requirement that the allocations take into account the economic arrangement of the partners). Conversely, if the exercising partner's right to share in partnership capital under the partnership agreement is less than the premium and exercise price, then only loss may be allocated to the exercising partner from partnership properties with unrealized loss, in proportion to their respective amounts of unrealized loss (subject to the requirement that the allocations take into account the economic arrangement of the partners).

One commenter recommended that the final regulations provide that the partnership may revalue its assets immediately before the exercise of the option (in addition to the revaluation that occurs immediately following the exercise of the option). This comment was made in response to one issue that arises when a revaluation event under §1.704–1(b)(2)(iv)(*f*) or (*s*) occurs while a noncompensatory option is outstanding and certain partnership property has increased in value. If, following the revaluation, but prior to the exercise of the option, the same property declines in value before the option is exercised, there may be insufficient unrealized income or gain in partnership property (that has not been allocated to the capital accounts of other partners) to allocate to the option holder's capital account upon exercise. To address this issue, one commenter recommended that, for purposes of partnership property revaluations, the portion of the unrealized gain that is treated as "reflected in the capital accounts previously" be reduced by the historic partners' share of the decline in asset value. The Treasury Department and the IRS have decided not to adopt these changes because the increased complexity that these new rules would add to the regulations outweighs the potential benefit.

Under the proposed regulations, if, after the allocations of unrealized gain and loss items to an exercising option holder, the exercising option holder's capital account still does not reflect his right to share in partnership capital under the partnership agreement, the partnership must reallocate capital between the existing partners and the exercising option holder (a "capital account reallocation"). This capital account reallocation provision has been retained from the proposed regulations.

D. *Corrective allocations*

The proposed regulations require the partnership to make corrective allocations of gross income or loss to the partners in the year in which the option is exercised so as to take into account any shift in the partners' capital accounts that occurs as a result of a capital account reallocation pursuant to the exercise of a noncompensatory option. Corrective allocations are allocations of tax items that differ from the partnership's allocations of book items. If there are not sufficient actual partnership items in the year of exercise to conform the partnership's tax allocations to the capital account reallocation, additional corrective allocations are required in succeeding taxable years until the capital account reallocation has been fully taken into account.

A number of comments were received regarding the requirement of corrective allocations in the proposed regulations. Some commenters recommended eliminating or substantially limiting the scope of corrective allocations. The Treasury Department and the IRS considered other alternatives but believe that corrective allocations are the most administrable alternative means to address the potential problem of income shifting when, prior to the exercise of a noncompensatory option, a partnership recognizes gain or loss that is, in part, economically attributable to the option holder, but is allocated entirely to the existing partners. Therefore, the final regulations retain the requirement for corrective allocations in certain circumstances.

i. Corrective Allocations when Historic Partners Depart

The final regulations require corrective allocations to be made so as to take into account any capital account reallocation upon exercise of a noncompensatory option. Therefore, partnership items may be correctively allocated to the exercising option holder only of items properly allocable to a partner that suffered a capital account reduction and only to the extent such partner suffered a capital account reduction. This approach may result in corrective allocations not being fully made if a partner that suffered a capital account reduction on exercise is no longer a partner in the issuing partnership at the time a corrective allocation would otherwise be made.

ii. Character Matching for Corrective Allocations

The proposed regulations provide that corrective allocations are *pro rata* allocations of gross income and gain or gross loss and deduction. The proposed regulations do not require any matching of character between the income or loss that is correctively allocated, and gains or losses that were allocated to existing partners prior to the option's exercise, but that were economically attributable to the option holder. Several commenters recommended that the regulations provide some type of matching requirement. The Treasury Department and the IRS believe that the complexity that could arise from a character matching requirement would outweigh the potential benefit of obtaining a more precise tax result for corrective allocations in some cases. Accordingly, the final regulations do not provide for a character matching requirement.

iii. Corrective Allocations Using Combinations of Income and Loss

Additionally, some commenters requested guidance on making corrective allocations in a year in which the partnership has both gross income and gain and gross loss and deduction. In some cases, a corrective allocation that completely takes into account the capital shift may not be possible in a given year if only gross income and gain, or gross loss and deduction, are used. However, commenters

noted that it may be possible to more fully take into account the capital shift if corrective allocations are made using a combination of gross income and gain and gross loss and deduction. The Treasury Department and IRS agree that combinations of gross income and gain and gross loss and deduction should be available for corrective allocations.

Accordingly, the final regulations provide a mechanism for making corrective allocations using combinations of gross income and gain and gross loss and deduction in certain circumstances. If the capital account reallocation is from the historic partners to the exercising option holder, then the corrective allocations must first be made with gross income and gain. If an allocation of gross income and gain alone does not completely take into account the capital account reallocation in a given year, then the partnership must also make corrective allocations using a *pro rata* portion of items of gross loss and deduction as to further take into account the capital account reallocation. Conversely, if the capital account reallocation is from the exercising option holder to the historic partners, then the corrective allocations must first be made with gross loss and deduction. If an allocation of gross loss and deduction alone does not completely take into account the capital account reallocation in a given year, then the partnership must also make corrective allocations using a *pro rata* portion of items of gross income and gain as to further take into account the capital account reallocation.

iv. Application of Section 706 to Corrective Allocations

One commenter requested clarification on the application of section 706 to the corrective allocation provisions. Because the exercise of a noncompensatory option may cause the partners' interests in the partnership to vary, the Treasury Department and the IRS believe that section 706 should apply in determining which items may be used for corrective allocations. Therefore, the final regulations also clarify that section 706 and its regulations and principles apply in determining the items of income, gain, loss, and deduction that may be subject to corrective allocation.

E. *The impact of partnership mergers, divisions, and terminations on outstanding noncompensatory options*

The proposed regulations do not address the impact of partnership mergers, divisions, and section 708 technical terminations on outstanding noncompensatory options. Some commenters requested guidance on these situations. The Treasury Department and the IRS believe that these issues are beyond the scope of these final regulations.

3. *Characterization Rule*

The proposed regulations generally respect noncompensatory options as such and do not characterize them as partnership equity. However, the proposed regulations characterize the holder of a noncompensatory option as a partner if the option holder's rights are substantially similar to the rights afforded to a partner. This rule under the proposed regulations applies only if, as of the date that the noncompensatory option is issued, transferred, or modified, there is a strong likelihood that the failure to treat the option holder as a partner would result in a substantial reduction in the present value of the partners' and the option holder's aggregate Federal tax liabilities. The proposed regulations use a facts and circumstances test to determine whether a noncompensatory option holder's rights are substantially similar to the rights afforded to a partner. The facts and circumstances for making this determination under the proposed regulations include, but are not limited to, whether the option is reasonably certain to be exercised and whether the option holder has partner attributes. The Treasury Department and the IRS have decided to retain these rules with certain modifications.

A. *The "substantially similar" test*

Some commenters criticized the breadth of the language in the proposed regulations that provides that all facts and circumstances will be considered in determining whether a noncompensatory option provides the holder with rights that are substantially similar to the rights afforded to a partner, suggesting instead that an exclusive list of factors be used. The Treasury Department and the IRS agree that the regulations should more specifically describe the circumstances in which an option holder will be considered to possess these rights. Therefore, the final regulations provide that a noncompensatory option provides its holder with rights that are substantially similar to the rights afforded to a partner if the option is reasonably certain to be exercised or if the option holder possesses partner attributes.

i. *The "reasonably certain to be exercised" test*

The proposed regulations list a number of non-exclusive factors that are used to determine whether a noncompensatory option is reasonably certain to be exercised, including the fair market value of the partnership interest that is the subject of the option, the exercise price of the option, the term of the option, the predictability and stability of the value of the underlying partnership interest, the fact that the option premium and exercise price (if the option is exercised) will become property of the partnership, and whether the partnership is expected to make distributions during the term of the option. With one exception, the final regulations adopt these factors and clarify that any other arrangements affecting or undertaken with a principal purpose of affecting the likelihood that the noncompensatory option will be exercised will be considered a factor in determining whether an option is reasonably certain to be exercised. Because the option premium represents a sunk cost to the option holder, and because the fact that the exercise price becomes property of the partnership is already reflected in the value of the partnership interest subject to the option, the final regulations do not include as a factor in the reasonable certainty test the fact that the option premium and exercise price will become property of the partnership.

Some commenters suggested that the characterization rule in the regulations adopt standards similar to those found in §1.1361–1(l) for determining whether there is a second class of stock in an S corporation, or those found in §1.1504–4 for determining whether a corporation is a member of an affiliated group. Commenters also recommended that the regulations provide for certain safe harbors and bright line tests for

determining whether an option holder's rights are substantially similar to the rights afforded to a partner, and whether there is a strong likelihood that the failure to treat the holder as a partner would result in a substantial reduction in the present value of the partners' and the holder's aggregate tax liabilities. After careful consideration of these comments, the Treasury Department and the IRS believe that limited safe harbors should be provided to limit the administrative burdens of the characterization rule. Accordingly, the final regulations provide two objective safe harbors, which are similar to two of the safe harbors in §1.1504–4 and §1.1361–1(l). However, these safe harbors apply only to the determination of whether a noncompensatory option is reasonably certain to be exercised, and not to the determination of whether a noncompensatory option holder possesses partner attributes.

The first safe harbor provides that a noncompensatory option is not considered reasonably certain to be exercised if it may be exercised no more than 24 months after the date of the applicable measurement event and it has a strike price equal to or greater than 110 percent of the fair market value of the underlying partnership interest on the date of the measurement event. The second safe harbor provides that a noncompensatory option is not considered reasonably certain to be exercised if the terms of the option provide that the strike price of the option is equal to or greater than the fair market value of the underlying partnership interest on the exercise date. For purposes of these safe harbors, an option whose strike price is determined by a formula is considered to have a strike price equal to or greater than the fair market value of the underlying partnership interest on the exercise date if the formula is agreed upon by the parties when the option is issued in a *bona fide* attempt to arrive at the fair market value on the exercise date and is to be applied based on the facts and circumstances in existence on the exercise date.

The safe harbors do not apply, however, if the parties to the noncompensatory option had a principal purpose of substantially reducing the present value of the aggregate Federal tax liabilities of the partners and the noncompensatory option holder.

The final regulations provide that failure of an option to satisfy one of these safe harbors does not affect the determination of whether the option is treated as reasonably certain to be exercised. Thus, options that do not satisfy the safe harbors may still be treated as not reasonably certain to be exercised under the facts and circumstances. Notwithstanding that an option is treated as not reasonably certain to be exercised on the date of one measurement event under either the safe harbors or the facts and circumstances test, the option may be treated as reasonably certain to be exercised at the time of a subsequent measurement event if the safe harbors and facts and circumstances test are no longer satisfied. Furthermore, even if an option is not reasonably certain to be exercised under either the safe harbors or the facts and circumstances test, the noncompensatory option may still be found to provide its holder with rights substantially similar to those afforded a partner under the partner attributes test.

The proposed regulations contain an example describing an option issued by a partnership with reasonably predictable earnings and concluding, based on the facts of the example, that the option described is reasonably certain to be exercised. Commenters stated that the example involved unrealistic facts demonstrating reasonably predictable earnings, and that the example wrongly implied that low volatility suggests a reasonable certainty of exercise. Upon further consideration of this example, the Treasury Department and the IRS have decided to delete the example from the final regulations.

ii. *The "partner attributes" test*

The proposed regulations provide that partner attributes include the extent to which the option holder shares in the economic benefit and detriment of partnership income and loss and the extent to which the option holder has the right to control or restrict the activities of the partnership. Some commenters requested clarification of this definition of partner attributes. Because all options issued by a partnership allow the holder to share, to some extent, in the economic benefit and detriment of partnership income and loss, the Treasury Department and the IRS agree that this language should be clarified.

The final regulations provide that the determination of whether a noncompensatory option holder possesses partner attributes is based on all the facts and circumstances, including whether the option holder, directly or indirectly, through the option agreement or a related agreement, is provided with voting or managerial rights in the partnership. Additionally, the final regulations provide that an option holder has partner attributes if, based on all the facts and circumstances, (1) the option holder is provided with rights (through the option agreement or a related agreement) that are similar to rights ordinarily afforded to a partner to participate in partnership profits through present possessory rights to share in current operating or liquidating distributions with respect to the underlying partnership interest; or (2) the option holder, directly or indirectly, undertakes obligations (through the option agreement or a related agreement) that are similar to obligations undertaken by a partner to bear partnership losses. In this way, the Treasury Department and the IRS believe that the final regulations clarify that the economic benefits and burdens relevant to the partner attributes test are those beyond the economic benefits and burdens inherent in basic option transactions.

As to an option holder's ability to control or restrict the activities of the partnership, some commenters stated that an option holder should not be considered to possess partner attributes solely because the holder has the ability to restrict partnership distributions or dilutive issuances of partnership equity while the option is outstanding. Option holders often are given such rights as a means of protecting the value of the option holder's potential future partnership interest. The Treasury Department and the IRS agree that such rights are reasonable restrictions that, by themselves, should not automatically lead to a conclusion that the option holder possesses partner attributes. Accordingly, the final regulations provide that a noncompensatory option holder will not ordinarily be considered to possess partner attributes solely because the noncompensatory option agreement significantly controls or restricts, or the noncompensatory option holder has the right to significantly control or restrict, a partnership decision that could substantially affect the value of the under-

lying partnership interest. In particular, the following rights of the option holder will not be treated as partner attributes: (1) the ability to impose reasonable restrictions on partnership distributions or dilutive issuances of partnership equity or options while the noncompensatory option is outstanding; and (2) the ability to choose the partnership's section 704(c) method for partnership properties.

Some commenters requested clarification on the analysis of partner attributes for an option holder who is also a partner in the issuing partnership. The proposed regulations provide that rights possessed by an option holder solely by virtue of owning a partnership interest and not by virtue of holding a noncompensatory option are not taken into account in determining whether the option holder has partner attributes, provided those rights are no greater than those held by other partners owning substantially similar interests. Commenters noted that, in some cases, there may be partners, such as managing or general partners, with unique interests that are not comparable to the interests of any other partners. The Treasury Department and the IRS agree that the regulations should address these situations. Accordingly, the final regulations provide that rights in the issuing partnership possessed by a noncompensatory option holder solely by virtue of owning an interest in the issuing partnership are not taken into account, provided that those rights are no greater than the rights granted to other partners owning substantially similar interests in the partnership and who do not hold noncompensatory options in the partnership. Additionally, the final regulations provide that if all of the partners owning substantially similar interests in the issuing partnership also hold noncompensatory options in the partnership, or if none of the other partners owns substantially similar interests in the partnership, then all facts and circumstances will be considered in determining whether the rights in the partnership possessed by the option holder are possessed solely by virtue of owning a partnership interest. If those rights are possessed solely by virtue of owning a partnership interest, the final regulations provide that they are not taken into account.

Additionally, in response to comments, the final regulations provide that for purposes of determining whether an option holder has partner attributes, the option holder will be treated as owning all partnership interests and noncompensatory options issued by the partnership that are owned by any person related to the option holder. For example, if the holder of a noncompensatory option is related to a person that owns an interest in the issuing partnership, and the interest provides the related person with partner attributes that are greater than the rights granted to other partners owning substantially similar interests in the partnership, the option will be characterized as a partnership interest under the final regulations if the strong likelihood test is satisfied. This provision is intended to prevent avoidance of the partner attributes test by planning among related parties. The Treasury Department and the IRS continue to study the extent to which financial instruments and partnership interests owned by related persons should be taken into account under the reasonable certainty test.

The proposed regulations contain an example describing a deep in the money option and concluding, based on the facts of the example, that the option holder possesses partner attributes. Commenters stated that the example added little to the existing guidance provided by the common law rule. Upon further consideration of this example, the Treasury Department and the IRS have decided to delete the example from the final regulations.

B. *The "strong likelihood" test*

The Treasury Department and the IRS received a number of comments regarding the provision in the proposed regulations that the characterization rule applies only if there is a strong likelihood that the failure to treat the option holder as a partner would result in a substantial reduction in the present value of the partners' and the holder's aggregate tax liabilities. Some commenters recommended that the regulations adopt language similar to that contained in §1.704–1(b)(2)(iii)(*b*)(*2*) and (*c*)(*2*), which provides that, in determining whether there is a reduction in the partners' total tax liability, tax consequences that result from the interaction of the allocation(s) with partner tax attributes that are unrelated to the partnership are taken into account. Similarly, in determining whether there would be a substantial reduction in the present value of the partners' and option holder's aggregate tax liabilities, commenters noted that it is appropriate to consider partner and option holder tax attributes that are unrelated to the partnership, and the interaction of those attributes with the option.

The Treasury Department and the IRS agree that it would be helpful for the regulations to specify certain factors that are considered in determining whether there is a strong likelihood that the failure to treat a noncompensatory option holder as a partner would result in a substantial reduction in the present value of the partners' and the option holder's aggregate Federal tax liabilities. The final regulations provide that all facts and circumstances should be considered in making this determination, including: (1) the interaction of the allocations of the issuing partnership and the partners' and noncompensatory option holder's Federal tax attributes (taking into account tax consequences that result from the interaction of the allocations with the partners' and noncompensatory option holder's Federal tax attributes that are unrelated to the partnership); (2) the absolute amount of the Federal tax reduction; (3) the amount of the reduction relative to overall Federal tax liability; and (4) the timing of items of income and deductions.

Additionally, to more specifically address the application of the strong likelihood test when a look-through entity (as defined in §1.704–1(b)(2)(iii)(*d*)(*2*)) is a party, the final regulations provide that if a partner or option holder is a look-through entity, such as a partnership or an S corporation, then the tax attributes of that entity's ultimate owners (that are not look-through entities) will be taken into account in determining whether there is a strong likelihood of a substantial tax reduction. The final regulations also provide that, if a partner is a member of a consolidated group, then tax attributes of the consolidated group and of another member with respect to a separate return year will be taken into account in determining whether there is a strong likelihood of a substantial tax reduction.

C. *Events that trigger testing under the characterization rule*

The proposed regulations test a noncompensatory option under the characterization rule upon issuance, transfer, or modification of the option. A number of comments were received recommending clarification, or narrowing of the list, of events that will trigger a testing of the option after original issuance. Several commenters argued that only material modifications of an option should lead to re-testing under the characterization rule. Several commenters also recommended restricting the types of transfers that will trigger testing of the option under the characterization rule, or removing the requirement to test upon transfer entirely. In response to these comments, the final regulations provide a more detailed description of the events that will trigger application of the characterization rule to a noncompensatory option.

The final regulations provide that the characterization rule will be applied upon the occurrence of a measurement event with respect to the noncompensatory option. The final regulations define a measurement event as: (1) issuance of the noncompensatory option; (2) an adjustment of the terms (modification) of the noncompensatory option or of the underlying partnership interest (including an adjustment pursuant to the terms of the noncompensatory option or the underlying partnership interest); or (3) transfer of the noncompensatory option if either (A) the term of the option exceeds 12 months, or (B) the transfer is pursuant to a plan in existence at the time of the issuance or modification of the noncompensatory option that has as a principal purpose the substantial reduction of the present value of the aggregate Federal tax liabilities of the partners and the noncompensatory option holder.

Additionally, in response to the comments, the Treasury Department and the IRS believe that it is appropriate to limit testing under the characterization rule to provide certainty for both taxpayers and the IRS, particularly in circumstances in which there is little potential for abuse. Therefore, the final regulations do not treat the following events as measurement events: (1) a transfer of the noncompensatory option that would otherwise be a measurement event if the transfer is at death or between spouses or former spouses under section 1041, or in a transaction that is disregarded for Federal tax purposes; (2) a modification that neither materially increases the likelihood that the option will be exercised nor provides the option holder with partner attributes; (3) a change in the strike price of a noncompensatory option, or in the interests in the issuing partnership that may be issued or transferred pursuant to the option, made pursuant to a *bona fide*, reasonable adjustment formula that has the intended effect of preventing dilution of the interests of the option holder; and (4) any other event as provided in guidance published in the Internal Revenue Bulletin. The Treasury Department and the IRS believe that these limitations will minimize the burden on taxpayers that could arise from frequent testings under the characterization rule in many situations, while preserving the ability of the IRS to enforce the characterization rule in appropriate circumstances.

Some commenters also requested that the regulations clarify whether the issuance, transfer, or modification of one noncompensatory option would trigger testing under the characterization rule of all other outstanding noncompensatory options issued by the same partnership. Under the final regulations, testing under the characterization rule occurs only on the date a measurement event occurs with respect to a particular noncompensatory option. Measurement events should be determined individually for each noncompensatory option issued by a partnership. For example, the modification of one noncompensatory option generally would be a measurement event for that particular option, and it would not be a measurement event for all other noncompensatory options issued by the partnership.

In addition, to address transfers of interests in the issuing partnership and situations involving look-through entities, proposed regulations under section 761 (REG–106918–08) are being published concurrently with these final regulations. Those proposed regulations would add three measurement events to the list above, but apply only if those measurement events are pursuant to a plan in existence at the time of the issuance or modification of the noncompensatory option that has as a principal purpose the substantial reduction of the present value of the aggregate Federal tax liabilities of the partners and the noncompensatory option holder. The proposed measurement events are: (1) issuance, transfer, or modification of an interest in, or liquidation of, the issuing partnership; (2) issuance, transfer, or modification of an interest in any look-through entity that directly, or indirectly through one or more look-through entities, owns the noncompensatory option; and (3) issuance, transfer, or modification of an interest in any look-through entity that directly, or indirectly through one or more look-through entities, owns an interest in the issuing partnership. The Treasury Department and the IRS believe that the first of these proposed measurement events is necessary because it is inconsistent to test a noncompensatory option under the characterization rule upon transfer of the noncompensatory option, but not upon transfer of an interest in the issuing partnership, because either type of transfer may change the analysis of whether there is a strong likelihood that the failure to treat the option holder as a partner would result in a substantial reduction in the present value of the partners' and option holder's aggregate tax liabilities. The Treasury Department and the IRS believe that the second and third proposed measurement events are necessary to prevent avoidance of the characterization rule through the use of look-through entities.

D. *Timing of characterization*

Some commenters requested clarification regarding the timing of the characterization of a noncompensatory option as a partnership interest under the regulations. For example, some commenters questioned whether an option that was characterized as a partnership interest upon transfer would be treated as transferred and then exercised by the transferee or exercised by the transferor and then transferred. The Treasury Department and the IRS believe that the tax consequences to the transferor and transferee upon a transfer of the option should be similar to the tax consequences upon a transfer of the underlying partnership interest. Accordingly, the final regulations provide that characterization of an option as a partnership interest under the regulations applies upon the issuance of the option, or immediately before any other

measurement event that gave rise to the characterization. Under this approach, if the characterization rule applied upon a transfer of a noncompensatory option, a section 743 adjustment for the benefit of the transferee would be made if the issuing partnership had a section 754 election in effect.

E. *Effect of characterization*

Some commenters questioned whether, once a noncompensatory option was characterized as a partnership interest under the characterization rule, the characterization rule could ever operate to re-characterize the interest as a noncompensatory option once again. The Treasury Department and the IRS believe that the characterization rule operates to treat noncompensatory options as partnerships interests in appropriate circumstances, and it should not be interpreted to treat partners as noncompensatory option holders. Accordingly, the final regulations provide that once a noncompensatory option is treated as a partnership interest, in no event may it be characterized as an option thereafter.

F. *Continuing applicability of general tax principles*

Finally, some commenters questioned whether general tax principles would continue to apply to the characterization of a noncompensatory option that, in substance, represents a current partnership interest. Because these rules in the final regulations are intended to supplement rather than supplant general tax principles, the Treasury Department and the IRS believe it is appropriate for general tax principles to continue to apply, in addition to the characterization rule of the regulations. Thus, the final regulations clarify that an option that is not treated as a partnership interest under the regulations may still be treated as a partnership interest under general principles of law. For example, if upon the issuance of a noncompensatory option, the option in substance constitutes a partnership interest under general tax principles, then the option will be treated as a partnership interest for Federal tax purposes, even if it is unlikely that the aggregate tax liabilities of the option holder and partners would be substantially reduced by the failure to treat the option holder as a partner. For this purpose, general tax principles include principles of tax law derived from the Internal Revenue Code, Treasury Regulations, case law, and administrative guidance issued by the IRS.

4. *Convertible Bond Provision*

Section 171(b)(1) provides that the amount of bond premium on a convertible bond does not include any amount attributable to the conversion features of the bond. A holder of partnership convertible debt who purchases the debt at a premium would generally be subject to the section 171 bond premium amortization rules. One commenter suggested that the regulations under §1.171–1(e)(1)(iii) be clarified to state that such regulations apply to debt that is convertible into an interest in the partnership issuing the debt. The final regulations adopt this comment.

5. *Original Issue Discount Provisions*

The original issue discount (OID) provisions provide special rules for debt instruments convertible into the stock of the issuer or a party related to the issuer. See §§1.1272–1(e), 1.1273–2(j), and 1.1275–4(a)(4). The proposed regulations proposed to apply these special rules to debt instruments convertible into partnership interests. These final regulations adopt these proposed amendments. Accordingly, the final regulations amend the OID provisions to treat partnership interests as stock for purposes of the special rules for convertible debt instruments. Treating convertible debt issued by partnerships and corporations differently for purposes of these special rules could create unjustified distinctions between the taxation of instruments that are economically equivalent.

Effective/Applicability Date

These final regulations apply to noncompensatory options that are issued on or after February 5, 2013.

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, and because the regulations do not impose a collection of information requirement 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 preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses, and no comments were received.

Drafting Information

The principal author of these regulations is Benjamin Weaver of the 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 the Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.171–1 is amended by adding a sentence at the end of paragraph (e)(1)(iii)(C) to read as follows:

§1.171–1 Bond premium.

* * * * *

(e) * * *

(1) * * *

(iii) * * *

(C) * * * For bonds issued on or after February 5, 2013, the term *stock* in the preceding sentence means an equity interest in any entity that is classified, for Federal tax purposes, as either a partnership or a corporation.

* * * * *

Par. 3. Section 1.704–1 is amended as follows:

1. Paragraph (b)(0) is amended by adding entries to the table in numerical order for paragraphs (b)(2)(iv)(*d*)(*4*),

(b)(2)(iv)(*h*)(*1*), (b)(2)(iv)(*h*)(*2*), (b)(2)(iv)(*s*), (b)(4)(ix), and (b)(4)(x).

2. The paragraph heading for paragraph (b)(1)(ii) is revised and a sentence is added at the end of the paragraph.

3. Paragraph (b)(2)(iv)(*d*)(*4*) is added.

4. Paragraph (b)(2)(iv)(*f*)(*1*) is revised.

5. Paragraph (b)(2)(iv)(*f*)(*5*)(iii) is amended by removing the "." at the end of the paragraph and adding in its place ", or".

6. Paragraph (b)(2)(iv)(*f*)(*5*)(*iv*) is redesignated as paragraph (b)(2)(iv)(*f*)(*5*)(*v*).

7. New paragraph (b)(2)(iv)(*f*)(*5*)(*iv*) is added.

8. Paragraph (b)(2)(iv)(*h*) is redesignated as (b)(2)(iv)(*h*)(*1*) and a new paragraph heading is added for paragraph (b)(2)(iv)(*h*)(*1*).

9. Paragraph (b)(2)(iv)(*h*)(*2*) is added.

10. The undesignated text following paragraph (b)(2)(iv)(*r*)(*2*) is designated as paragraph (b)(2)(iv)(*r*)(*3*), and a paragraph (b)(2)(iv)(*s*) is added after the newly designated paragraph (b)(2)(iv)(*r*)(*3*).

11. Paragraphs (b)(4)(ix) and (b)(4)(x) are added.

12. Paragraph (b)(5) is amended by adding *Examples 31* through *35*.

The additions and revisions read as follows:

§1.704–1 Partner's distributive share.

* * * * *

(b) * * * (0) * * *

Heading	Section
* * * * *	
Exercise of noncompensatory options	1.704–1(b)(2)(iv)(*d*)(*4*)
* * * * *	
In general	1.704–1(b)(2)(iv)(*h*)(*1*)
Adjustments for noncompensatory options	1.704–1(b)(2)(iv)(*h*)(*2*)
* * * * *	
Adjustments on the exercise of a noncompensatory option	1.704–1(b)(2)(iv)(*s*)
* * * * *	
Allocations with respect to noncompensatory options	1.704–1(b)(4)(ix)
Corrective allocations	1.704–1(b)(4)(x)
* * * * *	

(1) * * *

(ii) *Effective/applicability date.* * * * In addition, paragraph (b)(2)(iv)(*d*)(*4*), paragraph (b)(2)(iv)(*f*)(*1*), paragraph (b)(2)(iv)(*f*)(*5*)(*iv*), paragraph (b)(2)(iv)(*h*)(*2*), paragraph (b)(2)(iv)(*s*), paragraph (b)(4)(ix), paragraph (b)(4)(x), and *Examples 31* through *35* in paragraph (b)(5) of this section apply to noncompensatory options (as defined in §1.721–2(f)) that are issued on or after February 5, 2013.

* * * * *

(2) * * *

(iv) * * *

(*d*) * * *

(*4*) *Exercise of noncompensatory options.* Solely for purposes of paragraph (b)(2)(iv)(*b*)(*2*) of this section, the fair market value of the property contributed on the exercise of a noncompensatory option (as defined in §1.721–2(f)) does not include the fair market value of the option privilege, but does include the consideration paid to the partnership to acquire the option and the fair market value of any property (other than the option) contributed to the partnership on the exercise of the option. With respect to convertible debt, the fair market value of the property contributed on the exercise of the option is the adjusted issue price of the debt and the accrued but unpaid qualified stated interest (as defined in §1.1273–1(c)) on the debt immediately before the conversion, plus the fair market value of any property (other than the convertible debt) contributed to the partnership on the exercise of the option. See *Examples 31* through *35* of paragraph (b)(5) of this section.

* * * * *

(*f*) * * *

(*1*) The adjustments are based on the fair market value of partnership property (taking section 7701(g) into account) on the date of adjustment, as determined under paragraph (b)(2)(iv)(*h*) of this section. See *Example 33* of paragraph (b)(5) of this section.

* * * * *

(*5*) * * *

(*iv*) In connection with the issuance by the partnership of a noncompensatory option (other than an option for a *de minimis* partnership interest), or

* * * * *

(*h*) *Determinations of fair market value—*(*1*) *In general.* * * *

(*2*) *Adjustments for noncompensatory options.* The value of partnership property as reflected on the books of the partnership must be adjusted to account for any outstanding noncompensatory options (as defined in §1.721–2(f)) at the time of a revaluation of partnership property under paragraph (b)(2)(iv)(*f*) or (*s*) of this section. If the fair market value of outstanding noncompensatory options (as defined in §1.721–2(f)) as of the date of the adjustment exceeds the consideration paid to the partnership to acquire the options, then the value of partnership property as reflected on the books of the partnership must be reduced by that excess to the extent of the unrealized income or gain in partnership property (that has not been reflected in the capital accounts previously). This reduction is allocated only to properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation. If the consideration paid to the partnership to acquire the outstanding noncompensatory options (as defined in §1.721–2(f)) exceeds the fair market value of such options as of the date of the adjustment, then the value of partnership property as reflected on the books of the partnership must be increased by that excess to the extent of the unrealized loss in partnership property (that has not been reflected in the capital accounts pre-

viously). This increase is allocated only to properties with unrealized loss in proportion to their respective amounts of unrealized loss. However, any reduction or increase shall take into account the economic arrangement of the partners with respect to the property.

* * * * *

(*s*) *Adjustments on the exercise of a noncompensatory option*. A partnership agreement may grant a partner, on the exercise of a noncompensatory option (as defined in §1.721–2(f)), a right to share in partnership capital that exceeds (or is less than) the sum of the consideration paid to the partnership to acquire and exercise such option. Where such an agreement exists, capital accounts will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless the following requirements are met:

(*1*) In lieu of revaluing partnership property under paragraph (b)(2)(iv)(*f*) of this section immediately before the exercise of the option, the partnership revalues partnership property in accordance with the provisions of paragraphs (b)(2)(iv)(*f*)(*1*) through (*f*)(*4*) of this section immediately after the exercise of the option.

(*2*) In determining the capital accounts of the partners (including the exercising partner) under paragraph (b)(2)(iv)(*s*)(*1*) of this section, the partnership first allocates any unrealized income, gain, or loss in partnership property (that has not been reflected in the capital accounts previously) to the exercising partner to the extent necessary to reflect that partner's right to share in partnership capital under the partnership agreement, and then allocates any remaining unrealized income, gain, or loss (that has not been reflected in the capital accounts previously) to the existing partners, to reflect the manner in which the unrealized income, gain, or loss in partnership property would be allocated among those partners if there were a taxable disposition of such property for its fair market value on that date. For purposes of the preceding sentence, if the exercising partner's initial capital account as determined under §1.704–1(b)(2)(iv)(*b*) and (*d*)(*4*) of this section would be less than the amount that reflects the exercising partner's right to share in partnership capital under the partnership agreement, then only income or gain may be allocated to the exercising partner from partnership properties with unrealized appreciation, in proportion to their respective amounts of unrealized appreciation. If the exercising partner's initial capital account, as determined under §1.704–1(b)(2)(iv)(*b*) and (*d*)(*4*) of this section, would be greater than the amount that reflects the exercising partner's right to share in partnership capital under the partnership agreement, then only loss may be allocated to the exercising partner from partnership properties with unrealized loss, in proportion to their respective amounts of unrealized loss. However, any allocation must take into account the economic arrangement of the partners with respect to the property.

(*3*) If, after making the allocations described in paragraph (b)(2)(iv)(*s*)(*2*) of this section, the exercising partner's capital account does not reflect that partner's right to share in partnership capital under the partnership agreement, then the partnership reallocates partnership capital between the existing partners and the exercising partner so that the exercising partner's capital account reflects the exercising partner's right to share in partnership capital under the partnership agreement (a capital account reallocation). Any increase or decrease in the capital accounts of existing partners that occurs as a result of a capital account reallocation under this paragraph (b)(2)(iv)(*s*)(*3*) must be allocated among the existing partners in accordance with the principles of this section. See *Example 32* of paragraph (b)(5) of this section.

(*4*) The partnership agreement requires corrective allocations so as to take into account all capital account reallocations made under paragraph (b)(2)(iv)(*s*)(*3*) of this section (see paragraph (b)(4)(x) of this section). See *Example 32* of paragraph (b)(5) of this section.

* * * * *

(4) * * *

(ix) *Allocations with respect to noncompensatory options*—(*a*) *In general*. A partnership agreement may grant to a partner that exercises a noncompensatory option (as defined in §1.721–2(f)) a right to share in partnership capital that exceeds (or is less than) the sum of the amounts paid to the partnership to acquire and exercise the option. In such a case, allocations of income, gain, loss, and deduction to the partners while the noncompensatory option is outstanding cannot have economic effect because, if the noncompensatory option is exercised, the exercising partner, rather than the existing partners, may receive the economic benefit or bear the economic detriment associated with that income, gain, loss, or deduction. However, allocations of partnership income, gain, loss, and deduction to the partners while the noncompensatory option is outstanding will be deemed to be in accordance with the partners' interests in the partnership only if—

(*1*) The holder of the noncompensatory option is not treated as a partner under §1.761–3;

(*2*) The partnership agreement requires that, while a noncompensatory option is outstanding, the partnership comply with the rules of paragraph (b)(2)(iv)(*f*) of this section and that, on the exercise of the noncompensatory option, the partnership comply with the rules of paragraph (b)(2)(iv)(*s*) of this section; and

(*3*) All material allocations and capital account adjustments under the partnership agreement would be respected under section 704(b) if there were no outstanding noncompensatory options issued by the partnership. See *Examples 31* through *35* of paragraph (b)(5) of this section.

(*b*) *Substantial economic effect under sections 168(h) and 514(c)(9)(E)(i)(ll)*. An allocation of partnership income, gain, loss, or deduction to the partners will be deemed to have substantial economic effect for purposes of sections 168(h) and 514(c)(9)(E)(i)(ll) if—

(*1*) The allocation would meet the substantial economic effect requirements of paragraph (b)(2) of this section if there were no outstanding noncompensatory options issued by the partnership; and

(2) The partnership satisfies the requirements of paragraph (b)(4)(ix)(*a*)(*1*), (*2*), and (*3*) of this section.

(x) *Corrective allocations*—(*a*)—*In general*. If partnership capital is reallocated between existing partners and a partner exercising a noncompensatory option under paragraph (b)(2)(iv)(*s*)(*3*) of this section (a capital account reallocation), then the partnership must, beginning with the taxable year of the exercise and in all succeeding taxable years until the required allocations are fully taken into

account, make corrective allocations so as to take into account the capital account reallocation. A corrective allocation is an allocation (consisting of a *pro rata* portion of each item) for tax purposes of gross income and gain, or gross loss and deduction, that differs from the partnership's allocation of the corresponding book item. See *Example 32* of paragraph (b)(5) of this section.

(*b*) *Timing*. Section 706 and the regulations and principles thereunder apply in determining the items of income, gain, loss, and deduction that may be subject to corrective allocation.

(*c*) *Allocation of gross income and gain and gross loss and deduction*. If the capital account reallocation is from the historic partners to the exercising option holder, then the corrective allocations must first be made with gross income and gain. If an allocation of gross income and gain alone does not completely take into account the capital account reallocation in a given year, then the partnership must also make corrective allocations using a *pro rata* portion of items of gross loss and deduction as to further take into account the capital account reallocation. Conversely, if the capital account reallocation is from the exercising option holder to the historic partners, then the corrective allocations must first be made with gross loss and deduction. If an allocation of gross loss and deduction alone does not completely take into account the capital account reallocation in a given year, then the partnership must also make corrective allocations using a *pro rata* portion of items of gross income and gain as to further take into account the capital account reallocation.

(5) * * *

Example 31. (i) In Year 1, A and B each contribute cash of $9,000 to LLC, a newly formed limited liability company classified as a partnership for Federal tax purposes, in exchange for 100 units in LLC. Under the LLC agreement, each unit is entitled to participate equally in the profits and losses of LLC. LLC uses the cash contributions to purchase a nondepreciable property, Property A, for $18,000. Later in Year 1, at a time when Property A is valued at $20,000, LLC issues an option to C. The option allows C to buy 100 units in LLC for an exercise price of $15,000 in Year 2. C pays $1,000 to LLC to purchase the option. Assume that the LLC agreement satisfies the requirements of paragraph (b)(2) of this section and requires that, on the exercise of a noncompensatory option, LLC comply with the rules of paragraph (b)(2)(iv)(*s*) of this section. Also assume that C's option is a noncompensatory option under §1.721–2(f), and that C is not treated as a partner with respect to the option. Under paragraph (b)(2)(iv)(*f*)(*5*)(*iv*) of this section, LLC revalues its property in connection with the issuance of the option. The $2,000 unrealized gain in Property A is allocated equally to A and B under the LLC agreement. In Year 2, C exercises the option, contributing the $15,000 exercise price to the partnership. At the time the option is exercised, the value of Property A is $35,000.

Year 1 After Issuance of the Option

Assets			Liabilities and Capital		
	Basis	Value		Basis	Value
Cash Premium	$1,000	$1,000	Cash Premium	$1,000	$1,000
Property A	$18,000	$20,000	A	$9,000	$10,000
			B	$9,000	$10,000
Total	$19,000	$21,000		$19,000	$21,000

Year 2 After Exercise of the Option

Assets			Liabilities and Capital		
	Basis	Value		Basis	Value
Property A	$18,000	$35,000	A	$9,000	$17,000
Cash			B	$9,000	$17,000
Premium	$ 1,000	$ 1,000	C	$16,000	$17,000
Exercise Price	$15,000	$15,000			
Total	$34,000	$51,000		$34,000	$51,000

(ii) In lieu of revaluing LLC's property under paragraph (b)(2)(iv)(*f*) of this section immediately before the option is exercised, under paragraph (b)(2)(iv)(*s*)(*1*) of this section LLC must revalue its property under the principles of paragraph (b)(2)(iv)(*f*) of this section immediately after the exercise of the option. Under paragraphs (b)(2)(iv)(*b*) and (b)(2)(iv)(*d*)(*4*) of this section, C's capital account is credited with the amount paid for the option ($1,000) and the exercise price of the option ($15,000). Under the LLC agreement, however, C is entitled to LLC capital corresponding to 100 units of LLC (1/3 of LLC's capital). Immediately after the exercise of the option, LLC's properties are cash of $16,000 ($1,000 premium and $15,000 exercise price contributed by C) and Property A, which has a value of $35,000. Thus, the total value of LLC's property is $51,000. C is entitled to LLC capital equal to 1/3 of this value, or $17,000. As C is entitled to $1,000 more LLC capital than C's capital contributions to LLC, the provisions of paragraph (b)(2)(iv)(*s*) of this section apply.

(iii) Under paragraph (b)(2)(iv)(*s*)(*2*) of this section, LLC must increase C's capital account from $16,000 to $17,000 by, first, revaluing LLC property in accordance with the principles of paragraph (b)(2)(iv)(*f*) of this section. The unrealized gain in LLC's property (Property A) which has not been reflected in the capital accounts previously is $15,000 ($35,000 value less $20,000 book value). Under paragraph (b)(2)(iv)(*s*)(*2*) of this section, the first $1,000 of this gain must be allocated to C, and the remaining $14,000 of this gain is allocated equally to A and B in accordance with the LLC agreement. Because the revaluation of LLC property under paragraph (b)(2)(iv)(*s*)(*2*) of this section increases C's capital account to the amount agreed on by the members, LLC is not required to make a capital account reallocation under paragraph (b)(2)(iv)(*s*)(*3*) of this section. The $17,000 of unrealized booked gain in Property A ($35,000 value less $18,000 basis) is shared $8,000 to each A and B, and $1,000 to C. Un-

der paragraph (b)(2)(iv)(*f*)(*4*) of this section, the tax items from the revalued property must be allocated in accordance with section 704(c) principles.

	A		B		C	
	Tax	Book	Tax	Book	Tax	Book
Capital account after exercise .	$9,000	$10,000	$9,000	$10,000	$16,000	$16,000
Revaluation amount	0	$7,000	0	$7,000	0	$1,000
Capital account after revaluation	$9,000	$17,000	$9,000	$17,000	$16,000	$17,000

Example 32. (i) Assume the same facts as in *Example 31*, except that, in Year 2, before the exercise of the option, LLC sells Property A for $40,000, recognizing gain of $22,000. LLC does not distribute the sale proceeds to its partners and it has no other earnings in Year 2. With the proceeds ($40,000), LLC purchases Property B, a nondepreciable property. Also assume that C exercises the noncompensatory option at the beginning of Year 3 and that, at the time C exercises the option, the value of Property B is $41,000. In Year 3, LLC has gross income of $3,000 and deductions of $1,500.

Year 2 After Purchase of Property B

Assets			Liabilities and Capital		
	Basis	Value		Basis	Value
Cash			Cash		
Premium	$1,000	$1,000	Premium	$1,000	$1,000
Property B	$40,000	$40,000	A	$20,000	$20,000
			B	$20,000	$20,000
Total	$41,000	$41,000		$41,000	$41,000

Year 3 After Exercise of the Option

Assets			Liabilities and Capital		
	Basis	Value		Basis	Value
Property B	$40,000	$41,000	A	$20,000	$19,000
			B	$9,000	$17,000
Cash	$16,000	$16,000	C	$16,000	$19,000
Total	$56,000	$57,000		$56,000	$57,000

(ii) Under paragraphs (b)(2)(iv)(*b*) and (b)(2)(iv)(*d*)(*4*) of this section, C's capital account is credited with the amount paid for the option ($1,000) and the exercise price of the option ($15,000). Under the LLC agreement, however, C is entitled to LLC capital corresponding to 100 units of LLC (1/3 of LLC's capital). Immediately after the exercise of the option, LLC's properties are $16,000 cash ($1,000 option premium and $15,000 exercise price contributed by C) and Property B, which has a value of $41,000. Thus, the total value of LLC's property is $57,000. C is entitled to LLC capital equal to 1/3 of this amount, or $19,000. As C is entitled to $3,000 more LLC capital than C's capital contributions to LLC, the provisions of paragraph (b)(2)(iv)(*s*) of this section apply.

(iii) In lieu of revaluing LLC's property under paragraph (b)(2)(iv)(*f*) of this section immediately before the option is exercised, under paragraph (b)(2)(iv)(*s*)(*1*) of this section LLC must revalue its property under the principles of paragraph (b)(2)(iv)(*f*) of this section immediately after the exercise of the option. Under paragraph (b)(2)(iv)(*s*) of this section, LLC must increase C's capital account from $16,000 to $19,000 by, first, revaluing LLC property in accordance with the principles of paragraph (b)(2)(iv)(*f*) of this section, and allocating all $1,000 of unrealized gain from the revaluation to C under paragraph (b)(2)(iv)(*s*)(*2*). This brings C's capital account to $17,000.

(iv) Next, under paragraph (b)(2)(iv)(*s*)(*3*) of this section, LLC must reallocate $2,000 of capital from the existing partners (A and B) to C to bring C's capital account to $19,000 (the capital account reallocation). As A and B shared equally in all items from Property A, whose sale gave rise to the need for the capital account reallocation, each member's capital account is reduced by 1/2 of the $2,000 reduction ($1,000).

(v) Under paragraph (b)(2)(iv)(*s*)(*4*) of this section, beginning in the year in which the option is exercised, LLC must make corrective allocations so as to take into account the capital account reallocation. In Year 3, LLC has gross income of $3,000 and deductions of $1,500. Under paragraph (b)(2)(x)(*c*), LLC must allocate the book gross income of $3,000 equally among A, B, and C, but for tax purposes, however, LLC must allocate all of its gross income ($3,000) to C. LLC's book and tax deductions ($1,500) will then be allocated equally among A, B, and C. The $1,000 unrealized booked gain in Property B has been allocated entirely to C. Under paragraph (b)(2)(iv)(*f*)(*4*) of this section, the tax items from Property B must be allocated in accordance with section 704(c) principles.

	A		B		C	
	Tax	Book	Tax	Book	Tax	Book
Capital account after exercise . . .	$20,000	$20,000	$20,000	$20,000	$16,000	$16,000
Revaluation.	0	0	0	0	0	$1,000
Capital account after revaluation	$20,000	$20,000	$20,000	$20,000	$16,000	$17,000
Capital account reallocation	0	($1,000)	0	($1,000)	0	$2,000
Capital account after capital account reallocation	$20,000	$19,000	$20,000	$19,000	$16,000	$19,000
Income allocation (Yr.3)	0	$1,000	0	$1,000	$3,000	$1,000
Deduction allocation (Yr. 3)	($500)	($500)	($500)	($500)	($500)	($500)
Capital account at end of year 3 .	$19,500	$19,500	$19,500	$19,500	$18,500	$19,500

Example 33. (i) In Year 1, D and E each contribute cash of $10,000 to LLC, a newly formed limited liability company classified as a partnership for Federal tax purposes, in exchange for 100 units in LLC. Under the LLC agreement, each unit is entitled to participate equally in the profits and losses of LLC. LLC uses the cash contributions to purchase two non-depreciable properties, Property A and Property B, for $10,000 each. Also in Year 1, at a time when Property A and Property B are still valued at $10,000 each, LLC issues an option to F. The option allows F to buy 100 units in LLC for an exercise price of $15,000 in Year 2. F pays $2,000 to LLC to purchase the option. Assume that the LLC agreement satisfies the requirements of paragraph (b)(2) of this section and requires that, on the exercise of a noncompensatory option, LLC comply with the rules of paragraph (b)(2)(iv)(*s*) of this section. Also assume that F's option is a noncompensatory option under §1.721–2(f), and that F is not treated as a partner with respect to the option.

End of Year 1

Assets			Liabilities and Capital		
	Basis	Value		Basis	Value
Cash Premium	$2,000	$2,000	Cash Premium	$2,000	$2,000
Property A	$10,000	$10,000	D	D	D
Property B	$10,000	$10,000	E	$10,000	$10,000
Total	$22,000	$22,000		$22,000	$22,000

(ii) In year 2, prior to the exercise of F's option, G contributes $18,000 to LLC for 100 units in LLC. At the time of G's contribution, Property A has a value of $32,000 and a basis of $10,000, Property B has a value of $5,000 and a basis of $10,000, and the fair market value of F's option is $3,000. In year 2, LLC has no item of income, gain, loss, deduction, or credit.

(iii) Upon G's admission to the partnership, the capital accounts of D and E (which were $10,000 each prior to G's admission) are, in accordance with paragraph (b)(2)(iv)(*f*) of this section, adjusted upward to reflect their shares of the unrealized appreciation in the partnership's property. Property A has $22,000 of unrealized gain and Property B has $5,000 of unrealized loss. Under paragraph (b)(2)(iv)(*f*)(*1*) of this section, the adjustments must be based on the fair market value of LLC property (taking section 7701(g) into account) on the date of the adjustment, as determined under paragraph (b)(2)(iv)(*h*) of this section. The fair market value of partnership property must be reduced by the excess of the fair market value of the option as of the date of the adjustment over the consideration paid by F to acquire the option ($3,000 - $2,000 = $1,000) (under paragraph (b)(2)(iv)(*h*)(*2*) of this section), but only to the extent of the unrealized appreciation in LLC property that has not been reflected in the capital accounts previously ($22,000). This $1,000 reduction is allocated entirely to Property A, the only asset having unrealized appreciation not reflected in the capital accounts previously. Therefore, the book value of Property A is $31,000. Accordingly, the revaluation adjustments must reflect only $16,000 of the net appreciation in LLC's property ($21,000 of unrealized gain in Property A and $5,000 of unrealized loss in Property B). Thus, D's and E's capital accounts (which were $10,000 each prior to G's admission) must be adjusted upward (by $8,000) to $18,000 each. The $21,000 of built-in gain in Property A and the $5,000 of built-in loss in Property B must be allocated equally between D and E in accordance with section 704(c) principles.

	Assets			
	Basis	Value	Option Adjustment	704(b) Book
Property A	$10,000	$32,000	($1,000)	$31,000
Property B	$10,000	$5,000	0	$5,000
Cash	$2,000	$2,000	0	$2,000
Subtotal	$22,000	$39,000	($1,000)	$38,000
Cash Contributed by G	$18,000	$18,000	0	$18,000
Total	$40,000	$57,000	($1,000)	$56,000

Liabilities and Capital

	Tax	Value	704(b) Book
Cash			
Premium			
(option value)	$2,000	$3,000	$2,000
D	$10,000	$18,000	$18,000
E	$10,000	$18,000	$18,000
G	$18,000	$18,000	$18,000
Total	$40,000	$57,000	$56,000

(iv) In Year 2, after the admission of G, when Property A still has a value of $32,000 and a basis of $10,000 and Property B still has a value of $5,000 and a basis of $10,000, F exercises the option. On the exercise of the option, F's capital account is credited with the amount paid for the option ($2,000) and the exercise price of the option ($15,000). Under the LLC agreement, however, F is entitled to LLC capital corresponding to 100 units of LLC (1/4 of LLC's capital). Immediately after the exercise of the option, LLC's properties are worth $72,000 ($15,000 contributed by F, plus the value of LLC property prior to the exercise of the option, $57,000). F is entitled to LLC capital equal to 1/4 of this value, or $18,000. As F is entitled to $1,000 more LLC capital than F's capital contributions to LLC, the provisions of paragraph (b)(2)(iv)(*s*) of this section apply.

(v) Under paragraph (b)(2)(iv)(*s*) of this section, LLC must increase F's capital account from $17,000 to $18,000 by, first, revaluing LLC property in accordance with the principles of paragraph (b)(2)(iv)(*f*) of this section and allocating the first $1,000 of unrealized gain to F. The total unrealized gain which has not been reflected in the capital accounts previously is $1,000 (the difference between the actual value of Property A, $32,000, and the book value of Property A, $31,000). The entire $1,000 of book gain is allocated to F under paragraph (b)(2)(iv)(*s*)(*2*) of this section. Because the revaluation of LLC property under paragraph (b)(2)(iv)(*s*)(*2*) of this section increases F's capital account to the amount agreed on by the members, LLC is not required to make a capital account reallocation under paragraph (b)(2)(iv)(*s*)(*3*) of this section. The ($5,000) of unrealized booked loss in Property B has been allocated ($2,500) to each D and E, and the $22,000 of unrealized booked gain in Property A has been allocated $10,500 to each D and E, and $1,000 to F. Under paragraph (b)(2)(iv)(*f*)(*4*) of this section, the tax items from Properties A and B must be allocated in accordance with section 704(c) principles.

	D		E		G		F	
	Tax	Book	Tax	Book	Tax	Book	Tax	Book
Capital account after admission of G	$10,000	$18,000	$10,000	$18,000	$18,000	$18,000	0	0
Capital account after exercise of F's option	$10,000	$18,000	$10,000	$18,000	$18,000	$18,000	$17,000	$17,000
Revaluation	0	0	0	0	0	0	0	$1,000
Capital account after revaluation	$10,000	$18,000	$10,000	$18,000	$18,000	$18,000	$17,000	$18,000

Example 34. (i) On the first day of Year 1, H, I, and J form LLC, a limited liability company classified as a partnership for Federal tax purposes. H and I each contribute $10,000 cash to LLC for 100 units of common interest in LLC. J contributes $10,000 cash for a convertible preferred interest in LLC. J's convertible preferred interest entitles J to receive an annual allocation and distribution of cumulative LLC net profits in an amount equal to 10 percent of J's unreturned capital. J's convertible preferred interest also entitles J to convert, in Year 3, J's preferred interest into 100 units of common interest. If J converts, J has the right to the same share of LLC capital as J would have had if J had held the 100 units of common interest since the formation of LLC. Under the LLC agreement, each unit of common interest has an equal right to share in any LLC net profits that remain after payment of the preferred return. Assume that the LLC agreement satisfies the requirements of paragraph (b)(2) of this section and requires that, on the exercise of a noncompensatory option, LLC com-

ply with the rules of paragraph (b)(2)(iv)(*s*) of this section. Also assume that J's right to convert the preferred interest into a common interest qualifies as a noncompensatory option under §1.721–2(f), and that, prior to the exercise of the conversion right, the conversion right is not treated as a partnership interest.

(ii) LLC uses the $30,000 to purchase Property Z, a property that is depreciable on a straight-line basis over 15 years. In each of Years 1 and 2, LLC has net income of $2,500, comprised of $4,500 of gross income and $2,000 of depreciation. It allocates $1,000 of net income to J and distributes $1,000 to J in each year. LLC allocates the remaining $1,500 of net income equally to H and I in each year but makes no distributions to H and I.

	H		I		J	
	Tax	Book	Tax	Book	Tax	Book
Capital account upon formation	$10,000	$10,000	$10,000	$10,000	$10,000	$10,000
Allocation of income Years 1 and 2	$1,500	$1,500	$1,500	$1,500	$2,000	$2,000
Distributions Years 1 and 2	0	0	0	0	($2,000)	($2,000)
Capital account at end of Year 2	$11,500	$11,500	$11,500	$11,500	$10,000	$10,000

(iii) At the beginning of Year 3, when Property Z has a value of $38,000 and a basis of $26,000 ($30,000 original basis less $4,000 of depreciation) and LLC has accumulated undistributed cash of $7,000 ($9,000 gross receipts less $2,000 distributions), J converts J's preferred interest into a common interest. Under paragraphs (b)(2)(iv)(*b*) and (b)(2)(iv)(*d*)(*4*) of this section, J's capital account after the conversion equals J's capital account before the conversion, $10,000. On the conversion of the preferred interest, however, J is entitled to LLC capital corresponding to 100 units of common interest in LLC (1/3 of LLC's capital). At the time of the conversion, the total value of LLC property is $45,000. J is entitled to LLC capital equal to 1/3 of this value, or $15,000. As J is entitled to $5,000 more LLC capital than J's capital account immediately after the conversion, the provisions of paragraph (b)(2)(iv)(*s*) of this section apply.

Assets			Liabilities and Capital		
	Basis	Value		Basis	Value
Property Z	$26,000	$38,000	H	$11,500	$15,000
Undistributed			I	$11,500	$15,000
Income	$7,000	$7,000	J	$10,000	$15,000
Total	$33,000	$45,000	Total	$33,000	$45,000

(iv) Under paragraph (b)(2)(iv)(*s*) of this section, LLC must increase J's capital account from $10,000 to $15,000 by, first, revaluing LLC property in accordance with the principles of paragraph (b)(2)(iv)(*f*) of this section, and allocating the first $5,000 of unrealized gain from that revaluation to J. The unrealized gain in Property Z is $12,000 ($38,000 value less $26,000 basis). The first $5,000 of this unrealized gain must be allocated to J under paragraph (b)(2)(iv)(*s*)(*2*) of this section. The remaining $7,000 of the unrealized gain must be allocated equally to H and I in accordance with the LLC agreement. Because the revaluation of LLC property under paragraph (b)(2)(iv)(*s*)(*2*) of this section increases J's capital account to the amount agreed on by the members, LLC is not required to make a capital account reallocation under paragraph (b)(2)(iv)(*s*)(*3*) of this section. The $12,000 of unrealized booked gain in Property Z has been allocated $3,500 to each H and I, and $5,000 to J. Under paragraph (b)(2)(iv)(*f*)(*4*) of this section, the tax items from the revalued property must be allocated in accordance with section 704(c) principles.

	H		I		J	
	Tax	Book	Tax	Book	Tax	Book
Capital account prior to conversion	$11,500	$11,500	$11,500	$11,500	$10,000	$10,000
Revaluation on conversion	0	$3,500	0	$3,500	0	$5,000
Capital account after conversion	$11,500	$15,000	$11,500	$15,000	$10,000	$15,000

Example 35. (i) On the first day of Year 1, K and L each contribute cash of $10,000 to LLC, a newly formed limited liability company classified as a partnership for Federal tax purposes, in exchange for 100 units in LLC. Immediately after its formation, LLC borrows $10,000 from M. Under the terms of the debt instrument, interest of $1,000 is unconditionally payable at the end of each year and the $10,000 stated principal is repayable in five years. Throughout the term of the indebtedness, M has the right to convert the debt instrument into 100 units in LLC. If M converts, M has the right to the same share of LLC capital as M would have had if M had held 100 units in LLC since the formation of LLC. Under the LLC agreement, each unit participates equally in the profits and losses of LLC and has an equal right to share in LLC capital. Assume that the LLC agreement satisfies the requirements of paragraph (b)(2) of this section and requires that, on the exercise of a noncompensatory option, LLC comply with the rules of paragraph (b)(2)(iv)(*s*) of this section. Also assume that M's right to convert the debt into an interest in LLC qualifies as a noncompensatory option under §1.721–2(f), and that, prior to the exercise of the conversion right, M is not treated as a partner with respect to the convertible debt.

(ii) LLC uses the $30,000 to purchase Property D, property that is depreciable on a straight-line basis over 15 years. In each of Years 1, 2, and 3, LLC has net income of $2,000, comprised of $5,000 of gross income, $2,000 of depreciation, and interest expense (representing payments of interest on the loan from

M) of $1,000. LLC allocates this income equally to K and L but makes no distributions to either K or L.

	K		L		M	
	Tax	Book	Tax	Book	Tax	Book
Initial capital account	$10,000	$10,000	$10,000	$10,000	0	0
Year 1 net income	$1,000	$1,000	$1,000	$1,000	0	0
Year 2 net income	$1,000	$1,000	$1,000	$1,000	0	0
Year 3 net income	$1,000	$1,000	$1,000	$1,000	0	0
Year 4 initial capital account	$13,000	$13,000	$13,000	$13,000	0	0

(iii) At the beginning of Year 4, at a time when Property D, LLC's only asset, has a value of $33,000 and basis of $24,000 ($30,000 original basis less $6,000 depreciation in Years 1 through 3), and LLC has accumulated undistributed cash of $12,000 ($15,000 gross income less $3,000 of interest payments) in LLC, M converts the debt into a 1/3 interest in LLC. Under paragraphs (b)(2)(iv)(*b*) and (b)(2)(iv)(*d*)(*4*) of this section, M's capital account after the conversion is the adjusted issue price of the debt immediately before M's conversion of the debt, $10,000, plus any accrued but unpaid qualified stated interest on the debt, $0. On the conversion of the debt, however, M is entitled to receive LLC capital corresponding to 100 units of LLC (1/3 of LLC's capital). At the time of the conversion, the total value of LLC's property is $45,000. M is entitled to LLC capital equal to 1/3 of this value, or $15,000. As M is entitled to $5,000 more LLC capital than M's capital contribution to LLC ($10,000), the provisions of paragraph (b)(2)(iv)(*s*) of this section apply.

Assets			Liabilities and Capital		
	Basis	Value		Basis	Value
Property D	$24,000	$33,000	K	$13,000	$15,000
Cash	$12,000	$12,000	L	$13,000	$15,000
			M	$10,000	$15,000
Total	$36,000	$45,000		$36,000	$45,000

(iv) Under paragraph (b)(2)(iv)(*s*) of this section, LLC must increase M's capital account from $10,000 to $15,000 by, first, revaluing LLC property in accordance with the principles of paragraph (b)(2)(iv)(*f*) of this section, and allocating the first $5,000 of unrealized gain from that revaluation to M. The unrealized gain in Property D is $9,000 ($33,000 value less $24,000 basis). The first $5,000 of this unrealized gain must be allocated to M under paragraph (b)(2)(iv)(*s*)(*2*) of this section, and the remaining $4,000 of the unrealized gain must be allocated equally to K and L in accordance with the LLC agreement. Because the revaluation of LLC property under paragraph (b)(2)(iv)(*s*)(*2*) of this section increases M's capital account to the amount agreed upon by the members, LLC is not required to make a capital account reallocation under paragraph (b)(2)(iv)(*s*)(*3*) of this section. The $9,000 unrealized booked gain in property D has been allocated $2,000 to each K and L, and $5,000 to M. Under paragraph (b)(2)(iv)(*f*)(*4*) of this section, the tax items from the revalued property must be allocated in accordance with section 704(c) principles.

	K		L		M	
	Tax	Book	Tax	Book	Tax	Book
Year 4 capital account prior to exercise	$13,000	$13,000	$13,000	$13,000	0	0
Capital account after exercise	$13,000	$13,000	$13,000	$13,000	$10,000	$10,000
Revaluation	0	$2,000	0	$2,000	0	$ 5,000
Capital account after revaluation	$13,000	$15,000	$13,000	$15,000	$10,000	$15,000

Par. 4. Section 1.704–3 is amended by revising the first sentence of paragraph (a)(6)(i) to read as follows:

§1.704–3 Contributed property.

(a) * * *

(6) * * *(i) * * * The principles of this section apply to allocations with respect to property for which differences between book value and adjusted tax basis are created when a partnership revalues partnership property pursuant to §1.704–1(b)(2)(iv)(*f*) or 1.704–1(b)(2)(iv)(*s*) (reverse section 704(c) allocations). * * *

* * * * *

Par. 5. Section 1.721–2 is added to read as follows:

§1.721–2 Noncompensatory options.

(a) *Exercise of a noncompensatory option*—(1) *In general.* Notwithstanding §1.721–1(b)(1), section 721 applies to the exercise (as defined in paragraph (g)(4)

of this section) of a noncompensatory option (as defined in paragraph (f) of this section). Except as provided in paragraph (a)(2) of this section, section 721 applies to the exercise of a noncompensatory option when the holder pays the exercise price with either property or cash, regardless of whether the terms of the option require or permit cash payment. However, if the exercise price (as defined in paragraph (g)(5) of this section) of a noncompensatory option exceeds the capital account received by the option holder on the exercise of the option, then general tax principles will apply to determine the tax consequences of the transaction.

(2) *Exception*. Section 721 does not apply to the exercise of a noncompensatory option to the extent that the exercise price is satisfied with the partnership's obligation to the option holder for unpaid rent, royalties, or interest (including accrued original issue discount) that accrued on or after the beginning of the option holder's holding period for the obligation. The issuing partnership will not recognize gain or loss upon the transfer of a partnership interest to an exercising option holder in satisfaction of such unpaid rent, royalties, or interest (including accrued original issue discount).

(b) *Transfer of property or satisfaction of an obligation in exchange for a noncompensatory option*—(1) *In general*. Except as provided in paragraph (b)(2) of this section, section 721 does not apply to a transfer of property to a partnership in exchange for a noncompensatory option, or to the satisfaction of a partnership obligation with a noncompensatory option.

(2) *Exception*. Section 721 does apply to a transfer of property to a partnership in exchange for convertible equity (as defined in paragraph (g)(3) of this section).

(c) *Lapse of a noncompensatory option*. Section 721 does not apply to the lapse of a noncompensatory option.

(d) *Cash settlement of a noncompensatory option*. Section 721 does not apply to the settlement of a noncompensatory option in cash or property other than a partnership interest in the issuing partnership.

(e) *Issuance of a partnership interest in satisfaction of indebtedness for interest on convertible debt*. Section 721 does not apply to the transfer of a partnership interest to a noncompensatory option holder upon conversion of convertible debt in the partnership to the extent that the transfer is in satisfaction of the partnership's indebtedness for unpaid interest (including accrued original issue discount) on the convertible debt that accrued on or after the beginning of the convertible debt holder's holding period for the indebtedness. The debtor partnership will not, however, recognize gain or loss upon such conversion. For rules in determining whether a partnership interest transferred to a creditor is treated as payment of interest or accrued original issue discount, see §§1.446–2 and 1.1275–2, respectively.

(f) *Scope*. The provisions of this section apply only to noncompensatory options. For purposes of this section, the term *noncompensatory option* means an option (as defined in paragraph (g)(1) of this section) issued by a partnership (the issuing partnership), other than an option issued in connection with the performance of services.

(g) *Definitions*. The following definitions apply for the purposes of this section:

(1) *Option* means a contractual right to acquire an interest in the issuing partnership, including a call option, warrant, or other similar arrangement, the conversion feature of convertible debt (as defined in paragraph (g)(2) of this section), or the conversion feature of convertible equity (as defined in paragraph (g)(3) of this section). To achieve the purposes of this section, the Commissioner can treat other contractual agreements, including a futures contract, a forward contract, or a notional principal contract, as an option. A contract that otherwise constitutes an option will not fail to be treated as an option for purposes of this section merely because it may or must be settled in cash or property other than a partnership interest.

(2) *Convertible debt* is any indebtedness of a partnership that is convertible into an interest in the partnership that issued the debt.

(3) *Convertible equity* is equity in a partnership that is convertible into a different equity interest in the partnership that issued the convertible equity.

(4) *Exercise* means the exercise of an option in exchange for an interest in the issuing partnership or the conversion of convertible debt or convertible equity into an interest in the issuing partnership.

(5) *Exercise price* means, in the case of a call option, the exercise price of the call option; in the case of convertible equity, the converting partner's capital account with respect to that convertible equity, increased by the fair market value of cash or other property contributed to the partnership in connection with the conversion; and, in the case of convertible debt, the adjusted issue price (within the meaning of §1.1275–1(b)) of the debt converted, increased by accrued but unpaid qualified stated interest on the debt and by the fair market value of cash or other property contributed to the partnership in connection with the conversion.

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

Example. In Year 1, L and M form general partnership LM with cash contributions of $5,000 each, which are used to purchase land, Property D, for $10,000. In that same year, LM issues an option to N to buy a one-third interest in LM at any time before the end of Year 3. The exercise price of the option is $5,000, payable in either cash or property. N transfers Property E with a basis of $600 and a value of $1,000 to the partnership in exchange for the option. N provides no other consideration for the option. Assume that N's option is a noncompensatory option under paragraph (f) of this section and that N is not treated as a partner with respect to the option. Under paragraph (b) of this section, section 721(a) does not apply to N's transfer of Property E to LM in exchange for the option. In accordance with §1.1001–1, upon N's transfer of Property E to the partnership in exchange for the option, N recognizes $400 of gain. Under open transaction principles applicable to noncompensatory options, the partnership does not recognize any income for the premium (the property received in exchange for the option). The partnership has a basis of $1,000 in Property E. In Year 3, when the partnership property is valued at $16,000, N exercises the option, contributing Property F with a basis of $3,000 and a fair market value of $5,000 to the partnership. Under paragraph (a) of this section, neither the partnership nor N recognizes gain upon N's contribution of property to the partnership upon the exercise of the option. Under section 723, the partnership has a basis of $3,000 in Property F. The partnership does not recognize income for the premium (Property E) upon exercise of the option. See §1.704–1(b)(2)(iv)(*d*)(*4*) and (*s*) for special rules applicable to capital account adjustments on the exercise of a noncompensatory option.

(i) *Effective/applicability date*. This section applies to noncompensatory options that are issued on or after February 5, 2013.

Par. 6. Section 1.761–3 is added to read as follows:

§1.761–3 Certain option holders treated as partners.

(a) *Noncompensatory option treated as a partnership interest*—(1) *General rule*.

A noncompensatory option (as defined in paragraph (b)(2) of this section) is treated as a partnership interest for all Federal tax purposes if, on the date of a measurement event (as defined in paragraph (c) of this section) with respect to the option—

(i) The noncompensatory option (and any agreements associated with it) provides the option holder with rights that are substantially similar to the rights afforded a partner (as determined under paragraph (d) of this section); and

(ii) There is a strong likelihood that the failure to treat the holder of the noncompensatory option as a partner would result in a substantial reduction in the present value of the partners' and noncompensatory option holder's aggregate Federal tax liabilities (as determined under paragraph (e) of this section).

(2) *Continuing applicability of general principles of law*. The fact that an option is not treated as a partnership interest under this section does not prevent the option from being treated as a partnership interest under general principles of Federal tax law.

(3) *Timing of characterization*. If a noncompensatory option is treated under this section as a partnership interest, that treatment applies, as the case may be, upon the issuance of the option, or immediately before any other measurement event that gave rise to the characterization under paragraph (a)(1) of this section.

(4) *Effect of characterization*. If a noncompensatory option is treated as a partnership interest under this section or under general principles of law, the option holder will be treated as a partner with respect to the partnership interest and will receive a distributive share of the partnership's income, gain, loss, deduction, or credit (or items thereof), as determined in accordance with that partner's interest in the partnership (taking into account all facts and circumstances) in accordance with §1.704–1(b)(3). Once a noncompensatory option is treated as a partnership interest, in no event may it be characterized as an option thereafter.

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

(1) *Look-through entity*. *Look-through entity* means an entity described in §1.704–1(b)(2)(iii)(*d*)(*2*).

(2) *Noncompensatory option*. *Noncompensatory option* means an option (as defined in paragraph (b)(3) of this section) issued by a partnership, other than an option issued in connection with the performance of services. For purposes of applying this section, an option that would be a noncompensatory option under this paragraph if it had been issued by a partnership is a noncompensatory option if the option was issued by an eligible entity (as defined in §301.7701–3(a)) that would become a partnership under §301.7701–3(f)(2) if the noncompensatory option holder were treated as a partner. Also for purposes of applying this section, if a noncompensatory option is issued by such an eligible entity, then the eligible entity is treated as a partnership.

(3) *Option*. An *option* is a contractual right to acquire an interest in the issuing partnership, including a call option, warrant, or other similar arrangement. In addition, an option includes convertible debt (as defined in §1.721–2(g)(2)) and convertible equity (as defined in §1.721–2(g)(3)). To achieve the purposes of this section, the Commissioner can treat other contractual agreements, including a forward contract, a futures contract, or a notional principal contract, as an option. A contract that otherwise constitutes an option will not fail to be treated as an option for purposes of this section merely because it may or must be settled in cash or property other than a partnership interest.

(4) *Underlying partnership interest*. *Underlying partnership interest* means the interest in the issuing partnership that would be acquired by the noncompensatory option holder upon exercise of the noncompensatory option.

(c) *Measurement event*—(1) *General rule*. Except as provided in paragraph (c)(2) of this section, a measurement event with respect to a noncompensatory option is any of the following events:

(i) Issuance of the noncompensatory option;

(ii) An adjustment of the terms (modification) of the noncompensatory option or of the underlying partnership interest (as defined in paragraph (b)(4) of this section) (including an adjustment pursuant to the terms of the noncompensatory option or the underlying partnership interest);

(iii) Transfer of the noncompensatory option if either:

(A) The option may be exercised (or settled) more than 12 months after its issuance, or

(B) The transfer is pursuant to a plan in existence at the time of the issuance or modification of the noncompensatory option that has as a principal purpose the substantial reduction of the present value of the aggregate Federal tax liabilities of the partners and the noncompensatory option holder (under paragraph (a)(1)(ii) of this section);

(2) *Events not treated as measurement events*. A measurement event does not include the following events:

(i) A transfer of the noncompensatory option at death, between spouses or former spouses under section 1041, or in a transaction that is disregarded for Federal tax purposes;

(ii) A modification that neither materially increases the likelihood that the noncompensatory option will be exercised (as described in paragraph (d)(2) of this section) nor provides the noncompensatory option holder with partner attributes (as described in paragraph (d)(3) of this section);

(iii) A change in the strike price of a noncompensatory option or in the interests in the issuing partnership that may be issued or transferred pursuant to the noncompensatory option, made pursuant to a *bona fide*, reasonable adjustment formula that has the intended effect of preventing dilution of the interests of the noncompensatory option holder;

(iv) Any other event as provided in guidance published in the Internal Revenue Bulletin.

(d) *Rights substantially similar to partner rights*—(1) *In general*. A noncompensatory option provides the holder with rights that are substantially similar to the rights afforded to a partner if either the option is reasonably certain to be exercised or the option holder possesses partner attributes.

(2) *Reasonable certainty of exercise*—(i) *General rule*. The determination of whether a noncompensatory option is reasonably certain to be exercised at the time of a measurement event is based on all the facts and circumstances, including—

(A) The fair market value of the partnership interest that is the subject of the noncompensatory option;

(B) The strike price of the noncompensatory option;

(C) The term of the noncompensatory option;

(D) The volatility of the value or income of the issuing partnership or the underlying partnership interest;

(E) Anticipated distributions by the partnership during the term of the noncompensatory option;

(F) Any other special option features, such as a strike price that fluctuates;

(G) The existence of related options, including reciprocal options; and

(H) Any other arrangements affecting or undertaken with a principal purpose of affecting the likelihood that the noncompensatory option will be exercised.

(ii) *Safe harbors*—(A) *General rule*. Except as provided in paragraph (d)(2)(ii)(C) of this section, a noncompensatory option is not considered reasonably certain to be exercised if, as of the date of a measurement event with respect to the noncompensatory option—

(*1*) The option may be exercised no more than 24 months after the date of the measurement event and the strike price is equal to or greater than 110 percent of the fair market value of the underlying partnership interest on the date of the measurement event; or

(*2*) The terms of the option provide that the strike price of the option is equal to or greater than the fair market value of the underlying partnership interest on the exercise date.

(B) *Options exercisable at fair market value*. For purposes of paragraph (d)(2)(ii)(A) of this section, an option whose strike price is determined by a formula is considered to have a strike price equal to or greater than the fair market value of the underlying partnership interest on the exercise date if the formula is agreed upon by the parties when the option is issued in a *bona fide* attempt to arrive at the fair market value on the exercise date and is to be applied based on the facts and circumstances in existence on the exercise date.

(C) *Exception*. The safe harbors of paragraph (d)(2)(ii)(A) of this section do not apply if the parties to the noncompensatory option had a principal purpose described in paragraph (c)(1)(iii)(B) of this section with respect to a measurement event for that option (or, if multiple options were issued pursuant to a plan, a measurement event with respect to any option issued pursuant to that plan).

(D) *Failure to satisfy safe harbor*. Failure of an option to satisfy one of the safe harbors of paragraph (d)(2)(ii)(A) does not affect the determination of whether an option is treated as reasonably certain to be exercised.

(3) *Partner attributes*—(i) *General rule*. The determination of whether a holder of a noncompensatory option possesses partner attributes is based on all the facts and circumstances, including whether the option holder, directly or indirectly, through the option agreement or a related agreement, is provided with voting rights or managerial rights in the partnership.

(ii) *Certain factors that conclusively establish partner attributes*. For purposes of this section, a noncompensatory option holder has partner attributes if, based on all the facts and circumstances—

(A) The option holder is provided with rights (through the option agreement or a related agreement) that are similar to rights ordinarily afforded to a partner to participate in partnership profits through present possessory rights to share in current operating or liquidating distributions with respect to the underlying partnership interests; or

(B) The option holder, directly or indirectly, undertakes obligations (through the option agreement or a related agreement) that are similar to obligations undertaken by a partner to bear partnership losses.

(iii) *Special rules*. The following rules apply for purposes of paragraphs (d)(3)(i) and (d)(3)(ii) of this section:

(A) Rights in the issuing partnership possessed by a noncompensatory option holder solely by virtue of owning an interest in the issuing partnership are not taken into account, provided that those rights are no greater than the rights granted to other partners owning substantially similar interests in the partnership and who do not hold noncompensatory options in the partnership.

(B) If all of the partners owning substantially similar interests in the issuing partnership also hold noncompensatory options in the partnership, or if none of the other partners owns substantially similar interests in the partnership, then all facts and circumstances will be considered in determining whether the rights in the partnership possessed by the option holder are possessed solely by virtue of owning a partnership interest. If those rights are possessed solely by virtue of owning a partnership interest, they are not taken into account.

(C) A noncompensatory option holder will not ordinarily be considered to possess partner attributes solely because the noncompensatory option agreement significantly controls or restricts, or the noncompensatory option holder has the ability to significantly control or restrict, a partnership decision that could substantially affect the value of the underlying partnership interest. In particular, the following abilities of the option holder will not be treated as partner attributes:

(*1*) The ability to impose reasonable restrictions on partnership distributions or dilutive issuances of partnership equity or options while the noncompensatory option is outstanding.

(*2*) The ability to choose the partnership's section 704(c) method for partnership properties.

(D) When the applicable measurement event is a transfer described in paragraph (c)(1) of this section, the partner attributes of the transferee, not the transferor, are taken into account.

(E) The option holder will be treated as owning all partnership interests and noncompensatory options issued by the partnership that are owned by any person related to the option holder. For purposes of the preceding sentence, a person related to the option holder is defined as any person bearing a relationship to the option holder described in section 267(b) or 707(b).

(e) *Substantial tax reduction requirement*—(1) *General rule*. The determination of whether there is a strong likelihood that the failure to treat a noncompensatory option holder as a partner would result in a substantial reduction in the present value of the partners' and the noncompensatory option holder's aggregate Federal tax liabilities is based on all the facts and circumstances, including—

(i) The interaction of the allocations of the issuing partnership and the partners' and noncompensatory option holder's Federal tax attributes (taking into account tax consequences that result from the interaction of the allocations with the partners' and noncompensatory option holder's Fed-

eral tax attributes that are unrelated to the partnership);

(ii) The absolute amount of the Federal tax reduction;

(iii) The amount of the reduction relative to overall Federal tax liability; and

(iv) The timing of items of income and deductions.

(2) *Special rules.* For purposes of applying paragraph (e)(1) of this section to a partner or noncompensatory option holder that is—

(i) A look-through entity (as defined in paragraph (b)(1) of this section), the Federal tax consequences that result from the interaction of allocations of the partnership and the Federal tax attributes of any person that is an owner, or in the case of a trust or estate, the beneficiary, of an interest in such a partner or noncompensatory option holder, whether directly, or indirectly through one or more look-through entities, must be taken into account; or

(ii) A member of a consolidated group (within the meaning of §1.1502–1(h)), the tax consequences that result from the interaction of the issuing partnership's allocations and the tax attributes of the consolidated group and the tax attributes of another member with respect to a separate return year must be taken into account.

(f) *Example.* The following example illustrates the provisions of this section. For purposes of the example, assume that PRS is a partnership for Federal tax purposes, none of the noncompensatory option holders or partners are related persons, and that general principles of law do not apply to treat the noncompensatory option as a partnership interest. The example reads as follows:

Example. Active trade or business. PRS is engaged in an active real estate business, the amount of income, gain, loss, and deductions from which cannot be predicted with any reasonable certainty. In exchange for a premium of $10x, PRS issues a noncompensatory option to A to acquire a 10 percent interest in PRS for $110x at any time during a 3-year period commencing on the date on which the option is issued. At the time of the issuance of the noncompensatory option, a 10 percent interest in PRS has a fair market value of $100x. Due to the nature of PRS's business, the value of a 10 percent PRS interest in 3 years is not reasonably predictable as of the time the noncompensatory option is issued. Assuming there are no other facts affecting the certainty of the option's exercise, it is not reasonably certain that A's option will be exercised. Therefore, assuming that A does not possess partner attributes as described in paragraph (d)(3) of this section, A's noncompensatory option is not treated as a partnership interest under paragraph (a)(1) of this section.

(g) *Effective/applicability date.* This section applies to noncompensatory options issued on or after February 5, 2013.

Par. 7. Section 1.1272–1 is amended by adding a sentence at the end of paragraph (e) to read as follows:

§1.1272–1 Current inclusion of OID in income.

* * * * *

(e) * * * For debt instruments issued on or after February 5, 2013, the term *stock* in the preceding sentence means an equity interest in any entity that is classified, for Federal tax purposes, as either a partnership or a corporation.

* * * *

Par. 8. Section 1.1273–2 is amended by adding a sentence at the end of paragraph (j) to read as follows:

§1.1273–2 Determination of issue price and issue date.

* * * * *

(j) * * * For debt instruments issued on or after February 5, 2013, the term *stock* in the preceding sentence means an equity interest in any entity that is classified, for Federal tax purposes, as either a partnership or a corporation.

* * * * *

Par. 9. Section 1.1275–4 is amended by adding a sentence at the end of paragraph (a)(4) to read as follows:

§1.1275–4 Contingent payment debt instruments.

(a) * * *

(4) * * * For debt instruments issued on or after February 5, 2013, the term *stock* in the preceding sentence means an equity interest in any entity that is classified, for Federal tax purposes, as either a partnership or a corporation.

* * * * *

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

Approved January 24, 2013.

Mark J. Mazur,
Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on February 4, 2013, 8:45 a.m., and published in the issue of the Federal Register for February 5, 2013, 78 F.R. 7997)

Section 5000A.—Requirement to Maintain Minimum Essential Coverage

Proposed regulations on the shared responsibility payment for not maintaining minimum essential coverage under Section 5000A, which was added by the Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act of 2010, as amended by the TRICARE Affirmation Act and Public Law 111–173. See REG-148500-12, page 716.

26 CFR 1.36B–2: Eligibility for premium tax credit.

T.D. 9611

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Health Insurance Premium Tax Credit

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the health insurance premium tax credit enacted by the Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act of 2010. These final regulations provide guidance to individuals related to employees who may enroll in eligible employer-sponsored coverage and who wish to enroll in qualified health plans through Affordable Insurance Exchanges (Exchanges) and claim the premium tax credit.

DATES: *Effective Date:* These regulations are effective on February 1, 2013.

Applicability Date: For date of applicability, see §1.36B–1(o).

FOR FURTHER INFORMATION CONTACT: Andrew S. Braden, (202) 622–4960 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains final regulations that amend the Income Tax Regulations (26 CFR part 1) under section 36B of the Internal Revenue Code (Code) regarding whether health coverage under an employer-sponsored plan is affordable for individuals who are eligible to enroll in the plan by reason of their relationship to an employee (related individuals).

On August 17, 2011, a notice of proposed rulemaking (REG–131491–10, 2011–36 I.R.B. 208) was published in the **Federal Register** (76 FR 50931). On May 23, 2012, final regulations (T.D. 9590, 2012–24 I.R.B. 986) were published in the **Federal Register** (77 FR 30377). The final regulations reserved a rule (§1.36B–2(c)(3)(v)(A)(*2*)) for determining affordability of employer-sponsored coverage for related individuals. Written comments responding to the proposed and final regulations were received. The comments are available for public inspection at *www.regulations.gov* or on request. A public hearing was held on November 17, 2011. After consideration of all the comments, the proposed rule is adopted without change by this Treasury decision.

Explanation of Provisions and Summary of Comments

The proposed regulations provided that, for taxable years beginning before January 1, 2015, an eligible employer-sponsored plan is affordable for related individuals if the portion of the annual premium the employee must pay for self-only coverage (the required contribution percentage) does not exceed 9.5% of the taxpayer's household income. While several comments supported this rule, other comments asserted that the affordability of coverage for related individuals should be based on the portion of the annual premium the employee must pay for family coverage.

These final regulations adopt the proposed rule without change. The language of section 36B, through a cross-reference to section 5000A(e)(1)(B), specifies that the affordability test for related individuals is based on the cost of self-only coverage. By contrast, section 5000A, which establishes the shared responsibility payment applicable to individuals for failure to maintain minimum essential coverage, addresses affordability for employees in section 5000A(e)(1)(B) and, separately, for related individuals in section 5000A(e)(1)(C). Thus, proposed regulations under section 5000A, which the Treasury Department is releasing concurrently with these final regulations, provide that, for purposes of applying the affordability exemption from the shared responsibility payment in the case of related individuals, the required contribution is based on the premium the employee would pay for employer-sponsored family coverage.

Effective/Applicability Date

These final regulations apply to taxable years ending after December 31, 2013.

Special Analyses

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. Section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because the regulations do not impose a collection of information requirement 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 final 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 final regulations are Frank W. Dunham III and Stephen J. Toomey of the Office of Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and the Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.36B–2 is amended by revising paragraphs (c)(3)(v)(A)(*2*) and (c)(3)(v)(D), *Example 2* to read as follows:

§1.36B–2 Eligibility for premium tax credit.

* * * * *

(c) * * *

(3) * * *

(v) * * *

(A) * * *

(*2*) *Affordability for related individual.* Except as provided in paragraph (c)(3)(v)(A)(*3*) of this section, an eligible employer-sponsored plan is affordable for a related individual if the portion of the annual premium the employee must pay for self-only coverage does not exceed the required contribution percentage, as described in paragraph (c)(3)(v)(A)(*1*) of this section.

* * * * *

(D) *Examples.** * *

* * * * *

Example 2. Basic determination of affordability for a related individual. The facts are the same as in *Example 1*, except that C is married to J and X's plan requires C to contribute $5,300 for coverage for C and J for 2014 (11.3 percent of C's household income). Because C's required contribution for self-only coverage ($3,450) does not exceed 9.5 percent of household income, under paragraph (c)(3)(v)(A)(2) of this section, X's plan is affordable for C and J, and C and J are eligible for minimum essential coverage for all months in 2014.

* * * * *

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

Approved January 25, 2013.

Mark J. Mazur,
Assistant Secretary
of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on January 30, 2013, 11:15 a.m., and published in the issue of the Federal Register for February 1, 2013, 78 F.R. 7264)

Section 6621.—Determination of Rate of Interest

26 CFR 301.6621–1: Interest rate.

Interest rates: underpayment and overpayments. The rates for interest determined under section 6621 of the Code for the calendar quarter beginning April 1, 2013, will be 3 percent for overpayments (2 percent in the case of a corporation), 3 percent for the underpayments, and 5 percent for large corporate underpayments. The rate of interest paid on the portion of a corporate overpayment exceeding $10,000 will be 0.5 percent.

Rev. Rul. 2013–6

Section 6621 of the Internal Revenue Code establishes the interest rates on overpayments and underpayments of tax. Under section 6621(a)(1), the overpayment rate is the sum of the federal short-term rate plus 3 percentage points (2 percentage points in the case of a corporation), except the rate for the portion of a corporate overpayment of tax exceeding $10,000 for a taxable period is the sum of the federal short-term rate plus 0.5 of a percentage point. Under section 6621(a)(2), the underpayment rate is the sum of the federal short-term rate plus 3 percentage points.

Section 6621(c) provides that for purposes of interest payable under section 6601 on any large corporate underpayment, the underpayment rate under section 6621(a)(2) is determined by substituting "5 percentage points" for "3 percentage points."

See section 6621(c) and section 301.6621–3 of the Regulations on Procedure and Administration for the definition of a large corporate underpayment and for the rules for determining the applicable date. Section 6621(c) and section 301.6621–3 are generally effective for periods after December 31, 1990.

Section 6621(b)(1) provides that the Secretary will determine the federal short-term rate for the first month in each calendar quarter. Section 6621(b)(2)(A) provides that the federal short-term rate determined under section 6621(b)(1) for any month applies during the first calendar quarter beginning after that month. Section 6621(b)(2)(B) provides that in determining the addition to tax under section 6654 for failure to pay estimated tax for any taxable year, the federal short-term rate that applies during the third month following the taxable year also applies during the first 15 days of the fourth month following the taxable year. Section 6621(b)(3) provides that the federal short-term rate for any month is the federal short-term rate determined during that month by the Secretary in accordance with section 1274(d), rounded to the nearest full percent (or, if a multiple of 1/2 of 1 percent, the rate is increased to the next highest full percent).

Notice 88–59, 1988–1 C.B. 546, announced that, in determining the quarterly interest rates to be used for overpayments and underpayments of tax under section 6621, the Internal Revenue Service will use the federal short-term rate based on daily compounding because that rate is most consistent with section 6621 which, pursuant to section 6622, is subject to daily compounding

The federal short-term rate determined in accordance with section 1274(d) during January 2013 is the rate published in Revenue Ruling 2013–3, 2013–8 I.R.B. 500, to take effect beginning February 1, 2013. The federal short-term rate, rounded to the nearest full percent, based on daily compounding determined during the month of January 2013 is 0 percent. Accordingly, an overpayment rate of 3 percent (2 percent in the case of a corporation) and an underpayment rate of 3 percent are established for the calendar quarter beginning April 1, 2013. The overpayment rate for the portion of a corporate overpayment exceeding $10,000 for the calendar quarter beginning April 1, 2013, is 0.5 percent. The underpayment rate for large corporate underpayments for the calendar quarter beginning April 1, 2013, is 5 percent. These rates apply to amounts bearing interest during that calendar quarter.

The 3 percent rate also applies to estimated tax underpayments for the second calendar quarter in 2013.

Interest factors for daily compound interest for annual rates of 0.5 percent are published in Appendix A of this Revenue Ruling. Interest factors for daily compound interest for annual rates of 2 percent, 3 percent and 5 percent are published in Tables 9, 11, and 15 of Rev. Proc. 95–17, 1995–1 C.B. 563, 565, and 569.

Annual interest rates to be compounded daily pursuant to section 6622 that apply for prior periods are set forth in the tables accompanying this revenue ruling.

DRAFTING INFORMATION

The principal author of this revenue ruling is Deborah Colbert-James of the Office of Associate Chief Counsel (Procedure & Administration). For further information regarding this revenue ruling, contact Ms. Gulas at (202) 622–4570 (not a toll-free call).

APPENDIX A

365 Day Year

0.5% Compound Rate 184 Days

Days	Factor	Days	Factor	Days	Factor
1	0.000013699	63	0.000863380	125	0.001713784
2	0.000027397	64	0.000877091	126	0.001727506
3	0.000041096	65	0.000890801	127	0.001741228
4	0.000054796	66	0.000904512	128	0.001754951
5	0.000068495	67	0.000918223	129	0.001768673
6	0.000082195	68	0.000931934	130	0.001782396
7	0.000095894	69	0.000945646	131	0.001796119
8	0.000109594	70	0.000959357	132	0.001809843
9	0.000123294	71	0.000973069	133	0.001823566
10	0.000136995	72	0.000986781	134	0.001837290
11	0.000150695	73	0.001000493	135	0.001851013
12	0.000164396	74	0.001014206	136	0.001864737
13	0.000178097	75	0.001027918	137	0.001878462
14	0.000191798	76	0.001041631	138	0.001892186
15	0.000205499	77	0.001055344	139	0.001905910
16	0.000219201	78	0.001069057	140	0.001919635
17	0.000232902	79	0.001082770	141	0.001933360
18	0.000246604	80	0.001096484	142	0.001947085
19	0.000260306	81	0.001110197	143	0.001960811
20	0.000274008	82	0.001123911	144	0.001974536
21	0.000287711	83	0.001137625	145	0.001988262
22	0.000301413	84	0.001151339	146	0.002001988
23	0.000315116	85	0.001165054	147	0.002015714
24	0.000328819	86	0.001178768	148	0.002029440
25	0.000342522	87	0.001192483	149	0.002043166
26	0.000356225	88	0.001206198	150	0.002056893
27	0.000369929	89	0.001219913	151	0.002070620
28	0.000383633	90	0.001233629	152	0.002084347
29	0.000397336	91	0.001247344	153	0.002098074
30	0.000411041	92	0.001261060	154	0.002111801
31	0.000424745	93	0.001274776	155	0.002125529
32	0.000438449	94	0.001288492	156	0.002139257
33	0.000452154	95	0.001302208	157	0.002152985
34	0.000465859	96	0.001315925	158	0.002166713
35	0.000479564	97	0.001329641	159	0.002180441
36	0.000493269	98	0.001343358	160	0.002194169
37	0.000506974	99	0.001357075	161	0.002207898
38	0.000520680	100	0.001370792	162	0.002221627
39	0.000534386	101	0.001384510	163	0.002235356
40	0.000548092	102	0.001398227	164	0.002249085
41	0.000561798	103	0.001411945	165	0.002262815
42	0.000575504	104	0.001425663	166	0.002276544
43	0.000589211	105	0.001439381	167	0.002290274
44	0.000602917	106	0.001453100	168	0.002304004
45	0.000616624	107	0.001466818	169	0.002317734
46	0.000630331	108	0.001480537	170	0.002331465
47	0.000644039	109	0.001494256	171	0.002345195
48	0.000657746	110	0.001507975	172	0.002358926
49	0.000671454	111	0.001521694	173	0.002372657
50	0.000685161	112	0.001535414	174	0.002386388
51	0.000698869	113	0.001549133	175	0.002400120
52	0.000712578	114	0.001562853	176	0.002413851
53	0.000726286	115	0.001576573	177	0.002427583
54	0.000739995	116	0.001590293	178	0.002441315
55	0.000753703	117	0.001604014	179	0.002455047
56	0.000767412	118	0.001617734	180	0.002468779

365 Day Year

0.5% Compound Rate 184 Days

Days	Factor	Days	Factor	Days	Factor
57	0.000781121	119	0.001631455	181	0.002482511
58	0.000794831	120	0.001645176	182	0.002496244
59	0.000808540	121	0.001658897	183	0.002509977
60	0.000822250	122	0.001672619	184	0.002523710
61	0.000835960	123	0.001686340		
62	0.000849670	124	0.001700062		

366 Day Year

0.5% Compound Rate 184 Days

Days	Factor	Days	Factor	Days	Factor
1	0.000013661	63	0.000861020	125	0.001709097
2	0.000027323	64	0.000874693	126	0.001722782
3	0.000040984	65	0.000888366	127	0.001736467
4	0.000054646	66	0.000902040	128	0.001750152
5	0.000068308	67	0.000915713	129	0.001763837
6	0.000081970	68	0.000929387	130	0.001777522
7	0.000095632	69	0.000943061	131	0.001791208
8	0.000109295	70	0.000956735	132	0.001804893
9	0.000122958	71	0.000970409	133	0.001818579
10	0.000136620	72	0.000984084	134	0.001832265
11	0.000150283	73	0.000997758	135	0.001845951
12	0.000163947	74	0.001011433	136	0.001859638
13	0.000177610	75	0.001025108	137	0.001873324
14	0.000191274	76	0.001038783	138	0.001887011
15	0.000204938	77	0.001052459	139	0.001900698
16	0.000218602	78	0.001066134	140	0.001914385
17	0.000232266	79	0.001079810	141	0.001928073
18	0.000245930	80	0.001093486	142	0.001941760
19	0.000259595	81	0.001107162	143	0.001955448
20	0.000273260	82	0.001120839	144	0.001969136
21	0.000286924	83	0.001134515	145	0.001982824
22	0.000300590	84	0.001148192	146	0.001996512
23	0.000314255	85	0.001161869	147	0.002010201
24	0.000327920	86	0.001175546	148	0.002023889
25	0.000341586	87	0.001189223	149	0.002037578
26	0.000355252	88	0.001202900	150	0.002051267
27	0.000368918	89	0.001216578	151	0.002064957
28	0.000382584	90	0.001230256	152	0.002078646
29	0.000396251	91	0.001243934	153	0.002092336
30	0.000409917	92	0.001257612	154	0.002106025
31	0.000423584	93	0.001271291	155	0.002119715
32	0.000437251	94	0.001284969	156	0.002133405
33	0.000450918	95	0.001298648	157	0.002147096
34	0.000464586	96	0.001312327	158	0.002160786
35	0.000478253	97	0.001326006	159	0.002174477
36	0.000491921	98	0.001339685	160	0.002188168
37	0.000505589	99	0.001353365	161	0.002201859
38	0.000519257	100	0.001367044	162	0.002215550
39	0.000532925	101	0.001380724	163	0.002229242
40	0.000546594	102	0.001394404	164	0.002242933
41	0.000560262	103	0.001408085	165	0.002256625
42	0.000573931	104	0.001421765	166	0.002270317
43	0.000587600	105	0.001435446	167	0.002284010
44	0.000601269	106	0.001449127	168	0.002297702
45	0.000614939	107	0.001462808	169	0.002311395

366 Day Year

0.5% Compound Rate 184 Days

Days	Factor	Days	Factor	Days	Factor
46	0.000628608	108	0.001476489	170	0.002325087
47	0.000642278	109	0.001490170	171	0.002338780
48	0.000655948	110	0.001503852	172	0.002352473
49	0.000669618	111	0.001517533	173	0.002366167
50	0.000683289	112	0.001531215	174	0.002379860
51	0.000696959	113	0.001544897	175	0.002393554
52	0.000710630	114	0.001558580	176	0.002407248
53	0.000724301	115	0.001572262	177	0.002420942
54	0.000737972	116	0.001585945	178	0.002434636
55	0.000751643	117	0.001599628	179	0.002448331
56	0.000765315	118	0.001613311	180	0.002462025
57	0.000778986	119	0.001626994	181	0.002475720
58	0.000792658	120	0.001640678	182	0.002489415
59	0.000806330	121	0.001654361	183	0.002503110
60	0.000820003	122	0.001668045	184	0.002516806
61	0.000833675	123	0.001681729		
62	0.000847348	124	0.001695413		

TABLE OF INTEREST RATES

PERIODS BEFORE JUL. 1, 1975 — PERIODS ENDING DEC. 31, 1986

OVERPAYMENTS AND UNDERPAYMENTS

PERIOD	RATE	In 1995–1 C.B. DAILY RATE TABLE
Before Jul. 1, 1975	6%	Table 2, pg. 557
Jul. 1, 1975—Jan. 31, 1976	9%	Table 4, pg. 559
Feb. 1, 1976—Jan. 31, 1978	7%	Table 3, pg. 558
Feb. 1, 1978—Jan. 31, 1980	6%	Table 2, pg. 557
Feb. 1, 1980—Jan. 31, 1982	12%	Table 5, pg. 560
Feb. 1, 1982—Dec. 31, 1982	20%	Table 6, pg. 560
Jan. 1, 1983—Jun. 30, 1983	16%	Table 37, pg. 591
Jul. 1, 1983—Dec. 31, 1983	11%	Table 27, pg. 581
Jan. 1, 1984—Jun. 30, 1984	11%	Table 75, pg. 629
Jul. 1, 1984—Dec. 31, 1984	11%	Table 75, pg. 629
Jan. 1, 1985—Jun. 30, 1985	13%	Table 31, pg. 585
Jul. 1, 1985—Dec. 31, 1985	11%	Table 27, pg. 581
Jan. 1, 1986—Jun. 30, 1986	10%	Table 25, pg. 579
Jul. 1, 1986—Dec. 31, 1986	9%	Table 23, pg. 577

TABLE OF INTEREST RATES

FROM JAN. 1, 1987 — DEC. 31, 1998

	OVERPAYMENTS			UNDERPAYMENTS		
		1995–1 C.B.			1995–1 C.B.	
	RATE	TABLE	PG	RATE	TABLE	PG
Jan. 1, 1987—Mar. 31, 1987	8%	21	575	9%	23	577
Apr. 1, 1987—Jun. 30, 1987	8%	21	575	9%	23	577
Jul. 1, 1987—Sep. 30, 1987	8%	21	575	9%	23	577
Oct. 1, 1987—Dec. 31, 1987	9%	23	577	10%	25	579
Jan. 1, 1988—Mar. 31, 1988	10%	73	627	11%	75	629
Apr. 1, 1988—Jun. 30, 1988	9%	71	625	10%	73	627
Jul. 1, 1988—Sep. 30, 1988	9%	71	625	10%	73	627
Oct. 1, 1988—Dec. 31, 1988	10%	73	627	11%	75	629

TABLE OF INTEREST RATES

FROM JAN. 1, 1987 — DEC. 31, 1998

	OVERPAYMENTS			UNDERPAYMENTS		
		1995–1 C.B.			1995–1 C.B.	
	RATE	TABLE	PG	RATE	TABLE	PG
Jan. 1, 1989—Mar. 31, 1989	10%	25	579	11%	27	581
Apr. 1, 1989—Jun. 30, 1989	11%	27	581	12%	29	583
Jul. 1, 1989—Sep. 30, 1989	11%	27	581	12%	29	583
Oct. 1, 1989—Dec. 31, 1989	10%	25	579	11%	27	581
Jan. 1, 1990—Mar. 31, 1990	10%	25	579	11%	27	581
Apr. 1, 1990—Jun. 30, 1990	10%	25	579	11%	27	581
Jul. 1, 1990—Sep. 30, 1990	10%	25	579	11%	27	581
Oct. 1, 1990—Dec. 31, 1990	10%	25	579	11%	27	581
Jan. 1, 1991—Mar. 31, 1991	10%	25	579	11%	27	581
Apr. 1, 1991—Jun. 30, 1991	9%	23	577	10%	25	579
Jul. 1, 1991—Sep. 30, 1991	9%	23	577	10%	25	579
Oct. 1, 1991—Dec. 31, 1991	9%	23	577	10%	25	579
Jan. 1, 1992—Mar. 31, 1992	8%	69	623	9%	71	625
Apr. 1, 1992—Jun. 30, 1992	7%	67	621	8%	69	623
Jul. 1, 1992—Sep. 30, 1992	7%	67	621	8%	69	623
Oct. 1, 1992—Dec. 31, 1992	6%	65	619	7%	67	621
Jan. 1, 1993—Mar. 31, 1993	6%	17	571	7%	19	573
Apr. 1, 1993—Jun. 30, 1993	6%	17	571	7%	19	573
Jul. 1, 1993—Sep. 30, 1993	6%	17	571	7%	19	573
Oct. 1, 1993—Dec. 31, 1993	6%	17	571	7%	19	573
Jan. 1, 1994—Mar. 31, 1994	6%	17	571	7%	19	573
Apr. 1, 1994—Jun. 30, 1994	6%	17	571	7%	19	573
Jul. 1, 1994—Sep. 30, 1994	7%	19	573	8%	21	575
Oct. 1, 1994—Dec. 31, 1994	8%	21	575	9%	23	577
Jan. 1, 1995—Mar. 31, 1995	8%	21	575	9%	23	577
Apr. 1, 1995—Jun. 30, 1995	9%	23	577	10%	25	579
Jul. 1, 1995—Sep. 30, 1995	8%	21	575	9%	23	577
Oct. 1, 1995—Dec. 31, 1995	8%	21	575	9%	23	577
Jan. 1, 1996—Mar. 31, 1996	8%	69	623	9%	71	625
Apr. 1, 1996—Jun. 30, 1996	7%	67	621	8%	69	623
Jul. 1, 1996—Sep. 30, 1996	8%	69	623	9%	71	625
Oct. 1, 1996—Dec. 31, 1996	8%	69	623	9%	71	625
Jan. 1, 1997—Mar. 31, 1997	8%	21	575	9%	23	577
Apr. 1, 1997—Jun. 30, 1997	8%	21	575	9%	23	577
Jul. 1, 1997—Sep. 30, 1997	8%	21	575	9%	23	577
Oct. 1, 1997—Dec. 31, 1997	8%	21	575	9%	23	577
Jan. 1, 1998—Mar. 31, 1998	8%	21	575	9%	23	577
Apr. 1, 1998—Jun. 30, 1998	7%	19	573	8%	21	575
Jul. 1, 1998—Sep. 30, 1998	7%	19	573	8%	21	575
Oct. 1, 1998—Dec. 31, 1998	7%	19	573	8%	21	575

TABLE OF INTEREST RATES

FROM JANUARY 1, 1999 — PRESENT

NONCORPORATE OVERPAYMENTS AND UNDERPAYMENTS

	RATE	1995–1 C.B. TABLE	PAGE
Jan. 1, 1999—Mar. 31, 1999	7%	19	573
Apr. 1, 1999—Jun. 30, 1999	8%	21	575
Jul. 1, 1999—Sep. 30, 1999	8%	21	575
Oct. 1, 1999—Dec. 31, 1999	8%	21	575
Jan. 1, 2000—Mar. 31, 2000	8%	69	623
Apr. 1, 2000—Jun. 30, 2000	9%	71	625

TABLE OF INTEREST RATES

FROM JANUARY 1, 1999 — PRESENT

NONCORPORATE OVERPAYMENTS AND UNDERPAYMENTS

	RATE	1995–1 C.B. TABLE	PAGE
Jul. 1, 2000—Sep. 30, 2000	9%	71	625
Oct. 1, 2000—Dec. 31, 2000	9%	71	625
Jan. 1, 2001—Mar. 31, 2001	9%	23	577
Apr. 1, 2001—Jun. 30, 2001	8%	21	575
Jul. 1, 2001—Sep. 30, 2001	7%	19	573
Oct. 1, 2001—Dec. 31, 2001	7%	19	573
Jan. 1, 2002—Mar. 31, 2002	6%	17	571
Apr. 1, 2002—Jun. 30, 2002	6%	17	571
Jul. 1, 2002—Sep. 30, 2002	6%	17	571
Oct. 1, 2002—Dec. 31, 2002	6%	17	571
Jan. 1, 2003—Mar. 31, 2003	5%	15	569
Apr. 1, 2003—Jun. 30, 2003	5%	15	569
Jul. 1, 2003—Sep. 30, 2003	5%	15	569
Oct. 1, 2003—Dec. 31, 2003	4%	13	567
Jan. 1, 2004—Mar. 31, 2004	4%	61	615
Apr. 1, 2004—Jun. 30, 2004	5%	63	617
Jul. 1, 2004—Sep. 30, 2004	4%	61	615
Oct. 1, 2004—Dec. 31, 2004	5%	63	617
Jan. 1, 2005—Mar. 31, 2005	5%	15	569
Apr. 1, 2005—Jun. 30, 2005	6%	17	571
Jul. 1, 2005—Sep. 30, 2005	6%	17	571
Oct. 1, 2005—Dec. 31, 2005	7%	19	573
Jan. 1, 2006—Mar. 31, 2006	7%	19	573
Apr. 1, 2006—Jun. 30, 2006	7%	19	573
Jul. 1, 2006—Sep. 30, 2006	8%	21	575
Oct. 1, 2006—Dec. 31, 2006	8%	21	575
Jan. 1, 2007—Mar. 31, 2007	8%	21	575
Apr. 1, 2007—Jun. 30, 2007	8%	21	575
Jul. 1, 2007—Sep. 30, 2007	8%	21	575
Oct. 1, 2007—Dec. 31, 2007	8%	21	575
Jan. 1, 2008—Mar. 31, 2008	7%	67	621
Apr. 1, 2008—Jun. 30, 2008	6%	65	619
Jul. 1, 2008—Sep. 30, 2008	5%	63	617
Oct. 1, 2008—Dec. 31, 2008	6%	65	619
Jan. 1, 2009—Mar. 31, 2009	5%	15	569
Apr. 1, 2009—Jun. 30, 2009	4%	13	567
Jul. 1, 2009—Sep. 30, 2009	4%	13	567
Oct. 1, 2009—Dec. 31, 2009	4%	13	567
Jan. 1, 2010—Mar. 31, 2010	4%	13	567
Apr. 1, 2010—Jun. 30, 2010	4%	13	567
Jul. 1, 2010—Sep. 30, 2010	4%	13	567
Oct. 1, 2010—Dec. 31, 2010	4%	13	567
Jan. 1, 2011—Mar. 31, 2011	3%	11	565
Apr. 1, 2011—Jun. 30, 2011	4%	13	567
Jul. 1, 2011—Sep. 30, 2011	4%	13	567
Oct. 1, 2011—Dec. 31, 2011	3%	11	565
Jan. 1, 2012—Mar. 31, 2012	3%	59	613
Apr. 1, 2012—Jun. 30, 2012	3%	59	613
Jul. 1, 2012—Sep. 30, 2012	3%	59	613
Oct. 1, 2012—Dec. 31, 2012	3%	59	613
Jan. 1, 2013—Mar. 31, 2013	3%	11	565
Apr. 1, 2013—Jun. 30, 2013	3%	11	565

TABLE OF INTEREST RATES

FROM JANUARY 1, 1999 — PRESENT

CORPORATE OVERPAYMENTS AND UNDERPAYMENTS

	OVERPAYMENTS			UNDERPAYMENTS		
		1995–1 C.B.			1995–1 C.B.	
	RATE	TABLE	PG	RATE	TABLE	PG
Jan. 1, 1999—Mar. 31, 1999	6%	17	571	7%	19	573
Apr. 1, 1999—Jun. 30, 1999	7%	19	573	8%	21	575
Jul. 1, 1999—Sep. 30, 1999	7%	19	573	8%	21	575
Oct. 1, 1999—Dec. 31, 1999	7%	19	573	8%	21	575
Jan. 1, 2000—Mar. 31, 2000	7%	67	621	8%	69	623
Apr. 1, 2000—Jun. 30, 2000	8%	69	623	9%	71	625
Jul. 1, 2000—Sep. 30, 2000	8%	69	623	9%	71	625
Oct. 1, 2000—Dec. 31, 2000	8%	69	623	9%	71	625
Jan. 1, 2001—Mar. 31, 2001	8%	21	575	9%	23	577
Apr. 1, 2001—Jun. 30, 2001	7%	19	573	8%	21	575
Jul. 1, 2001—Sep. 30, 2001	6%	17	571	7%	19	573
Oct. 1, 2001—Dec. 31, 2001	6%	17	571	7%	19	573
Jan. 1, 2002—Mar. 31, 2002	5%	15	569	6%	17	571
Apr. 1, 2002—Jun. 30, 2002	5%	15	569	6%	17	571
Jul. 1, 2002—Sep. 30, 2002	5%	15	569	6%	17	571
Oct. 1, 2002—Dec. 31, 2002	5%	15	569	6%	17	571
Jan. 1, 2003—Mar. 31, 2003	4%	13	567	5%	15	569
Apr. 1, 2003—Jun. 30, 2003	4%	13	567	5%	15	569
Jul. 1, 2003—Sep. 30, 2003	4%	13	567	5%	15	569
Oct. 1, 2003—Dec. 31, 2003	3%	11	565	4%	13	567
Jan. 1, 2004—Mar. 31, 2004	3%	59	613	4%	61	615
Apr. 1, 2004—Jun. 30, 2004	4%	61	615	5%	63	617
Jul. 1, 2004—Sep. 30, 2004	3%	59	613	4%	61	615
Oct. 1, 2004—Dec. 31, 2004	4%	61	615	5%	63	617
Jan. 1, 2005—Mar. 31, 2005	4%	13	567	5%	15	569
Apr. 1, 2005—Jun. 30, 2005	5%	15	569	6%	17	571
Jul. 1, 2005—Sep. 30, 2005	5%	15	569	6%	17	571
Oct. 1, 2005—Dec. 31, 2005	6%	17	571	7%	19	573
Jan. 1, 2006—Mar. 31, 2006	6%	17	571	7%	19	573
Apr. 1, 2006—Jun. 30, 2006	6%	17	571	7%	19	573
Jul. 1, 2006—Sep. 30, 2006	7%	19	573	8%	21	575
Oct. 1, 2006—Dec. 31, 2006	7%	19	573	8%	21	575
Jan. 1, 2007—Mar. 31, 2007	7%	19	573	8%	21	575
Apr. 1, 2007—Jun. 30, 2007	7%	19	573	8%	21	575
Jul. 1, 2007—Sep. 30, 2007	7%	19	573	8%	21	575
Oct. 1, 2007—Dec. 31, 2007	7%	19	573	8%	21	575
Jan. 1, 2008—Mar. 31, 2008	6%	65	619	7%	67	621
Apr. 1, 2008—Jun. 30, 2008	5%	63	617	6%	65	619
Jul. 1, 2008—Sep. 30, 2008	4%	61	615	5%	63	617
Oct. 1, 2008—Dec. 31, 2008	5%	63	617	6%	65	619
Jan. 1, 2009—Mar. 31, 2009	4%	13	567	5%	15	569
Apr. 1, 2009—Jun. 30, 2009	3%	11	565	4%	13	567
Jul. 1, 2009—Sep. 30, 2009	3%	11	565	4%	13	567
Oct. 1, 2009—Dec. 31, 2009	3%	11	565	4%	13	567
Jan. 1, 2010—Mar. 31, 2010	3%	11	565	4%	13	567
Apr. 1, 2010—Jun. 30, 2010	3%	11	565	4%	13	567
Jul. 1, 2010—Sep. 30, 2010	3%	11	565	4%	13	567
Oct. 1, 2010—Dec. 31, 2010	3%	11	565	4%	13	567
Jan. 1, 2011—Mar. 31, 2011	2%	9	563	3%	11	565
Apr. 1, 2011—Jun. 30, 2011	3%	11	565	4%	13	567
Jul. 1, 2011—Sep. 30, 2011	3%	11	565	4%	13	567
Oct. 1, 2011—Dec. 31, 2011	2%	9	563	3%	11	565
Jan. 1, 2012—Mar. 31, 2012	2%	57	611	3%	59	613

TABLE OF INTEREST RATES

FROM JANUARY 1, 1999 — PRESENT

CORPORATE OVERPAYMENTS AND UNDERPAYMENTS

	OVERPAYMENTS			UNDERPAYMENTS		
		1995–1 C.B.			1995–1 C.B.	
	RATE	TABLE	PG	RATE	TABLE	PG
Apr. 1, 2012—Jun. 30, 2012	2%	57	611	3%	59	613
Jul. 1, 2012—Sep. 30, 2012	2%	57	611	3%	59	613
Oct. 1, 2012—Dec. 31, 2012	2%	57	611	3%	59	613
Jan. 1, 2013—Mar. 31, 2013	2%	9	563	3%	11	565
Apr. 1, 2013—Jun. 30, 2013	2%	9	563	3%	11	565

TABLE OF INTEREST RATES FOR
LARGE CORPORATE UNDERPAYMENTS

FROM JANUARY 1, 1991 — PRESENT

	RATE	1995–1 C.B. TABLE	PG
Jan. 1, 1991—Mar. 31, 1991	13%	31	585
Apr. 1, 1991—Jun. 30, 1991	12%	29	583
Jul. 1, 1991—Sep. 30, 1991	12%	29	583
Oct. 1, 1991—Dec. 31, 1991	12%	29	583
Jan. 1, 1992—Mar. 31, 1992	11%	75	629
Apr. 1, 1992—Jun. 30, 1992	10%	73	627
Jul. 1, 1992—Sep. 30, 1992	10%	73	627
Oct. 1, 1992—Dec. 31, 1992	9%	71	625
Jan. 1, 1993—Mar. 31, 1993	9%	23	577
Apr. 1, 1993—Jun. 30, 1993	9%	23	577
Jul. 1, 1993—Sep. 30, 1993	9%	23	577
Oct. 1, 1993—Dec. 31, 1993	9%	23	577
Jan. 1, 1994—Mar. 31, 1994	9%	23	577
Apr. 1, 1994—Jun. 30, 1994	9%	23	577
Jul. 1, 1994—Sep. 30, 1994	10%	25	579
Oct. 1, 1994—Dec. 31, 1994	11%	27	581
Jan. 1, 1995—Mar. 31, 1995	11%	27	581
Apr. 1, 1995—Jun. 30, 1995	12%	29	583
Jul. 1, 1995—Sep. 30, 1995	11%	27	581
Oct. 1, 1995—Dec. 31, 1995	11%	27	581
Jan. 1, 1996—Mar. 31, 1996	11%	75	629
Apr. 1, 1996—Jun. 30, 1996	10%	73	627
Jul. 1, 1996—Sep. 30, 1996	11%	75	629
Oct. 1, 1996—Dec. 31, 1996	11%	75	629
Jan. 1, 1997—Mar. 31, 1997	11%	27	581
Apr. 1, 1997—Jun. 30, 1997	11%	27	581
Jul. 1, 1997—Sep. 30, 1997	11%	27	581
Oct. 1, 1997—Dec. 31, 1997	11%	27	581
Jan. 1, 1998—Mar. 31, 1998	11%	27	581
Apr. 1, 1998—Jun. 30, 1998	10%	25	579
Jul. 1, 1998—Sep. 30, 1998	10%	25	579
Oct. 1, 1998—Dec. 31, 1998	10%	25	579
Jan. 1, 1999—Mar. 31, 1999	9%	23	577
Apr. 1, 1999—Jun. 30, 1999	10%	25	579
Jul. 1, 1999—Sep. 30, 1999	10%	25	579
Oct. 1, 1999—Dec. 31, 1999	10%	25	579
Jan. 1, 2000—Mar. 31, 2000	10%	73	627
Apr. 1, 2000—Jun. 30, 2000	11%	75	629
Jul. 1, 2000—Sep. 30, 2000	11%	75	629
Oct. 1, 2000—Dec. 31, 2000	11%	75	629

TABLE OF INTEREST RATES FOR
LARGE CORPORATE UNDERPAYMENTS

FROM JANUARY 1, 1991 — PRESENT

	RATE	1995–1 C.B. TABLE	PG
Jan. 1, 2001—Mar. 31, 2001	11%	27	581
Apr. 1, 2001—Jun. 30, 2001	10%	25	579
Jul. 1, 2001—Sep. 30, 2001	9%	23	577
Oct. 1, 2001—Dec. 31, 2001	9%	23	577
Jan. 1, 2002—Mar. 31, 2002	8%	21	575
Apr. 1, 2002—Jun. 30, 2002	8%	21	575
Jul. 1, 2002—Sep. 30, 2002	8%	21	575
Oct. 1, 2002—Dec. 30, 2002	8%	21	575
Jan. 1, 2003—Mar. 31, 2003	7%	19	573
Apr. 1, 2003—Jun. 30, 2003	7%	19	573
Jul. 1, 2003—Sep. 30, 2003	7%	19	573
Oct. 1, 2003—Dec. 31, 2003	6%	17	571
Jan. 1, 2004—Mar. 31, 2004	6%	65	619
Apr. 1, 2004—Jun. 30, 2004	7%	67	621
Jul. 1, 2004—Sep. 30, 2004	6%	65	619
Oct. 1, 2004—Dec. 31, 2004	7%	67	621
Jan. 1, 2005—Mar. 31, 2005	7%	19	573
Apr. 1, 2005—Jun. 30, 2005	8%	21	575
Jul. 1, 2005—Sep. 30, 2005	8%	21	575
Oct. 1, 2005—Dec. 31, 2005	9%	23	577
Jan. 1, 2006—Mar. 31, 2006	9%	23	577
Apr. 1, 2006—Jun. 30, 2006	9%	23	577
Jul. 1, 2006—Sep. 30, 2006	10%	25	579
Oct. 1, 2006—Dec. 31, 2006	10%	25	579
Jan. 1, 2007—Mar. 31, 2007	10%	25	579
Apr. 1, 2007—Jun. 30, 2007	10%	25	579
Jul. 1, 2007—Sep. 30, 2007	10%	25	579
Oct. 1, 2007—Dec. 31, 2007	10%	25	579
Jan. 1, 2008—Mar. 31, 2008	9%	71	625
Apr. 1, 2008—Jun. 30, 2008	8%	69	623
Jul. 1, 2008—Sep. 30, 2008	7%	67	621
Oct. 1, 2008—Dec. 31, 2008	8%	69	623
Jan. 1, 2009—Mar. 31, 2009	7%	19	573
Apr. 1, 2009—Jun. 30, 2009	6%	17	571
Jul. 1, 2009—Sep. 30, 2009	6%	17	571
Oct. 1, 2009—Dec. 31, 2009	6%	17	571
Jan. 1, 2010—Mar. 31, 2010	6%	17	571
Apr. 1, 2010—Jun. 30, 2010	6%	17	571
Jul. 1, 2010—Sep. 30, 2010	6%	17	571
Oct. 1, 2010—Dec. 31, 2010	6%	17	571
Jan. 1, 2011—Mar. 31, 2011	5%	15	569
Apr. 1, 2011—Jun. 30, 2011	6%	17	571
Jul. 1, 2011—Sep. 30, 2011	6%	17	571
Oct. 1, 2011—Dec. 31, 2011	5%	15	569
Jan. 1, 2012—Mar. 31, 2012	5%	63	617
Apr. 1, 2012—Jun. 30, 2012	5%	63	617
Jul. 1, 2012—Sep. 30, 2012	5%	63	617
Oct. 1, 2012—Dec. 31, 2012	5%	63	617
Jan. 1, 2013—Mar. 31, 2013	5%	15	569
Apr. 1, 2013—Jun. 30, 2013	5%	15	569

TABLE OF INTEREST RATES FOR CORPORATE
OVERPAYMENTS EXCEEDING $10,000

FROM JANUARY 1, 1995 — PRESENT

	RATE	1995–1 C.B. TABLE	PG
Jan. 1, 1995—Mar. 31, 1995	6.5%	18	572
Apr. 1, 1995—Jun. 30, 1995	7.5%	20	574
Jul. 1, 1995—Sep. 30, 1995	6.5%	18	572
Oct. 1, 1995—Dec. 31, 1995	6.5%	18	572
Jan. 1, 1996—Mar. 31, 1996	6.5%	66	620
Apr. 1, 1996—Jun. 30, 1996	5.5%	64	618
Jul. 1, 1996—Sep. 30, 1996	6.5%	66	620
Oct. 1, 1996—Dec. 31, 1996	6.5%	66	620
Jan. 1, 1997—Mar. 31, 1997	6.5%	18	572
Apr. 1, 1997—Jun. 30, 1997	6.5%	18	572
Jul. 1, 1997—Sep. 30, 1997	6.5%	18	572
Oct. 1, 1997—Dec. 31, 1997	6.5%	18	572
Jan. 1, 1998—Mar. 31, 1998	6.5%	18	572
Apr. 1, 1998—Jun. 30, 1998	5.5%	16	570
Jul. 1, 1998—Sep. 30, 1998	5.5%	16	570
Oct. 1, 1998—Dec. 31, 1998	5.5%	16	570
Jan. 1, 1999—Mar. 31, 1999	4.5%	14	568
Apr. 1, 1999—Jun. 30, 1999	5.5%	16	570
Jul. 1, 1999—Sep. 30, 1999	5.5%	16	570
Oct. 1, 1999—Dec. 31, 1999	5.5%	16	570
Jan. 1, 2000—Mar. 31, 2000	5.5%	64	618
Apr. 1, 2000—Jun. 30, 2000	6.5%	66	620
Jul. 1, 2000—Sep. 30, 2000	6.5%	66	620
Oct. 1, 2000—Dec. 31, 2000	6.5%	66	620
Jan. 1, 2001—Mar. 31, 2001	6.5%	18	572
Apr. 1, 2001—Jun. 30, 2001	5.5%	16	570
Jul. 1, 2001—Sep. 30, 2001	4.5%	14	568
Oct. 1, 2001—Dec. 31, 2001	4.5%	14	568
Jan. 1, 2002—Mar. 31, 2002	3.5%	12	566
Apr. 1, 2002—Jun. 30, 2002	3.5%	12	566
Jul. 1, 2002—Sep. 30, 2002	3.5%	12	566
Oct. 1, 2002—Dec. 31, 2002	3.5%	12	566
Jan. 1, 2003—Mar. 31, 2003	2.5%	10	564
Apr. 1, 2003—Jun. 30, 2003	2.5%	10	564
Jul. 1, 2003—Sep. 30, 2003	2.5%	10	564
Oct. 1, 2003—Dec. 31, 2003	1.5%	8	562
Jan. 1, 2004—Mar. 31, 2004	1.5%	56	610
Apr. 1, 2004—Jun. 30, 2004	2.5%	58	612
Jul. 1, 2004—Sep. 30, 2004	1.5%	56	610
Oct. 1, 2004—Dec. 31, 2004	2.5%	58	612
Jan. 1, 2005—Mar. 31, 2005	2.5%	10	564
Apr. 1, 2005—Jun. 30, 2005	3.5%	12	566
Jul. 1, 2005—Sep. 30, 2005	3.5%	12	566
Oct. 1, 2005—Dec. 31, 2005	4.5%	14	568
Jan. 1, 2006—Mar. 31, 2006	4.5%	14	568
Apr. 1, 2006—Jun. 30, 2006	4.5%	14	568
Jul. 1, 2006—Sep. 30, 2006	5.5%	16	570
Oct. 1, 2006—Dec. 31, 2006	5.5%	16	570
Jan. 1, 2007—Mar. 31, 2007	5.5%	16	570
Apr. 1, 2007—Jun. 30, 2007	5.5%	16	570
Jul. 1, 2007—Sep. 30, 2007	5.5%	16	570
Oct. 1, 2007—Dec. 31, 2007	5.5%	16	570
Jan. 1, 2008—Mar. 31, 2008	4.5%	62	616
Apr. 1, 2008—Jun. 30, 2008	3.5%	60	614
Jul. 1, 2008—Sep. 30, 2008	2.5%	58	612

TABLE OF INTEREST RATES FOR CORPORATE
OVERPAYMENTS EXCEEDING $10,000

FROM JANUARY 1, 1995 — PRESENT

	RATE	1995–1 C.B. TABLE	PG
Oct. 1, 2008—Dec. 31, 2008	3.5%	60	614
Jan. 1, 2009—Mar. 31, 2009	2.5%	10	564
Apr. 1, 2009—Jun. 30, 2009	1.5%	8	562
Jul. 1, 2009—Sep. 30, 2009	1.5%	8	562
Oct. 1, 2009—Dec. 31, 2009	1.5%	8	562
Jan. 1, 2010—Mar. 31, 2010	1.5%	8	562
Apr. 1, 2010—Jun. 30, 2010	1.5%	8	562
Jul. 1, 2010—Sep. 30, 2010	1.5%	8	562
Oct. 1, 2010—Dec. 31, 2010	1.5%	8	562
Jan. 1, 2011—Mar. 31, 2011	0.5%*		
Apr. 1, 2011—Jun. 30, 2011	1.5%	8	562
Jul. 1, 2011—Sep. 30, 2011	1.5%	8	562
Oct. 1, 2011—Dec. 31, 2011	0.5%*		
Jan. 1, 2012—Mar. 31, 2012	0.5%*		
Apr. 1, 2012—Jun. 30, 2012	0.5%*		
Jul. 1, 2012—Sep. 30, 2012	0.5%*		
Oct. 1, 2012—Dec. 31, 2012	0.5%*		
Jan. 1, 2013—Mar. 31, 2013	0.5%*		
Apr. 1, 2013—Jun. 30, 2013	0.5%*		

Part III. Administrative, Procedural, and Miscellaneous

Work Opportunity Tax Credit—Transition Relief

Notice 2013–14

I. PURPOSE

This notice provides guidance on § 309 of the American Taxpayer Relief Act of 2012 (the Act), Pub. L. No. 112–240, enacted on January 2, 2013, and transition relief for employers claiming the Work Opportunity Tax Credit (the WOTC) under §§ 51 and 3111(e) of the Internal Revenue Code (the Code), as extended by the Act. Section 309 of the Act amended § 51 to extend the WOTC through December 31, 2013, for taxable employers and for qualified tax-exempt organizations. Specifically, this notice provides employers that hire members of targeted groups additional time beyond the 28-day deadline in § 51(d)(13) of the Code for submitting Form 8850, *Pre-Screening Notice and Certification Request for the Work Opportunity Credit*, to Designated Local Agencies (DLAs).

II. BACKGROUND

Section 51 of the Code provides for the WOTC for employers that hire individuals who are members of targeted groups. An employer must obtain certification that an individual is a targeted group member before the employer may claim the credit. Certification of an individual's targeted group status is obtained from a DLA. A DLA is a State employment security agency established in accordance with 29 U.S.C. §§ 49–49n. An employer must submit Form 8850 to the DLA not later than the 28th day after the individual begins work for the employer.

The Returning Heroes and Wounded Warriors Work Opportunity Tax Credits, contained in § 261 of the VOW to Hire Heroes Act of 2011, Tit. II, subtitle D, of Pub. L. No. 112–056 (the VOW Act), enacted on November 21, 2011, amended § 51 of the Code to extend and expand the WOTC to employers hiring certain qualified veterans (as defined in § 51(d)(3)) before January 1, 2013. The VOW Act did not extend the WOTC for targeted group members other than qualified veterans. Thus, the WOTC was not available with respect to targeted group members who began work after December 31, 2011, other than qualified veterans.

The VOW Act also amended §§ 52 and 3111 to make a reduced WOTC available to organizations described in § 501(c) and exempt from taxation under § 501(a) ("qualified tax-exempt organizations") as a credit against the employer share of social security tax imposed under § 3111(a). The reduced credit is available for qualified tax-exempt organizations that hire qualified veterans for which the WOTC would have been allowable under § 51 if the organization were not a qualified tax-exempt organization. The credit was first available to qualified tax-exempt organizations for qualified veterans hired on or after November 21, 2011. For additional guidance on the WOTC for qualified tax-exempt organizations and changes made to the WOTC under the VOW Act, see Notice 2012–13, 2012–9 I.R.B. 421.

Notice 2012–13 provided transition relief for all employers that hired any qualified veteran described in § 51(d)(3) of the Code on or after November 22, 2011, and before May 22, 2012. Those employers were considered to have satisfied the requirements of § 51(d)(13)(A)(ii) if they submitted the completed Form 8850 to the DLA to request certification not later than June 19, 2012.

III. AMENDMENTS MADE BY THE ACT

The Act extends the WOTC through December 31, 2013, for taxable employers hiring individuals in targeted groups as defined in § 51(d)(1) through (d)(10) of the Code, and for qualified tax-exempt organizations hiring qualified veterans as defined in § 51(d)(3) of the Code. This extension does not apply to the "unemployed veterans" or "disconnected youth" targeted group categories (as defined in § 51(d)(14) of the Code), which had expired as of January 1, 2011. As mentioned above, during 2012, the WOTC was available for employers hiring qualified veterans, and not for hiring members of other targeted groups. Thus, the Act retroactively extended the availability of the WOTC for taxable employers who hired individuals from those other targeted groups in 2012.

Because the Act did not amend §§ 52 or 3111(e), qualified tax-exempt organizations may continue to claim the WOTC under § 3111(e) only for hiring qualified veterans, and not for hiring any other targeted group members.

IV. TRANSITION RELIEF

Section 51(d)(13)(A) of the Code provides that an individual shall not be treated as a member of a targeted group unless (1) on or before the day the individual begins work, the employer obtains certification from the DLA that the individual is a member of a targeted group; or (2) the employer completes a pre-screening notice (Form 8850) on or before the day the individual is offered employment and submits such notice to the DLA to request certification not later than 28 days after the individual begins work.

Because the WOTC was extended retroactively for 2012 for members of targeted groups (other than qualified veterans), employers need additional time to comply with the requirements of § 51(d)(13)(A) for those targeted groups. Similarly, because the WOTC for qualified veterans was set to expire for qualified veterans hired after December 31, 2012, employers that hire qualified veterans after December 31, 2012, may also need additional time to comply with the requirements of § 51(d)(13)(A). For these reasons, the Treasury Department and the IRS have determined that it is appropriate to provide employers with additional time to file Form 8850 with a DLA.

(1) *Transition relief for taxable employers that hire members of targeted groups (other than qualified veterans)*

A taxable employer that hires a member of a targeted group (as defined in § 51(d)(2) through (10), other than a qualified veteran described in § 51(d)(3)) on or after January 1, 2012, and on or before March 31, 2013, will be considered to have satisfied the requirements of § 51(d)(13)(A)(ii) if it submits the completed Form 8850 to the DLA to request certification not later than April 29, 2013.

(2) *Transition relief for all employers that hire qualified veterans*

An employer that hires any qualified veteran described in § 51(d)(3) on or after January 1, 2013, and on or before March 31, 2013, will be considered to have satisfied the requirements of § 51(d)(13)(A)(ii) if it submits the completed Form 8850 to the DLA to request certification not later than April 29, 2013.

DRAFTING INFORMATION

The principal authors of this notice are Shoshanna Tanner and Ligeia Donis of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding the WOTC, contact Ms. Tanner at (202) 622–6080 (not a toll-free number). For further information on how to claim the WOTC on behalf of tax-exempt organizations, contact Ms. Donis at (202) 622–6040 (not a toll-free number).

Part IV. Items of General Interest

Notice of Proposed Rulemaking

Treatment of Grantor of an Option on a Partnership Interest

REG–106918–08

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to the tax treatment of noncompensatory options and convertible instruments issued by a partnership. Specifically, the proposed regulations expand the characterization rule measurement events to include certain transfers of interests in the issuing partnership and other look-through entities, and provide additional guidance in determining the character of the grantor's gain or loss as a result of a closing transaction with respect to, or a lapse of, an option on a partnership interest. The proposed regulations will affect partnerships that issue noncompensatory options, the partners of such partnerships, and the holders of such options.

DATES: Written or electronic comments and requests for a public hearing must be received by May 6, 2013.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–106918–08), 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–106918–08), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically via the Federal eRulemaking Portal at *www.regulations.gov* (IRS REG–106918–08).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations under §1.761–3, Benjamin Weaver at (202) 622–3050; concerning the proposed regulations under §*1.1234–3*, Shawn Tetelman at (202) 622–3930; concerning submissions of comments and requests for a public hearing, Oluwafunmilayo (Funmi) Taylor, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to 26 CFR part 1 under sections 761 and 1234 of the Internal Revenue Code (Code). On January 22, 2003, proposed regulations (REG–103580–02, 2003–9 I.R.B. 543) relating to the tax treatment of noncompensatory options and convertible instruments issued by a partnership (noncompensatory partnership option regulations) were published in the **Federal Register** (68 FR 2930). Final regulations in this issue of the Bulletin contain amendments to the Income Tax Regulations (26 CFR Part 1), which finalize the proposed regulations. However, the Treasury Department and the IRS have decided to propose amendments to the regulations expanding the characterization rule measurement events to include certain transfers of interests in the issuing partnership and other look-through entities.

Additionally, the Treasury Department and the IRS received comments on the proposed regulations expressing uncertainty as to whether section 1234(b) applies to the grantor of an option on a partnership interest on the lapse or repurchase of the option. The comments indicated that it was unclear whether the term "securities," as used in section 1234(b)(2)(B), includes partnership interests. After consideration of all comments received, the IRS and Treasury Department believe that it is appropriate to propose an amendment to the regulations under section 1234(b) to expressly treat partnership interests as securities for purposes of section 1234(b).

Explanation of Provisions

1. *Proposed Additions to the Noncompensatory Partnership Option Characterization Rule Measurement Events*

The final regulations being published elsewhere in this issue of the Bulletin, relating to the tax treatment of noncompensatory partnership options, contain a characterization rule providing that the holder of a noncompensatory option is treated as a partner under certain circumstances. Under the characterization rule, a noncompensatory option is treated as a partnership interest if, on the date of a measurement event (1) the noncompensatory option provides the option holder with rights that are substantially similar to the rights afforded a partner, and (2) there is a strong likelihood that the failure to treat the holder of the noncompensatory option as a partner would result in a substantial reduction in the present value of the partners' and noncompensatory option holder's aggregate Federal tax liabilities. The final regulations define a measurement event as: (1) issuance of the noncompensatory option; (2) an adjustment of the terms (modification) of the noncompensatory option or of the underlying partnership interest (including an adjustment pursuant to the terms of the noncompensatory option or the underlying partnership interest); or (3) transfer of the noncompensatory option if either (A) the option may be exercised (or settled) more than 12 months after its issuance, or (B) the transfer is pursuant to a plan in existence at the time of the issuance or modification of the noncompensatory option that has as a principal purpose the substantial reduction of the present value of the aggregate Federal tax liabilities of the partners and the noncompensatory option holder.

The Treasury Department and the IRS believe it is appropriate to expand the list of measurement events to include certain transfers of interests in the issuing partnership and look-through entities. The proposed regulations add three measurement events to the list above, but apply only if those measurement events are pursuant to a plan in existence at the time of the issuance or modification of the noncompensatory option that has as a principal purpose the substantial reduction of

the present value of the aggregate Federal tax liabilities of the partners and the noncompensatory option holder. The three additional measurement events are: (1) issuance, transfer, or modification of an interest in, or liquidation of, the issuing partnership; (2) issuance, transfer, or modification of an interest in any look-through entity that directly, or indirectly through one or more look-through entities, owns the noncompensatory option; and (3) issuance, transfer, or modification of an interest in any look-through entity that directly, or indirectly through one or more look-through entities, owns an interest in the issuing partnership. The Treasury Department and the IRS believe that the first of these measurement events is necessary because it is inconsistent to test a noncompensatory option under the characterization rule upon transfer of the noncompensatory option, but not upon transfer of an interest in the issuing partnership, because either type of transfer may change the analysis of whether there is a strong likelihood that the failure to treat the option holder as a partner would result in a substantial reduction in the present value of the partners' and option holder's aggregate tax liabilities. The Treasury Department and the IRS believe that the second and third measurement events are necessary to prevent avoidance of the characterization rule through the use of look-through entities.

Like the measurement events in the final regulations, the three measurement events in the proposed regulations are subject to exceptions in §1.761–3(c)(2). The Treasury Department and the IRS believe that the limitations on these measurement events will reduce the administrative burden associated with testing under the characterization rule upon these events.

The Treasury Department and the IRS request comments on the appropriate procedures for notifying the partners and the partnership upon the occurrence of a measurement event.

2. *Character of Gain or Loss on Lapse, Sale, or Exchange of Partnership Options*

A. *Character of gain or loss to the grantor of the option*

In response to comments, the proposed regulations address the application of section 1234(b) to the grantor of an option on a partnership interest on the lapse or repurchase of the option. Section 1234(b) provides that, in the case of the grantor of an option, gain or loss from any closing transaction with respect to, and gain on lapse of, an option in property shall be treated as gain or loss from the sale or exchange of a capital asset held not more than one year. Section 1234(b)(2)(B) defines the term property to mean stock and securities (including stocks and securities dealt with on a when issued basis), commodities, and commodity futures. Accordingly, for section 1234(b) to apply to a closing transaction with respect to, or lapse of, an option on a partnership interest, a partnership interest would have to be a security and, thus, property within the meaning of section 1234(b)(2)(B). The proposed regulations provide that the term "securities" as used in section 1234(b)(2)(B) includes partnership interests. As a result, in the case of the grantor of an option on a partnership interest, gain or loss from any closing transaction with respect to, and gain on lapse of, the option is generally treated under the proposed regulations as gain or loss from the sale or exchange of a capital asset held not more than 1 year.

B. *Character of gain or loss to the option holder*

With respect to an option holder, under section 1234(a), gain or loss on the sale or exchange of, or loss on failure to exercise, an option is considered gain or loss from the sale or exchange of property that has the same character as the property to which the option relates would have in the hands of the taxpayer. Although a partnership interest is generally considered a capital asset, section 751(a) may apply to recharacterize a portion of a partner's gain on the sale or exchange of a partnership interest as ordinary. A number of commenters on the noncompensatory partnership option proposed regulations questioned whether section 751 applies to the lapse, repurchase, sale, exchange, or other termination of a noncompensatory option.

The Treasury Department and the IRS continue to study this issue and request comments on (1) if section 751(a) applies to the lapse, repurchase, sale, or exchange of a noncompensatory option, (a) how the option holder's share of income or loss from section 751 property would be determined under §1.751–1(a)(2), and (b) how a partner in the issuing partnership that transfers its partnership interest while the option is outstanding would determine its share of income or loss from section 751 property under §1.751–1(a)(2) (that is, should it be reduced by the amount of income or loss from section 751 property attributable to the option holder); and (2) if section 751(a) does not apply to the lapse, repurchase, sale, or exchange of a noncompensatory option, what measures, if any, should be taken to ensure that ordinary income is not permanently eliminated.

Effective/Applicability Date

To coordinate the proposed regulations with the final noncompensatory partnership option regulations, the proposed regulations are proposed to have the same effective date as the final noncompensatory partnership option regulations. Therefore, the proposed regulations are proposed to apply to options issued on or after February 5, 2013.

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 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 this regulation, and because the regulation does not impose a collection of information requirement on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this 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 Requests for 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 Treasury Department and the IRS

request comments on all aspects of the proposed rules. All comments are available at *www.regulations.gov* or upon request. A public hearing may be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal authors of these proposed regulations are Benjamin Weaver of the Office of Associate Chief Counsel (Passthroughs and Special Industries) and Shawn Tetelman of the Office of Associate Chief Counsel (Financial Institutions and Products). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.761–3 is amended by adding paragraph (c)(1)(iv) to read as follows:

§1.761–3 Certain option holders treated as partners.

* * * * *

(c) * * *

(1) * * *

(iv) An event described in paragraphs (c)(1)(iv)(A), (B), or (C) of this section, provided the event is pursuant to a plan in existence at the time of the issuance or modification of the noncompensatory option that has as a principal purpose the substantial reduction of the present value of the aggregate Federal tax liabilities of the partners and the noncompensatory option holder (under paragraph (a)(1)(ii) of this section):

(A) Issuance, transfer, or modification of an interest in, or liquidation of, the issuing partnership;

(B) Issuance, transfer, or modification of an interest in any look-through entity (as defined in paragraph (b)(1) of this section) that directly, or indirectly through one or more look-through entities, owns the noncompensatory option;

(C) Issuance, transfer, or modification of an interest in any look-through entity that directly, or indirectly through one or more look-through entities, owns an interest in the issuing partnership.

* * * * *

Par. 3. Section 1.1234–3 is amended by adding a sentence at the end of paragraph (b)(2) to read as follows:

§1.1234–3 Special rules for the treatment of grantors of certain options granted after September 1, 1976.

* * * * *

(b) * * *

(2) * * * For purposes of the preceding sentence, for options granted on or after February 5, 2013, the term *securities* includes partnership interests.

* * * * *

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

(Filed by the Office of the Federal Register on February 4, 2013, 8:45 a.m., and published in the issue of the Federal Register for February 5, 2013, 78 F.R. 8060)

Notice of Proposed Rulemaking and Notice of Public Hearing

Shared Responsibility Payment for Not Maintaining Minimum Essential Coverage

REG–148500–12

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations relating to the requirement to maintain minimum essential coverage enacted by the Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act of 2010, as amended by the TRICARE Affirmation Act and Public Law 111–173. These proposed regulations provide guidance on the liability for the shared responsibility payment for not maintaining minimum essential coverage. This document also provides notice of a public hearing on these proposed regulations.

DATES: Comments must be received by May 2, 2013. Outlines of topics to be discussed at the public hearing scheduled for May 29, 2013, at 10:00 a.m., must be received by May 3, 2013.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–148500–12), 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–148500–12), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically via the Federal eRulemaking Portal at *www.regulations.gov* (IRS REG–148500–12). The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Sue-Jean Kim or John B. Lovelace, (202) 622–4960; concerning the submission of comments, the public hearing, and to be placed on the building access list to attend the public hearing, Oluwafunmilayo Taylor, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for

the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:M:S, Washington, DC 20224.

Comments on the collection of information should be received by April 2, 2013. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the IRS, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information;

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

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

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

The collection of information in these proposed regulations is in §1.5000A–3 and §1.5000A–4. The collection of information is necessary to determine whether the shared responsibility payment provision applies to a taxpayer and compute any shared responsibility payment imposed on a taxpayer. The likely respondents are individuals required to file Federal income tax returns under section 6012(a)(1) of the Internal Revenue Code (Code).

The burden for the collection of information contained in proposed regulation §1.5000A–3 and §1.5000A–4 will be reflected in the burden on a form that the IRS will create to request the information in the proposed regulation.

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

Background

Under the Patient Protection and Affordable Care Act, Public Law 111–148 (124 Stat. 119 (2010)) and the Health Care and Education Reconciliation Act of 2010, Public Law 111–152 (124 Stat. 1029 (2010)) (collectively, the Affordable Care Act), the Federal government, State governments, insurers, employers, and individuals are entrusted with shared responsibility to reform and improve the availability, quality, and affordability of health insurance coverage in the United States. The Affordable Care Act expands Medicaid eligibility for residents of electing States and increases Federal funding for the expansion. The Affordable Care Act also provides individuals and small businesses the ability to purchase private health insurance through State-based, State Partnership, or Federally facilitated competitive market places called Affordable Insurance Exchanges (Exchanges). Through Exchanges, insurance companies will compete for business on a level playing field and qualified consumers will have a choice of health plans to fit their needs.

In addition, the Affordable Care Act includes various insurance market reforms to increase the ability of individuals to enroll in health insurance coverage regardless of preexisting conditions and to eliminate the ability of insurers to charge higher premium prices based on factors other than age, tobacco use, rating area, or family size. Moreover, the Affordable Care Act builds upon the existing private employer-based health insurance system to ensure continued access to high quality health insurance coverage at low cost.

Finally, to ensure effective and efficient implementation of the insurance market reforms, the Affordable Care Act requires a nonexempt individual to maintain minimum essential coverage or make a shared responsibility payment. Section 1501(b) of the Affordable Care Act added section 5000A to a new chapter 48 of subtitle D (Miscellaneous Excise Taxes) of the Code effective for months beginning after December 31, 2013. Section 5000A was subsequently amended by the TRICARE Affirmation Act of 2010, Public Law 111–159 (124 Stat. 1123) and Public Law 111–173 (124 Stat. 1215).

Shared Responsibility Payment for Not Maintaining Minimum Essential Coverage

Section 5000A provides nonexempt individuals with a choice: maintain minimum essential coverage for themselves and any nonexempt family members or include an additional payment with their Federal income tax return. Section 5000A(a) and section 5000A(b) provide that nonexempt individuals must have minimum essential coverage for each month beginning after December 31, 2013, or make an additional payment (the shared responsibility payment) with their Federal income tax return for the taxable year that includes such month. Under section 5000A(b)(3)(A), a taxpayer is liable for the shared responsibility payment if any nonexempt individual who may be claimed by the taxpayer as a dependent for a taxable year does not have minimum essential coverage in a month included in that taxable year. Married taxpayers filing a joint return for any taxable year are jointly liable for any shared responsibility payment imposed for the year.

Exempt Individuals

Many individuals are exempt from the shared responsibility payment, including some whose religious beliefs conflict with acceptance of the benefits of private or public insurance and those who do not have an affordable health insurance coverage option available. Section 1311(d)(4)(H) of the Affordable Care Act (42 U.S.C. 18031(d)(4)(H)) directs Exchanges to issue to qualified individuals certificates of exemption from the requirement to maintain minimum essential coverage or the shared responsibility payment under section 5000A. Section 1411 of the Affordable Care Act (42 U.S.C. 18081) generally provides procedures for determining an individual's eligibility for various benefits relating to health coverage, including exemptions from the application of section 5000A. The Department of Health and Human Services and the Department of the Treasury are working in close coordination to release regulations and other guidance related to Exchanges.

On March 27, 2012, the Department of Health and Human Services released final regulations related to the establish-

ment of, and the standards applicable to, Exchanges (45 CFR 155.10 and following sections (Exchange regulations)). Section 155.200(b) of the Exchange regulations directs an Exchange to issue exemption certificates in accordance with sections 1311(d)(4)(H) and 1411 of the Affordable Care Act (42 USC 18031(d)(4)(H), 18081). The Department of Health and Human Services is publishing proposed regulations detailing the standards by which Exchanges will issue certificates of exemption under section 5000A. Patient Protection and Affordable Care Act; Exchange Functions: Eligibility for Exemptions; Minimum Essential Coverage Provisions (to be codified at 45 CFR 155.600 and following sections).

Section 5000A(d) and (e) describe individuals who are exempt from making the shared responsibility payment even if they do not have minimum essential coverage for a given month. Under section 5000A(d)(2)(A), an individual is exempt for a month for which an Exchange certifies that the individual is a member of a recognized religious sect or a division thereof described in section 1402(g)(1) and is an adherent of established tenets or teachings of that sect or division. Section 1402(g)(1) provides an exemption from self-employment tax for members of a qualified religious sect or division thereof. A qualified religious sect or division thereof described in section 1402(g)(1) is a sect or division thereof that the Commissioner of Social Security finds: (1) has established tenets or teachings by reason of which its members and adherents are conscientiously opposed to acceptance of the benefits of any private or public insurance that makes payments in the event of death, disability, old age, or retirement or makes payments toward the cost of, or provides services for, medical care (including the benefits of any insurance system established by the Social Security Act); (2) maintains, and has maintained for a substantial period of time, a practice whereby its members make provision for its dependent members that is reasonable in view of their general level of living; and (3) has been in existence at all times since December 31, 1950.

Section 5000A(d)(2)(B) provides that an individual is exempt for a month that the individual is a member of a health care sharing ministry. A health care sharing ministry is an organization: (1) which is described in section 501(c)(3) and exempt from tax under section 501(a); (2) members of which share a common set of ethical or religious beliefs and share medical expenses among themselves in accordance with those beliefs, and regardless of the State in which a member resides or is employed; (3) members of which retain membership even after they develop a medical condition; (4) which has itself (or a predecessor of which has) been in existence at all times since December 31, 1999; (5) members of which have continuously and without interruption shared medical expenses since at least December 31, 1999; and (6) which conducts an annual audit performed by an independent certified public accounting firm in accordance with generally accepted accounting principles the report of which is made available to members of the public upon request.

Section 5000A(d)(3) provides that an individual is exempt for a month that the individual is neither a citizen or national of the United States nor an alien lawfully present in the United States.

Section 5000A(d)(4) provides that an individual is exempt for a month that the individual is incarcerated, except for incarceration pending the disposition of charges.

Section 5000A(e)(1) provides that an individual is exempt for a month for which the individual lacks access to affordable minimum essential coverage. For this purpose, an individual lacks access to affordable coverage if the individual's required contribution (determined on an annual basis) for minimum essential coverage exceeds a percentage (8 percent for 2014) of the individual's household income for the most recent taxable year for which the Secretary of Health and Human Services, in consultation with the Secretary, determines information is available.

In general, section 5000A(c)(4)(B) defines a taxpayer's *household income* as the sum of the taxpayer's modified adjusted gross income and the modified adjusted gross income of any other member of a taxpayer's family (that is, individuals for whom the taxpayer properly claims a deduction under section 151 (relating to the personal exemption deduction)) who are required to file a Federal income tax return. Under section 5000A(c)(4)(C), *modified adjusted gross income* means adjusted gross income (within the meaning of section 62) increased by amounts excluded from gross income under section 911 and tax-exempt interest a taxpayer receives or accrues in the taxable year. Unlike section 36B(d)(2)(B), modified adjusted gross income for purposes of section 5000A does not include Social Security benefits that are not includable in gross income. For purposes of determining the affordability of minimum essential coverage under section 5000A(e)(1), the taxpayer's household income is increased by the portion of the required contribution made through a salary reduction arrangement and excluded from gross income.

For purposes of determining household income, a taxpayer's family includes all individuals for whom the taxpayer properly claims a personal exemption deduction under section 151 for the taxable year. *See also* §1.36B–1(d). Taxpayers may claim a personal exemption deduction for themselves, a spouse, and each of their dependents. Section 152 provides that a taxpayer's dependent may be a qualifying child or qualifying relative, including an unrelated individual who lives with the taxpayer.

For an employee eligible to purchase coverage under an eligible employer-sponsored plan, the required contribution for purposes of the exemption under section 5000A(e)(1) is the employee's share of the annual premium for self-only coverage. For an individual eligible to purchase coverage under an eligible employer-sponsored plan because the individual is related to an employee, the determination of whether the individual's coverage is affordable is made by reference to the employee's required contribution. For all individuals who are ineligible to purchase coverage under an eligible employer-sponsored plan, the required contribution is the annual premium for the lowest cost bronze plan available on the Exchange where the individual lives reduced by the credit allowable under section 36B for the taxable year (determined as if the individual enrolled in a plan through such Exchange for the entire taxable year).

Section 5000A(e)(2) provides that an individual is exempt for a month included in a calendar year if the individual's household income for the most recent taxable year for which information is available is

less than the amount of gross income specified in section 6012(a)(1) for the taxpayer. Section 6012(a)(1) provides, for each filing status, gross income thresholds above which individuals are required to file Federal income tax returns.

As described in this preamble, income-based exemptions under section 5000A(e)(1) and section 5000A(e)(2) rely upon household income for the most recent taxable year that the Secretary of Health and Human Services, after consultation with the Secretary of Treasury, determines information is available. The Secretary of Health and Human Services, after consultation with the Secretary of the Treasury, determined that the household income for these exemptions that is available and relevant is the household income for the year for which an exemption is being claimed. See section III.A.3.b. of the preamble to Patient Protection and Affordable Care Act; Exchange Functions: Eligibility for Exemptions; Minimum Essential Coverage Provisions (to be codified at 45 CFR 155.600 and following sections, and 45 CFR 156.600 and following sections). The determination by the Secretary of Health and Human Services is reflected in the proposed regulations.

Section 5000A(e)(3) provides that an individual is exempt for a month that the individual is a member of an Indian tribe as defined in section 45A(c)(6). Section 45A(c)(6) describes certain Federally recognized Indian tribes (including any qualified Alaska Native village or regional or village corporation). The Federally recognized Indian tribes are listed in Indian Entities Recognized and Eligible to Receive Services from the United States Bureau of Indian Affairs, 75 Fed. Reg. 60810 (Oct. 1, 2010), as supplemented by 75 Fed. Reg. 661124 (Oct. 27, 2010), or its successor.

Under section 5000A(e)(4), an individual is exempt for a month the last day of which occurs in a period when the individual does not have minimum essential coverage for a continuous period of less than three months (a short coverage gap). The length of a gap in coverage is determined without regard to the calendar years in which months in the gap occur. If an individual has more than one short coverage gap in a calendar year, the exemption applies only to the earliest short coverage gap. Section 5000A(e)(4) authorizes the Secretary to issue regulations that provide for collecting the shared responsibility payment in cases where gaps in coverage straddle more than one taxable year.

Section 5000A(e)(5) provides that an individual is exempt for a month that the Exchange determines, in accordance with guidance promulgated by the Secretary of Health and Human Services, the individual suffered a hardship that prevented the individual from obtaining coverage under a qualified health plan. The Department of Health and Human Services is proposing rules on the criteria for application of the hardship exemption. Patient Protection and Affordable Care Act; Exchange Functions: Eligibility for Exemptions; Minimum Essential Coverage (to be codified at 45 CFR 155.605(g)).

Computation of Shared Responsibility Payment

Under section 5000A(c), the amount of the shared responsibility payment for any taxable year is generally the sum of monthly penalty amounts for all months in the taxable year in which any nonexempt individual for whom the taxpayer is liable under section 5000A(b) did not have minimum essential coverage. The shared responsibility payment amount for any taxable year may not exceed an amount equal to the national average premium for bronze-level qualified health plans offered through Exchanges for the applicable family size involved.

The monthly penalty amount for a month is equal to 1/12 of the greater of the following amounts: (1) the flat dollar amount or (2) the percentage of income. The flat dollar amount is the lesser of the following amounts: (a) the sum of the applicable dollar amounts for all nonexempt individuals without minimum essential coverage for whom the taxpayer is liable or (b) 300 percent of the applicable dollar amount. The applicable dollar amount is $95 for 2014, $325 for 2015, and $695 for 2016, and will be increased for calendar years beginning after 2016 by a cost-of-living adjustment. If a nonexempt individual has not attained the age of 18 as of the beginning of a month, the applicable dollar amount for that individual is one-half of the regular applicable dollar amount.

The percentage of income is calculated as the excess of the taxpayer's household income over the taxpayer's Federal income tax return filing threshold under section 6012(a)(1), multiplied by a percentage figure. The percentage figure is 1 percent for taxable years beginning in 2014, 2 percent for taxable years beginning in 2015, and 2.5 percent for taxable years beginning after 2015.

Minimum Essential Coverage

Section 5000A(f) defines *minimum essential coverage* as one of the following: (1) coverage under a specified government sponsored program, (2) coverage under an eligible employer-sponsored plan, (3) coverage under a health plan offered in the individual market within a State, (4) coverage under a grandfathered health plan, and (5) other health benefits coverage that the Secretary of Health and Human Services, in coordination with the Secretary, recognizes for purposes of section 5000A(f).

Under section 5000A(f)(1)(A), specified government sponsored programs include the following: (1) the Medicare program under part A of title XVIII of the Social Security Act, (2) the Medicaid program under title XIX of the Social Security Act, (3) the Children's Health Insurance Program (CHIP) under title XXI of the Social Security Act, (4) medical coverage under chapter 55 of title 10, United States Code, including the TRICARE program, (5) veterans health care programs under chapter 17 or 18 of title 38, as determined by the Secretary of Veterans Affairs, in coordination with the Secretary of Health and Human Services and the Secretary of Treasury, (6) a health plan under section 2504(e) of title 22 relating to Peace Corps volunteers, and (7) the Nonappropriated Fund Health Benefits Program of the Department of Defense, established under section 349 of the National Defense Authorization Act for Fiscal Year 1995, Public Law 103–337 (10 U.S.C. 1587 note).

Under section 5000A(f)(2), an eligible employer-sponsored plan is, with respect to an employee, a group health plan or group health insurance coverage offered by an employer to the employee that is: (1) a governmental plan, within the meaning of section 2791(d)(8) of the Public Health Service Act, or (2) any other plan or coverage offered in the small or large group market within a State. An eligi-

ble employer-sponsored plan also includes a grandfathered health plan offered in a group market.

Under section 1251 of the Affordable Care Act (42 U.S.C. 18011), a grandfathered health plan is a group health plan or health insurance coverage that provided coverage as of the enactment date of the Affordable Care Act (March 23, 2010) or in which an individual was enrolled as of that date. *See also* §54.9815–1251T(a) (providing guidance regarding grandfathered health plans).

As described in this preamble, the Department of Health and Human Services, in coordination with the Treasury Department, may designate other health benefits coverage as minimum essential coverage. The Department of Health and Human Services is proposing a regulation that provides criteria and a process by which other types of coverage may be designated as minimum essential coverage. Patient Protection and Affordable Care Act; Exchange Functions: Eligibility for Exemptions; Minimum Essential Coverage Provisions (to be codified at 45 CFR 156.600 and following sections).

Under section 5000A(f)(3), health coverage that consists of coverage of certain excepted benefits specified in section 2791(c) of the Public Health Service Act (42 U.S.C. 300gg–91(c)) is not minimum essential coverage. There are four categories of excepted benefits. The first category includes accidental death and dismemberment coverage, disability insurance, general liability insurance, automobile liability insurance, workers' compensation, credit-only insurance (for example, mortgage insurance), and coverage for employer-provided on-site medical clinics. *See* 42 U.S.C. 300gg–91(c)(1). The second category of excepted benefits includes limited-scope dental or vision benefits, long-term care benefits, and benefits provided under certain health flexible spending arrangements. *See* 42 U.S.C. 300gg–91(c)(2). The third category of excepted benefits includes, but only if offered under a policy, certificate, or contract of insurance separate from, and not coordinated with, any group or individual health plan maintained by the same plan sponsor, coverage only for a specified disease or illness (for example, cancer-only policies) or fixed indemnity insurance (for example, a policy that pays a fixed dollar amount, such as $100, per day of hospitalization or illness regardless of the amount of medical expense incurred). *See* 42 U.S.C. 300gg–91(c)(3). The last category of excepted benefits includes, but only if offered under a policy, certificate, or contract of insurance separate from the primary health coverage, Medicare supplemental polices (also known as Medigap or MedSupp insurance), TRICARE supplemental policies, and similar supplemental coverage to coverage under a group health plan. *See* 42 U.S.C. 300gg–91(c)(4).

Under section 5000A(f)(4), an individual is treated as having minimum essential coverage for a month: (1) if the individual is a *bona fide* resident of a United States possession for the month or (2) if the month occurs during any period described in section 911(d)(1)(A) or section 911(d)(1)(B) that is applicable to the individual. Section 911(d)(1)(A) is applicable to a citizen of the United States who has a tax home outside the United States and is a *bona fide* resident of a foreign country or countries during an uninterrupted period that includes an entire taxable year. For example, an individual who resides abroad for an entire calendar year is treated as having minimum essential coverage for each month of that calendar year regardless of whether the individual has health coverage of any type. Section 911(d)(1)(B) is applicable to a U.S. citizen or U.S. resident (within the meaning of section 7701(b)) who has a tax home outside the United States and is present in a foreign country or countries for at least 330 full days during a period of 12 consecutive months. In general, an individual who meets either of the foregoing residency requirements under section 911(d)(1) is treated as a qualified individual for purposes of section 911 and may elect to exclude certain foreign earned income and housing costs from gross income.

Administration and Procedure

Under section 5000A(b)(2), an individual liable for the shared responsibility payment under section 5000A must report the payment with the individual's Federal income tax return for the taxable year including the month or months for which the payment is owed.

Under section 5000A(g)(1), the shared responsibility payment is payable upon notice and demand by the Secretary. The shared responsibility payment is generally assessed and collected in the same manner as an assessable penalty under subchapter B of chapter 68 (sections 6671 through 6725). Unlike the assessable penalties, however, the Secretary may not file notice of lien or levy on the taxpayer's property for failing to pay the assessed shared responsibility payment. Further, a taxpayer may not be subject to criminal prosecution or penalty for failing to pay the assessed shared responsibility payment in a timely manner.

Explanation of Provisions

1. *Maintenance of Minimum Essential Coverage and Liability for Shared Responsibility Payment*

The proposed regulations provide that, for a month, a nonexempt individual must either have minimum essential coverage or pay the shared responsibility payment.

a. *Coverage for a month*

The proposed regulations provide that, for any calendar month, an individual is treated as having minimum essential coverage if the individual is enrolled in and entitled to receive benefits under a program or plan that is minimum essential coverage for at least one day during the month.

b. *Liability for shared responsibility payment*

i. Liability for dependents

Under section 5000A(b)(3)(A), if an individual with respect to whom the shared responsibility payment is imposed for a month is another individual's dependent (as defined in section 152) for the taxable year including that month, the other individual is liable for the shared responsibility payment for the dependent. The proposed regulations clarify that a taxpayer is liable for the shared responsibility payment imposed with respect to any individual for a month in a taxable year for which the taxpayer may claim a personal exemption deduction for the individual (that is, the dependent) for that taxable year. Whether the taxpayer actually claims the individual as a

dependent for the taxable year does not affect the taxpayer's liability for the shared responsibility payment for the individual.

The proposed regulations provide special rules for determining liability for the shared responsibility payment attributable to individuals who are adopted or placed in foster care during a taxable year. If a taxpayer legally adopts a child and is entitled to claim the child as a dependent under section 151 for the taxable year when the adoption occurs, the taxpayer is not liable for a shared responsibility payment attributable to the child for the months before the adoption. Conversely, if a taxpayer who is entitled to claim a child as a dependent under section 151 for the taxable year places the child for adoption during the year, the taxpayer is not liable for a shared responsibility payment attributable to the child for the months after the adoption.

The proposed regulations define *shared responsibility family* to include all individuals for whom a taxpayer (including a spouse, if married filing jointly) is liable for the shared responsibility payment. The proposed regulations clarify that a taxpayer who is an exempt individual remains liable for a shared responsibility payment imposed for a nonexempt dependent who does not have minimum essential coverage.

ii. Joint liability

Section 5000A(b)(3)(B) provides that, if an individual for whom the shared responsibility payment is imposed for a month files a joint return for the taxable year including that month, the individual and the individual's spouse are jointly liable for the shared responsibility payment. The proposed regulations clarify that whether one spouse is an exempt individual does not affect the joint liability of the two spouses for the shared responsibility payment.

2. *Minimum Essential Coverage*

a. *Government sponsored programs*

Section 5000A(f)(1)(A) specifies several government sponsored programs as providing minimum essential coverage by referring to the Federal law authorizing a particular program. In most cases, the relevant law describes a single program or a discrete portion of a larger program. For example, section 5000A(f)(1)(A)(i) lists Part A of the Medicare program under title XVIII of the Social Security Act. However, in some cases, the relevant law establishes programs with limited coverage. For instance, some of the programs under title XIX of the Social Security Act do not provide a scope of benefits comparable to the primary Medicaid program under the same title. In addition, the Secretary of Veterans Affairs, in coordination with the Secretaries of Health and Human Services and Treasury, determined that only certain health care programs under chapter 17 or 18 of title 38, United States Code provide comprehensive benefits. The programs with limited coverage are similar to coverage consisting of excepted benefits that is not minimum essential coverage under section 5000A(f)(3). Accordingly, the proposed regulations identify limited benefit programs under title XIX of the Social Security Act that are not minimum essential coverage and specify comprehensive health care programs under chapter 17 or 18 of title 38, United States Code, that are minimum essential coverage.

b. *Eligible employer-sponsored plans*

In general

Section 5000A(f)(2) defines *eligible employer-sponsored plan*, for an employee, as a group health plan or group health insurance coverage offered by an employer to the employee that is either of the following: (1) a governmental plan (within the meaning of section 2791(d)(8) of the Public Health Service Act (PHSA) (42 U.S.C. 300gg–91(d)(8)) or (2) any other plan or coverage offered in the small or large group market within a State. The terms *group health plan* and *group health insurance coverage* are not defined in section 5000A. However, section 5000A(f)(5) provides that any term used in section 5000A that is also used in title I of the Affordable Care Act has the same meaning as when used in that title.

Section 1301(b)(3) of the Affordable Care Act (42 U.S.C. 18021(b)(3)) provides that *group health plan* has the same meaning as in section 2791(a) of the PHSA (42 U.S.C. 301gg–91(a)(1)). Section 2791(a) of the PHSA provides that *group health plan* means an employee welfare benefit plan (as defined in section 3(1) of the Employee Retirement Income Security Act of 1974 (ERISA) (29 U.S.C. 1002(1)) to the extent that the plan provides medical care (as defined in section 2791(a)(2) of the PHSA and including items and services paid for as medical care) to employees and their dependents directly or through insurance, reimbursement, or otherwise. Section 3(1) of ERISA defines *employee welfare benefit plan* as any plan, fund, or program established or maintained by an employer or by an employee organization, or by both, to the extent that the plan, fund, or program is established or maintained for the purpose of providing for its participants or their beneficiaries, through the purchase of insurance or otherwise, various benefits, which may include medical, surgical, or hospital care or benefits.

Group health plans within the meaning of section 1301(b)(3) of the Affordable Care Act (42 U.S.C. 18021(b)(3)) include both insured health plans and self-insured health plans. Accordingly, a self-insured group health plan is an eligible employer-sponsored plan.

ii. Continuation and retiree coverage

Employers are required to offer certain former employees continuation coverage under Federal or State law. Many employers offer health benefits coverage to retired employees. Under the PHSA and ERISA, group health plans and employee welfare benefit plans, respectively, include plans offered to former employees. Accordingly, the proposed regulations clarify that coverage provided by an employer to a former employee, including coverage under the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA), Public Law 99–272 (100 Stat. 82), and retiree health coverage, qualifies as coverage under an eligible employer-sponsored plan.

c. *Other health benefits coverage*

Under section 5000A(f)(1)(E), the Secretary of Health and Human Services, in coordination with the Secretary of the Treasury, may designate other health benefits coverage as minimum essential coverage. The Department of Health and Human Services is proposing rules providing standards for determining whether certain other types of health insurance

coverage constitute minimum essential coverage and procedures for plan sponsors to follow for a plan to be identified as minimum essential coverage under section 5000A. Patient Protection and Affordable Care Act; Exchange Functions: Eligibility for Exemptions; Minimum Essential Coverage Provisions (to be codified at 45 CFR 156.600 and following sections).

3. *Exempt Individuals*

a. *In general*

The term *applicable individual* is used in section 5000A to describe an individual who is subject to the minimum essential coverage provision under section 5000A(a). Section 5000A(d)(2) through section 5000A(d)(4) describe one category of individuals who are not applicable individuals for purposes of section 5000A. Section 5000A(e)(1) through 5000A(e)(5) describe another category of individuals who are exempt from liability for the shared responsibility payment imposed under section 5000A(b). Although the two categories are distinct in the statute, the consequence for individuals described in either category is the same: individuals in both categories are not subject to the shared responsibility payment for not maintaining minimum essential coverage. Accordingly, the proposed regulations refer to all individuals described in section 5000A(d)(2), (d)(3), or (d)(4), or section 5000A(e)(1), (e)(2), (e)(3), (e)(4), or (e)(5), as *exempt individuals*. For a month, a nonexempt individual is any individual who is alive for the entire month and is not an exempt individual for the month.

The proposed regulations provide that, in general, an individual is treated as an exempt individual for a month if the individual is an exempt individual for at least one day in the month. In the case of certain individuals who are nonresident aliens (as defined in section 7701(b)(1)(B)), individuals whose household income falls below the return filing threshold, and individuals who experience short coverage gaps, the proposed regulations provide rules on how to determine whether an individual is exempt for a particular month. An individual is exempt for all months included in a taxable year when the individual is a nonresident alien. In the case of an individual whose household income falls below the return filing threshold for a taxable year, the individual is exempt for all months in the taxable year. In the case of an individual experiencing a coverage gap, the individual is exempt for a month included in the first short coverage gap in a calendar year.

b. *Members of recognized religious sects or divisions*

Under section 5000A(d)(2)(A), an individual is exempt for a month that the individual has in effect a religious conscience exemption certification. Only an Exchange may grant a religious conscience exemption certification. Individuals who are members of a recognized religious sect or division thereof described in section 1402(g)(1) and who are adherents of the established tenets or teachings of the sect or division are eligible to receive a religious conscience exemption certification.

c. *Exempt noncitizens*

The proposed regulations clarify that an individual who is not a citizen or national of the United States is exempt for a month if the individual is not lawfully present in the United States in that month within the meaning of 45 CFR 155.20 (referring to lawful immigration status within the United States). In addition, an individual who is not a citizen or national of the United States is treated as not lawfully present in the United States for a month in a taxable year if the individual is a nonresident alien as defined in section 7701(b)(1)(B) for that taxable year.

d. *Incarcerated individuals*

Section 5000A(d)(4) provides that an individual is exempt for a month for which the individual is incarcerated (other than incarceration pending the disposition of charges). The proposed regulations clarify that an individual confined for at least one day in a jail, prison, or similar penal institution or correctional facility after the disposition of charges is exempt for the month that includes the day.

e. *Individuals who cannot afford coverage*

Section 5000A(e)(1)(A) provides that an individual is exempt for a month for which the individual does not have access to affordable minimum essential coverage. For this purpose, an individual does not have access to affordable coverage for a month if the individual's required contribution (determined on an annual basis) for coverage for the month exceeds 8 percent of the taxpayer's household income for the taxable year. Under section 5000A(e)(1)(D), for any plan year beginning after 2014, the 8 percent figure is replaced by the percentage figure that the Secretary of Health and Human Services determines reflects the excess of the rate of premium growth between the preceding calendar year and 2013 over the rate of income growth for the same period.

For purposes of determining affordability of coverage, in accordance with section 5000A(e)(1)(A), the proposed regulations require that the taxpayer's household income be increased by the portion of the required contribution made through a salary reduction arrangement and excluded from gross income. In many cases, information on the excluded amount may not be available to the IRS or to the employee. Comments are requested on practicable ways, if any, in which the required adjustment to household income may be made with the information available under sections 6051, 6055, 6056, or other provisions of the Code.

i. Individuals eligible for minimum essential coverage under an eligible employer-sponsored plan

A. Eligibility for coverage under an eligible employer-sponsored plan

If an individual is eligible for coverage under an eligible employer-sponsored plan, whether as an employee or as an individual related to an employee, the individual's qualification for the lack of affordable coverage exemption is determined solely by reference to the cost of coverage under the eligible employer-sponsored plan. The proposed regulations clarify that an employee or related individual is treated as eligible for coverage under an eligible employer-sponsored plan for each month included in the plan year if the employee or related individual could have enrolled in the plan for that month during an open or special enrollment period.

The proposed regulations also clarify that an employed individual who is eligible for coverage under an eligible employer-sponsored plan offered by the individual's employer is not treated as eligible as a related individual for coverage under a plan offered by the employer of another employed individual. Thus, if two or more members of a family are employed and their respective employers offer self-only and family coverage under eligible employer-sponsored plans, each employed individual determines the affordability of coverage using the premium for the self-only coverage offered by the individual's employer. Neither individual may determine the affordability of coverage using the premium for family coverage offered by the other individual's employer. In these cases, each employed individual's self-only coverage may be treated as affordable, even though the aggregate cost of covering all employed individuals may exceed 8 percent of the family's household income. The Department of Health and Human Services is proposing rules that would permit families in these circumstances to qualify for the hardship exemption described in section 5000A(e)(5). Patient Protection and Affordable Care Act; Exchange Functions: Eligibility for Exemptions; Minimum Essential Coverage Provisions (to be codified at 45 CFR 155.605(g)).

The proposed regulations provide that *employee* includes a former employee. Thus, an individual eligible to enroll in retiree coverage under a group health plan that is an eligible employer-sponsored plan as defined in section 5000A(f)(2) is treated as eligible to purchase minimum essential coverage under an eligible employer-sponsored plan under the same rules applicable to current employees. The treatment of former employees is consistent with other provisions of the Code, the PHSA, and ERISA that apply to group health plans of employers.

In addition, the proposed regulations provide that an individual eligible to enroll in continuation coverage required under Federal law, such as COBRA, or a comparable State law is eligible to purchase minimum essential coverage under an eligible employer-sponsored plan only if the individual enrolls in the coverage. This treatment of former employees eligible for continuation coverage is consistent with the rules provided in §1.36B–2(c)(3)(iv).

B. Required contribution for employees eligible for coverage under an employer-sponsored plan

Section 5000A(e)(1)(B)(i) provides that, in the case of an employee eligible to purchase minimum essential coverage through an eligible employer-sponsored plan, the required contribution is the portion of the annualized premium that the individual would pay (without regard to whether paid through salary reduction or otherwise) for self-only coverage. The proposed regulations clarify that, for an employee eligible for coverage under an eligible employer-sponsored plan, the required contribution is the portion of the annual premium that the employee would pay for the lowest cost self-only coverage.

C. Required contribution for a related individual eligible for coverage under an eligible employer-sponsored plan

Section 5000A(e)(1)(C) provides that, in the case of a related individual eligible to purchase minimum essential coverage under an eligible employer-sponsored plan because of the individual's relationship with an employee, the related individual's affordability determination is made by reference to the employee's required contribution. The proposed regulations provide that a related individual is an individual who is eligible for coverage under an eligible employer-sponsored plan because of a relationship to an employee and for whom a personal exemption deduction under section 151 is properly claimed on the employee's Federal income tax return. For example, an employee's spouse is treated as a related individual if the spouse files a joint return with the employee and is eligible for employer-sponsored coverage only under the plan offered to the employee. An individual who is eligible to enroll in an eligible employer-sponsored plan by reason of a relationship to an employee, but who is not claimed as a dependent by the employee, is not treated as a related individual. For purposes of section 5000A, the unclaimed dependent's household income is independently determined.

The proposed regulations clarify that if an employee or related individual is eligible to enroll in an eligible employer-sponsored plan, any eligibility for other coverage (for example, government sponsored minimum essential coverage) is disregarded for purposes of the exemption for lack of affordable coverage.

The proposed regulations further clarify that the required contribution for a related individual's coverage is determined by reference to the premium for the lowest cost coverage under the eligible employer-sponsored plan in which the employee and all related individuals who are included in the employee's family and not otherwise exempt are eligible to enroll. Thus, the required contribution for a spouse and claimed dependents (who are not otherwise exempt) is the premium that the employee would pay for the lowest cost coverage covering the employee, the spouse, and the claimed dependents. The required contribution for self-only coverage under an eligible employer-sponsored plan may cost less than 8 percent of household income, while the required contribution for family coverage under the same employer plan may cost more than 8 percent of household income. In such a case, the employee is not exempt under section 5000A(e)(1), while the employee's spouse and claimed dependents are exempt.

Finally, some individuals who are claimed as dependents by a taxpayer may not be eligible for coverage under the taxpayer's eligible employer-sponsored plan. The affordability of coverage for these individuals is determined in the manner that applies to them individually. Thus, if a taxpayer is not allowed to enroll a niece who is the taxpayer's dependent in the taxpayer's eligible employer-sponsored plan, the required contribution for the niece is not determined by reference to the cost of coverage under the plan. Instead, unless the niece is eligible for coverage under another eligible employer-sponsored plan, her required contribution is determined under the rules applicable to individuals eligible only to purchase coverage in the individual market.

ii. Individuals eligible only to purchase coverage in the individual market

Section 5000A(e)(1)(B)(ii) defines the term *required contribution* for an individual eligible only to purchase coverage in

the individual market. The proposed regulations clarify that, for any individual who is not an employee or related individual eligible for minimum essential coverage under an eligible employer-sponsored plan, the required contribution is the premium for the lowest cost bronze plan available in the individual market through the Exchange serving the rating area where the individual resides, reduced by the maximum amount of any premium tax credit that would be allowable if the individual were enrolled in the plan offered through the Exchange.

As explained in this preamble, under the proposed regulations, both the annual premium for the applicable lowest cost bronze plan and the credit allowable under section 36B are determined by reference to coverage for those members of the individual's family who are not otherwise exempt (*nonexempt family*). Consequently, the required contribution is the same for all members of a nonexempt family who are ineligible for coverage under an eligible employer-sponsored plan.

A. Premium for the lowest cost bronze plan

The proposed regulations provide that the lowest cost bronze plan is the lowest cost bronze-level qualified health plan available in the Exchange serving the rating area that would cover all members of the nonexempt family who are ineligible for coverage under an eligible employer-sponsored plan. Accordingly, the premium for the lowest cost bronze plan is the same for all individuals in a nonexempt family.

The proposed regulations provide special rules for determining the premium for the lowest cost bronze plan if the Exchange does not offer a bronze-level plan that would cover the taxpayer's entire nonexempt family. The proposed regulations provide that, in general, the premium for the lowest cost bronze plan is the sum of the premiums for the lowest cost bronze plans that would, taken together, cover the taxpayer's nonexempt family (for example, for an uncle and two adult dependent nieces, a self-only plan for the uncle and a two-adult or family plan for the nieces). Alternatively, the proposed regulations provide that a taxpayer may elect to use the premium for the lowest cost bronze plan that would apply to a set of individuals that have the same characteristics as the taxpayer's nonexempt family (such as one adult plus children) as if one plan covered all members of the taxpayer's shared responsibility family.

B. Credit allowable under section 36B

In general, a premium tax credit is allowable under section 36B for any coverage month (within the meaning of §1.36B–3(c)) that occurs in a taxable year in which a taxpayer is an applicable taxpayer (within the meaning of §1.36B–2(b)). A month is not a coverage month for an individual, and thus no premium tax credit is allowable for the individual's coverage, if the individual is eligible for minimum essential coverage other than coverage offered in the individual market for that month. In general, an applicable taxpayer is a taxpayer whose household income for the taxable year is between 100 percent and 400 percent of the Federal poverty line for the taxpayer's family size.

Section 36B(b)(1) provides that the premium tax credit for any taxable year is the sum of the premium assistance amounts with respect to all coverage months occurring in the taxable year. Under section 36B(b)(2), for any coverage month, the premium assistance amount is the lesser of the following: (1) the monthly premiums for the month for one or more qualified health plans in which the taxpayer or a member of the taxpayer's family (coverage family) is enrolled through the Exchange serving the rating area where they reside or (2) any excess of the adjusted monthly premium for the month for the applicable second lowest cost silver plan for the taxpayer over an amount equal to 1/12 of the product of the applicable percentage and the taxpayer's household income for the taxpayer. Section 36B, therefore, calculates the allowable credit by treating the family as a single, aggregated unit.

The proposed regulations take a similar family-unit approach to determine the affordability of Exchange coverage. The proposed regulations provide that, for purposes of section 5000A, each individual in the taxpayer's nonexempt family is treated as having enrolled in a qualified health plan through the appropriate Exchange for purposes of determining the credit allowable under section 36B. Therefore, for each individual, a month is treated as a coverage month if the individual is ineligible for minimum essential coverage other than coverage in the individual market for the month. The proposed regulations further provide that the premium assistance amount for the month is the amount that would be allowable under the rules of section 36B if each member of the individual's nonexempt family enrolled in a qualified health plan through an Exchange. Accordingly, for a month that an individual included in a nonexempt family is eligible for minimum essential coverage other than coverage in the individual market, the month is not a coverage month for that individual, the individual is not included in the coverage family for purposes of section 36B, and no premium assistance amount is allowable for the coverage attributable to such individual.

f. *Household income below return filing threshold*

Section 5000A(e)(2) provides that an individual is exempt for a month in a calendar year if the individual's household income for the taxable year is less than the amount of gross income specified in section 6012(a)(1) with respect to the taxpayer. The proposed regulations refer to "the amount of gross income specified in section 6012(a)(1) with respect to the taxpayer" (that is, the minimum amount of gross income that triggers the individual's requirement to file a Federal income tax return under that section) as the applicable filing threshold.

The proposed regulations further clarify that, for any individual who is properly claimed as a dependent, the applicable filing threshold is that of the taxpayer who claims the individual as a dependent. Therefore, if a taxpayer is exempt under section 5000A(e)(2), any individual the taxpayer properly claims as a dependent also is exempt as well. The Treasury Department and the IRS recognize that some taxpayers who do not have sufficient gross income to trigger a return filing requirement nevertheless may have household income that exceeds the return filing threshold. For example, if a taxpayer whose gross income is below the applicable filing threshold files a Federal income tax return in order to claim certain tax benefits (such as the earned income credit or

additional child tax credit) and claims a dependent whose gross income triggers a return filing requirement, the household income (which combines the taxpayer's and the dependent's income) may exceed the filing threshold. The Department of Health and Human Services is proposing rules providing that individuals in this circumstance may qualify for a hardship exemption. Patient Protection and Affordable Care Act; Exchange Functions: Eligibility for Exemptions; Minimum Essential Coverage Provisions (to be codified at 45 CFR 155.605(g)). The Treasury Department and the IRS are considering additional methods of accommodating individuals in these circumstances.

g. *Short coverage gap*

The proposed regulations clarify that a continuous period without minimum essential coverage is determined by reference to calendar months (for example, January or February) in conjunction with the coverage rule in §1.5000A–1(b). Therefore, if an individual is enrolled in and entitled to receive benefits under a plan identified as minimum essential coverage for one day in a calendar month, the month is not included in the continuous period when determining the application of the short coverage gap exemption. As a result, the proposed regulations provide that an individual qualifies for the short coverage gap exemption if the continuous period without minimum essential coverage is less than three full calendar months and is the first short coverage gap in the individual's taxable year.

i. Coverage gap straddling multiple taxable years

In general, section 5000A(e)(4)(B)(i) provides that the length of a continuous period is determined without regard to the calendar years in which months in the period occur. However, whether an individual had coverage during the last month, or the last two months, of a taxable year affects the determination of whether any gap in coverage that the individual experiences in the first month, or the first and second months, of the following taxable year qualifies as a short coverage gap. Accordingly, if a calendar year taxpayer has a continuous period of 3 months or longer that starts in November or December of one taxable year and ends in the next taxable year, then January and any ensuing months of the second taxable year that are included in the period are ineligible for the short coverage gap exemption.

Section 5000A(e)(4) expressly authorizes the Secretary to prescribe rules for the collection of the shared responsibility payment in cases in which continuous periods include months in more than one taxable year. Each Federal income tax return covers a single taxable year and requires the taxpayer to account for coverage of the taxpayer's shared responsibility family during the months included in that taxable year. To require a taxpayer to take into account months in the following taxable year may delay or impede the taxpayer's ability to file a timely Federal income tax return. Accordingly, to provide taxpayers with certainty when filing their Federal income tax returns, the proposed regulations provide that an individual who lacks minimum essential coverage for a period no longer than the last two months of a taxable year will be deemed to have a short coverage gap exemption for those months if the short coverage gap is the first to occur in that taxable year, without regard to whether the individual is covered during the first months of the following taxable year.

ii. Coordination with other exemptions

The proposed regulations clarify that, for purposes of determining whether a short coverage gap applies, an individual is treated as covered under minimum essential coverage for a month in which the individual qualifies for a section 5000A exemption (other than the short coverage gap exemption). Therefore, the short coverage exemption applies to a month in which no other section 5000A exemption applies, and a month in which an individual is otherwise exempt is not taken into account in determining the length of the continuous period without coverage.

h. *Claiming section 5000A exemptions*

The exemptions for members of recognized religious sects or divisions and for individuals who have suffered a hardship are available only to individuals who have been certified as meeting the relevant criteria by the Exchange serving the rating area where the individuals seeking the exemption reside.

In addition, Exchanges will provide, upon request, exemption certifications for members of health care sharing ministries, incarcerated individuals, and members of Indian tribes. If an individual receives an exemption certification from an Exchange, the taxpayer who is responsible for accounting for that individual's coverage must provide information about the certification on the taxpayer's Federal income tax return. Alternatively, a taxpayer may claim any of these exemptions on the taxpayer's Federal income tax return for the taxable year.

Finally, the income-based exemptions for individuals who lack affordable coverage or have household income below the applicable income tax return filing threshold and the exemption for short coverage gaps may be claimed only on the individual's Federal income tax return for the applicable year. Thus, an individual claiming the affordability exemption under section 5000A(e)(1) for part or all of a taxable year will do so on the Federal income tax return that reports the individual's income establishing qualification for the exemption. An individual who has household income below the applicable Federal income tax return filing threshold and files a Federal income tax return may claim the exemption under section 5000A(e)(2) on the return. However, an individual who has household income below the applicable Federal income tax return filing threshold is not required to file a Federal income tax return to claim the exemption under section 5000A(e)(2).

Pursuant to section 6001, taxpayers are required to maintain all records and information substantiating any claim for exemption on the taxpayer's Federal income tax return, regardless of whether the individual was certified by an Exchange as qualifying for an exemption or first claimed the exemption on a Federal income tax return.

4. *Computation of Shared Responsibility Payment*

Under section 5000A(b)(1) and 5000A(b)(3)(A), a taxpayer is liable for the shared responsibility payment with respect to any nonexempt individual who

is included in the taxpayer's shared responsibility family. The maximum annual amount of the shared responsibility payment for a taxpayer is the national average premium for the bronze level plan available through Exchanges that provides coverage for the applicable family size involved. The proposed regulations clarify that the applicable family size involved for purposes of identifying the appropriate bronze level plan includes only the nonexempt members of the taxpayer's shared responsibility family who do not have minimum essential coverage.

Under section 5000A(c), the annual amount of the shared responsibility payment is the lesser of the applicable national average bronze plan premium or the sum of the monthly penalty amounts. The monthly penalty amount may vary month to month because of changes in the composition of the taxpayer's shared responsibility family. To provide a meaningful value with which the sum of the monthly penalty amounts are compared, the proposed regulations provide that the applicable national average bronze plan premium must similarly be determined for each month and then aggregated for comparison with the sum of the monthly penalty amounts. Consequently, the applicable national average bronze plan premium may vary from month to month during the year to account for changes in the taxpayer's shared responsibility family.

5. *Procedure and Administration*

a. *Inclusion with Federal income tax return*

Section 5000A(b)(2) provides that the shared responsibility payment for a month must be included with a taxpayer's Federal income tax return for the taxable year that includes the month. The proposed regulations clarify that the time for assessing the shared responsibility payment is the same time as that prescribed by section 6501 for the taxable year including the month for which the taxpayer is liable for the payment.

b. *Assessment and collection*

Section 5000A(g)(1) provides that the shared responsibility payment is payable upon notice and demand by the Secretary and, except as provided in section 5000A(g)(2), is assessed and collected in the same manner as an assessable penalty under subchapter B of chapter 68 of the Code (sections 6671 through 6725). The proposed regulations clarify that the shared responsibility payment is not subject to deficiency procedures of subchapter B of chapter 63 of the Code. In addition, the proposed regulations clarify that interest on the shared responsibility payment accrues in accordance with the rules in section 6601. The proposed regulations further provide that the Secretary may offset any liability for the shared responsibility payment against any overpayment due the taxpayer, in accordance with section 6402(a).

Applicability Date

These regulations are proposed to apply for months beginning after December 31, 2013.

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 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 the proposed regulations. Pursuant to the Regulatory Flexibility Act (RFA) (5 U.S.C. chapter 6), it is hereby certified that the proposed regulations will not have a significant economic impact on a substantial number of small entities. The applicability of the proposed regulations is limited to individuals, who are not small entities as defined by the RFA (5 U.S.C. 601). Accordingly, the RFA does not apply. Therefore, a regulatory flexibility analysis is not required. Pursuant to section 7805(f) of the Code, the proposed regulations have 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 the proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the "Addresses" heading. The Treasury Department and the IRS request comments on all aspects of the proposed rules. All comments will be available at *www.regulations.gov* or upon request.

A public hearing has been scheduled for May 29, 2013, beginning at 10:00 a.m., in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of §601.601(a)(3) of this chapter apply to the hearing. Persons who wish to present oral comments at the hearing must submit electronic or written comments, and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by May 3, 2013. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal authors of the proposed regulations are William L. Candler and Sue-Jean Kim, Office of the Associate Chief Counsel (Income Tax & Accounting). Other personnel from the Treasury Department and the IRS participated in the development of the regulations.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended to read 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 1.5000A–4 also issued under 26 U.S.C. 5000A(e)(4).

Par 2. Sections 1.5000A–0 through 1.5000A–5 are added to read as follows:

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This section lists the captions contained in §§1.5000A–1 through 1.5000A–5.

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§1.5000A–1 Maintenance of minimum essential coverage and liability for the shared responsibility payment.

(a) *In general*. For each month during the taxable year, a nonexempt individual must have minimum essential coverage or pay the shared responsibility payment. For a month, a nonexempt individual is an individual in existence for the entire month who is not an exempt individual described in §1.5000A–3.

(b) *Coverage under minimum essential coverage*—(1) *In general*. An individual has minimum essential coverage for a month in which the individual is enrolled in and entitled to receive benefits under a program or plan identified as minimum essential coverage in §1.5000A–2 for at least one day in the month.

(2) *Special rule for United States citizens or residents residing outside the United States or residents of territories*. An individual is treated as having minimum essential coverage for a month—

(i) If the month occurs during any period described in section 911(d)(1)(A) or section 911(d)(1)(B) that is applicable to the individual; or

(ii) If, for the month, the individual is a *bona fide* resident of a possession of the United States (as determined under section 937(a)).

(c) *Liability for shared responsibility payment*—(1) *In general*. A taxpayer is liable for the shared responsibility payment for a month for which—

(i) The taxpayer is a nonexempt individual without minimum essential coverage; or

(ii) A nonexempt individual for whom the taxpayer is liable under paragraph (c)(2) or (c)(3) of this section does not have minimum essential coverage.

(2) *Liability for dependents*—(i) *In general*. For a month when a nonexempt individual does not have minimum essential coverage, if the nonexempt individual is a dependent (as defined in section 152) of another individual for the other individual's taxable year including that month, the other individual is liable for the shared responsibility payment attributable to the dependent's lack of coverage. An individual is a dependent of a taxpayer for a taxable year if the individual satisfies the definition of dependent under section 152, regardless of whether the taxpayer claims the individual as a dependent on a Federal income tax return for the taxable year. If an individual may be claimed as a dependent by more than one taxpayer in the same calendar year, the taxpayer who properly claims the individual as a dependent for the taxable year is liable for the shared responsibility payment attributable to the individual. If more than one taxpayer may claim an individual as a dependent in the same calendar year but no one claims the individual as a dependent, the taxpayer with priority under the rules of section 152 to claim the individual as a dependent is liable for the shared responsibility payment for the individual.

(ii) *Special rules for dependents adopted or placed in foster care during the taxable year*—(A) *Taxpayers adopting an individual*. If a taxpayer adopts a nonexempt dependent (or accepts a nonexempt dependent who is an eligible foster child as defined in section 152(f)(1)(C)) during the taxable year and is otherwise liable for a nonexempt dependent under paragraph (c)(2)(i) of this section, the taxpayer is liable under paragraph (c)(2)(i) of this section for the nonexempt dependent only for the full months in the taxable year that follow the month in which the adoption or acceptance occurs.

(B) *Taxpayers placing an individual for adoption*. If a taxpayer who is otherwise liable for a nonexempt dependent under paragraph (c)(2)(i) of this section places (or, by operation of law, must place) the nonexempt dependent for adoption or foster care during the taxable year, the taxpayer is liable under paragraph (c)(2)(i) of this section for the nonexempt dependent only for the full months in the taxable year that precede the month in which the adoption or foster care placement occurs.

(C) *Examples*. The following examples illustrate the provisions of this paragraph (c)(2)(ii). In each example the taxpayer's taxable year is a calendar year.

Example 1. Taxpayers adopting a child. (i) E and F, married individuals filing a joint return, initiate proceedings for the legal adoption of a 2-year old child, G, in January 2016. On May 15, 2016, G becomes the adopted child (within the meaning of section 152(f)(1)(B)) of E and F, and resides with them for the remainder of 2016. G meets all requirements under section 152 to be E and F's dependent for 2016. Prior to the adoption, G resides with H, an unmarried individual, with H providing all of G's support.

(ii) Under paragraph (c)(2) of this section, E and F are not liable for a shared responsibility payment attributable to G for January through May of 2016, but are liable for a shared responsibility payment attributable to G, if any, for June through December of 2016. H is not liable for a shared responsibility payment attributable to G for any month in 2016, because G is not H's dependent for 2016 under section 152.

Example 2. Taxpayers placing a child for adoption. (i) The facts are the same as *Example 1*, except the legal adoption occurs on August 15, 2016. G meets all requirements under section 152 to be H's dependent for 2016.

(ii) Under paragraph (c)(2) of this section, H is liable for a shared responsibility payment attributable to G, if any, for January through July of 2016, but is not liable for a shared responsibility payment attributable to G for August through December of 2016. E and F are not liable for a shared responsibility payment attributable to G for any month in 2016, because G is not E and F's dependent for 2016 under section 152.

(3) *Liability of individuals filing a joint return*. Married individuals (within the meaning of section 7703) who file a joint return for a taxable year are jointly liable for any shared responsibility payment for a month included in the taxable year.

(d) *Definitions*. The definitions in this paragraph (d) apply to this section and §§1.5000A–2 through 1.5000A–5.

(1) *Affordable Care Act*. *Affordable Care Act* refers to the Patient Protection and Affordable Care Act, Public Law 111–148 (124 Stat. 119 (2010)), and the Health Care and Education Reconciliation Act of 2010, Public Law 111–152 (124 Stat. 1029 (2010)), as amended.

(2) *Qualified health plan*. *Qualified health plan* has the same meaning as in section 1301(a) of the Affordable Care Act (42 U.S.C. 18021(a)).

(3) *Exchange*. *Exchange* has the same meaning as in 45 CFR 155.20.

(4) *Rating area*. *Rating area* has the same meaning as in §1.38B–1(n).

(5) *Shared responsibility family*. *Shared responsibility family* means, for a month, all nonexempt individuals for whom the taxpayer (and the taxpayer's spouse, if the taxpayer is married and files a joint return with the spouse) is liable for the shared responsibility payment under paragraph (c) of this section.

(6) *Family*. A taxpayer's family means the individuals for whom the taxpayer properly claims a deduction for a personal exemption under section 151 for the taxable year.

(7) *Household income*—(i) *In general*. *Household income* means the sum of—

(A) A taxpayer's modified adjusted gross income; and

(B) The aggregate modified adjusted gross income of all other individuals who—

(*1*) Are included in the taxpayer's family under paragraph (d)(6) of this section; and

(*2*) Are required to file a Federal income tax return for the taxable year (determined without regard to the exception under section 1(g)(7) to the requirement to file a Federal income tax return).

(ii) *Modified adjusted gross income*. *Modified adjusted gross income* means adjusted gross income (within the meaning of section 62) increased by—

(A) Amounts excluded from gross income under section 911; and

(B) Tax-exempt interest the taxpayer receives or accrues during the taxable year.

(8) *Self-only coverage*. *Self-only coverage* means health insurance that covers one individual.

(9) *Family coverage*. *Family coverage* means health insurance that covers more than one individual.

(10) *Employee*. *Employee* includes former employees.

(11) *Month*. *Month* means calendar month.

§1.5000A–2 Minimum essential coverage.

(a) *In general*. *Minimum essential coverage* means coverage under a government sponsored program (described in paragraph (b) of this section), an eligible employer-sponsored plan (described in paragraph (c) of this section), a plan in the individual market (described in paragraph (d) of this section), a grandfathered health plan (described in paragraph (e) of this section), or other health benefits coverage (described in paragraph (f) of this section). Minimum essential coverage does not include coverage described in paragraph (g) of this section. All terms defined in this section apply for purposes of this section and §1.5000A–1 and §§1.5000A–3 through 1.5000A–5.

(b) *Government sponsored program*. *Government sponsored program* means any of the following:

(1) The Medicare program under part A of title XVIII of the Social Security Act (42 U.S.C.1395c and following sections);

(2) The Medicaid program under title XIX of the Social Security Act (42 U.S.C. 1396 and following sections) other than—

(i) Optional coverage of family planning services under section 1902(a)(10)(A)(ii)(XXI) of the Social Security Act (42 U.S.C. 1396a(a)(10)(A)(ii)(XXI));

(ii) Optional coverage of tuberculosis-related services under section 1902(a)(10)(A)(ii)(XII) (42 U.S.C. 1396a(a)(10)(A)(ii)(XII));

(iii) Coverage of pregnancy-related services under section 1902(a)(10)(A)(i)(IV) and (a)(10)(A)(ii)(IX) (42 U.S.C. 1396a(a)(10)(A)(i)(IV), (a)(10)(A)(ii)(IX)); or

(iv) Coverage of medical emergency services under 8 U.S.C. 1611(b)(1)(A), as authorized by section 1903(v) of the Social Security Act (42 U.S.C. 1396b(v)).

(3) The Children's Health Insurance Program (CHIP) under title XXI of the Social Security Act (42 U.S.C 1397aa and following sections);

(4) Medical coverage under chapter 55 of title 10, U.S.C., including coverage under the TRICARE program;

(5) The following health care programs under chapter 17 or 18 of title 38, U.S.C.:

(i) The medical benefits package authorized for eligible veterans under 38 U.S.C. 1710 and 38 U.S.C. 1705;

(ii) The Civilian Health and Medical Program of the Department of Veterans Affairs (CHAMPVA) authorized under 38 U.S.C. 1781; and

(iii) The comprehensive health care program authorized under 38 U.S.C. 1803 and 38 U.S.C. 1821 for certain children of Vietnam Veterans and Veterans of covered service in Korea who are suffering from spina bifida.

(6) A health plan under section 2504(e) of title 22, U.S.C. (relating to Peace Corps volunteers); and

(7) The Nonappropriated Fund Health Benefits Program of the Department of Defense, established under section 349 of the National Defense authorization Act for Fiscal Year 1995 (Public Law No. 103–337; 10 U.S.C. 1587 note).

(c) *Eligible employer-sponsored plan*—(1) *In general*. *Eligible employer-sponsored plan* means, with respect to any employee, a group health plan (whether an insured group health plan or a self-insured group health plan) or group health insurance coverage offered by an employer to the employee, which is—

(i) A governmental plan (within the meaning of section 2791(d)(8) of the Public Health Service Act (42 U.S.C.300gg–91(d)(8)));

(ii) Any other plan or coverage offered in the small or large group market within a State;

(iii) A grandfathered health plan (within the meaning of paragraph (e) of this section) offered in a group market.

(2) *Group health plan*. *Group health plan* has the same meaning as in section 2791(a) of the Public Health Service Act (42 U.S.C.300gg–91(a)(1)).

(3) *Group health insurance coverage*. *Group health insurance coverage* has the same meaning as in section 2791(b) of the Public Health Service Act (42 U.S.C.300gg–91(b)).

(4) *Large and small group market*. *Large group market* and *small group market* have the same meanings as in section 1304(a)(3) of the Affordable Care Act (42 U.S.C. 18024(a)(3)).

(5) *Government sponsored program not treated as eligible employer-sponsored plan*. A government sponsored program described in paragraph (b) of this section is not an eligible employer-sponsored plan.

(d) *Plan in the individual market*. *Plan in the individual market* means health in-

surance coverage offered to individuals not in connection with a group health plan, including a qualified health plan offered by an Exchange.

(e) *Grandfathered health plan*. *Grandfathered health plan* means any group health plan or group health insurance coverage to which section 1251 of the Affordable Care Act (42 U.S.C.18011) applies.

(f) *Other health benefits coverage*. Minimum essential coverage includes any plan or arrangement recognized by the Secretary of Health and Human Services as minimum essential coverage for purposes of section 5000A under 45 CFR 156.600 and following sections.

(g) *Excepted benefits*. Minimum essential coverage does not include any health insurance coverage that consists of excepted benefits that are described in section 2791(c)(1), (c)(2), (c)(3), or (c)(4) of the Public Health Service Act (42 U.S.C. §300gg–91(c)).

§1.5000A–3 Exempt individuals.

(a) *Members of recognized religious sects*—(1) *In general*. An individual is an exempt individual for a month that includes a day on which the individual has in effect a religious conscience exemption certification described in paragraph (a)(2) of this section.

(2) *Exemption certification*. A religious conscience exemption certification is issued by an Exchange in accordance with the requirements of section 1311(d)(4)(H) of the Affordable Care Act (42 U.S.C. 18031(d)(4)(H)) and 45 CFR 155.605(c), 45 CFR 155.615(b) and certifies that an individual is—

(i) A member of a recognized religious sect or division thereof that is described in section 1402(g)(1); and

(ii) An adherent of established tenets or teachings of the sect or division as described in that section.

(b) *Member of health care sharing ministries*—(1) *In general*. An individual is an exempt individual for a month that includes a day on which the individual is a member of a health care sharing ministry.

(2) *Health care sharing ministry*. For purposes of this section, *health care sharing ministry* means an organization—

(i) That is described in section 501(c)(3) and is exempt from tax under section 501(a);

(ii) Members of which share a common set of ethical or religious beliefs and share medical expenses among themselves in accordance with those beliefs and without regard to the State in which a member resides or is employed;

(iii) Members of which retain membership even after they develop a medical condition;

(iv) That (or a predecessor of which) has been in existence at all times since December 31, 1999;

(v) Members of which have shared medical expenses continuously and without interruption since at least December 31, 1999; and

(vi) That conducts an annual audit performed by an independent certified public accounting firm in accordance with generally accepted accounting principles and makes the annual audit report available to the public upon request.

(c) *Exempt noncitizens*—(1) *In general*. An individual is an exempt individual for a month that the individual is an exempt noncitizen.

(2) *Exempt noncitizens*. For purposes of this section, an individual is an exempt noncitizen for a month if the individual—

(i) Is not a U.S. citizen or U.S. national for any day during the month; and

(ii) Is either—

(A) A nonresident alien (within the meaning of section 7701(b)(1)(B)) for the taxable year that includes the month; or

(B) An individual who is not lawfully present (within the meaning of 45 CFR 155.20) in the United States on any day in the month.

(d) *Incarcerated individuals*—(1) *In general*. An individual is an exempt individual for a month that includes a day on which the individual is incarcerated.

(2) *Incarcerated*. For purposes of this section, the term *incarcerated* means confined, after the disposition of charges, in a jail, prison, or similar penal institution or correctional facility.

(e) *Individuals with no affordable coverage*—(1) *In general*. An individual is an exempt individual for a month in which the individual lacks affordable coverage. For purposes of this paragraph (e), an individual lacks affordable coverage in a month if the individual's required contribution (determined on an annual basis) for minimum essential coverage for the month exceeds the required contribution percentage (as defined in paragraph (e)(2) of this section) of the individual's household income. For purposes of this paragraph (e), an individual's household income is increased by any amount of the required contribution made through a salary reduction arrangement that is excluded from gross income.

(2) *Required contribution percentage*—(i) *In general*. Except as provided in paragraph (e)(2)(ii) of this section, the required contribution percentage is 8 percent.

(ii) *Indexing*. For plan years beginning in any calendar year after 2014, the required contribution percentage is the percentage determined by the Department of Health and Human Services that reflects the excess of the rate of premium growth between the preceding calendar year and 2013 over the rate of income growth for the period.

(iii) *Plan year*. For purposes of this paragraph (e), *plan year* means the eligible employer-sponsored plan's regular 12-month coverage period (or the remainder of a 12-month coverage period for a new employee or an individual who enrolls during a special enrollment period).

(3) *Individuals eligible for coverage under eligible employer-sponsored plans*—(i) *Eligibility*—(A) *In general*. Except as provided in paragraph (e)(3)(i)(B) of this section, an employee or related individual (as defined in paragraph (e)(3)(ii)(B) of this section) is treated as eligible for coverage under an eligible employer-sponsored plan for a month during a plan year if the employee or related individual could have enrolled in the plan for any day in that month during an open or special enrollment period, regardless of whether the employee or related individual is eligible for any other type of minimum essential coverage. For purposes of this paragraph (e)(3), an employee eligible for coverage under an eligible employer-sponsored plan offered by the employee's employer is not treated as eligible as a related individual for coverage under an eligible employer-sponsored plan (for example, an eligible employer-sponsored plan offered by the employer of the employee's spouse) for any month included in the plan year of the eligible employer-sponsored plan offered by the employee's employer.

(B) *Special rule for continuation coverage*. An individual who may enroll in continuation coverage required under Federal law or a State law that provides comparable continuation coverage is eligible for coverage under an eligible employer-sponsored plan only if the individual enrolls in the coverage.

(ii) *Required contribution for individuals eligible for coverage under an eligible employer-sponsored plan*—(A) *Employees*. In the case of an employee who is eligible to purchase coverage under an eligible employer-sponsored plan sponsored by the employee's employer, the required contribution is the portion of the annual premium that the employee would pay (whether though salary reduction or otherwise) for the lowest cost self-only coverage.

(B) *Individuals related to employees*. In the case of an individual who is eligible for coverage under an eligible employer-sponsored plan because of a relationship to an employee and for whom a personal exemption deduction under section 151 is claimed on the employee's Federal income tax return (related individual), the required contribution is the portion of the annual premium that the employee would pay (whether through salary reduction or otherwise) for the lowest cost family coverage that would cover the employee and all related individuals who are included in the employee's family and are not otherwise exempt under §1.5000A–3.

(C) *Required contribution for part-year period*. For each individual described in paragraph (e)(3)(ii)(A) or (e)(3)(ii)(B) of this section, affordability under paragraph (e)(3) of this section is determined separately for each employment period that is less than a full calendar year or for the portions of an employer's plan year that fall in different taxable years of the individual. Coverage under an eligible employer-sponsored plan is affordable for a part-year period if the annualized required contribution for self-only coverage (in the case of the employee) or family coverage (in the case of a related individual) under the plan for the part-year period does not exceed the required contribution percentage of the individual's household income for the taxable year. The annualized required contribution is the required contribution determined under paragraph (e)(3)(ii)(A) or (e)(3)(ii)(B) of this section for the part-year period times a fraction, the numerator of which is 12 and the denominator of which is the number of months in the part-year period during the individual's taxable year. Only full calendar months are included in the computation under this paragraph (e)(3)(ii)(C).

(D) *Examples*. The following examples illustrate the application of this paragraph (e)(3). Unless stated otherwise, in each example, each individual's taxable year is a calendar year, the individual is ineligible for any other exemptions described in this section for a month, the rate of premium growth has not exceeded the rate of income growth since 2013, and the individual's employer offers a single plan that uses a calendar plan year and is an eligible employer-sponsored plan as described in §1.5000A–2(c).

Example 1. Unmarried employee with no dependents. Taxpayer A is an unmarried individual with no dependents. In November 2015, A is eligible to enroll in self-only coverage under a plan offered by A's employer for calendar year 2016. If A enrolls in the coverage, A is required to pay $5,000 of the total annual premium. In 2016, A's household income is $60,000. Under paragraph (e)(3)(ii)(A) of this section, A's required contribution is $5,000, the portion of the annual premium A pays for self-only coverage. Under paragraph (e)(1) of this section, A lacks affordable coverage for 2016 because A's required contribution ($5,000) is greater than 8 percent of A's household income ($4,800).

Example 2. Married employee with dependents. Taxpayers B and C are married and file a joint return for 2016. B and C have two children, D and E. In November 2015, B is eligible to enroll in self-only coverage under a plan offered by B's employer for calendar year 2016 at a cost of $5,000 to B. C, D, and E are eligible to enroll in family coverage under the same plan for 2016 at a cost of $20,000 to B. B, C, D, and E's household income is $90,000. Under paragraph (e)(3)(ii)(A) of this section, B's required contribution is B's share of the cost for self-only coverage, $5,000. Under paragraph (e)(1) of this section, B has affordable coverage for 2016 because B's required contribution ($5,000) does not exceed 8 percent of B's household income ($7,200). Under paragraph (e)(3)(ii)(B) of this section, the required contribution for C, D, and E is B's share of the cost for family coverage, $20,000. Under paragraph (e)(1) of this section, C, D, and E lack affordable coverage for 2016 because their required contribution ($20,000) exceeds 8 percent of their household income ($7,200).

Example 3. Plan year is a fiscal year. (i) Taxpayer F is an unmarried individual with no dependents. In June 2015, F is eligible to enroll in self-only coverage under a plan offered by F's employer for the period July 2015 through June 2016 at a cost to F of $4,750. In June 2016, F is eligible to enroll in self-only coverage under a plan offered by F's employer for the period July 2016 through June 2017 at a cost to F of $5,000. In 2016, F's household income is $60,000.

(ii) Under paragraph (e)(3)(ii)(C) of this section, F's annualized required contribution for the period January 2016 through June 2016 is $4,750 ($2,375 paid for premiums in 2016 x 12/6). Under paragraph (e)(1) of this section, F has affordable coverage for January 2016 through June 2016 because F's annualized required contribution ($4,750) does not exceed 8 percent of F's household income ($4,800).

(iii) Under paragraph (e)(3)(ii)(C) of this section, F's annualized required contribution for the period July 2016 to December 2016 is $5,000 ($2,500 paid for premiums in 2016 x 12/6). Under paragraph (e)(1) of this section, F lacks affordable coverage for July 2016 through December 2016 because F's annualized required contribution ($5,000) exceeds 8 percent of F's household income ($4,800).

Example 4. Eligibility for coverage under an eligible employer-sponsored plan and under government sponsored coverage. Taxpayer G is unmarried and has one child, H. In November 2015, H is eligible to enroll in family coverage under a plan offered by G's employer for 2016. H is also eligible to enroll in the CHIP program for 2016. Under paragraph (e)(3)(i) of this section, H is treated as eligible for coverage under an eligible employer-sponsored plan for each month in 2016, notwithstanding that H is eligible to enroll in government sponsored coverage for the same period.

(4) *Individuals ineligible for coverage under eligible employer-sponsored plans*—(i) *Eligibility for coverage other than an eligible employer-sponsored plan*. An individual is treated as ineligible for coverage under an eligible employer-sponsored plan for a month that is not described in paragraph (e)(3)(i) of this section.

(ii) *Required contribution for individuals ineligible for coverage under eligible employer-sponsored plans*—(A) *In general*. In the case of an individual who is ineligible for coverage under an eligible employer-sponsored plan, the required contribution is the premium for the applicable plan, reduced by the maximum amount of any credit allowable under section 36B for the taxable year (determined as if the individual was covered for the entire taxable year by a qualified health plan offered through the Exchange serving the rating area where the individual resides).

(B) *Applicable plan*—(*1*) *In general*. Except as provided in paragraph (e)(4)(ii)(B)(*2*) of this section, *applicable plan* means the single lowest cost bronze plan available in the individual market through the Exchange serving the rating area in which the individual resides (without regard to whether the individual purchased a qualified health plan though the Exchange) that would cover all individu-

als in the individual's nonexempt family. For purposes of this paragraph (e)(4), an individual's *nonexempt family* means the family (as defined in §1.5000A–1(d)(6)) that includes the individual, excluding any family members who are otherwise exempt under section 1.5000A–3 or are treated as eligible for coverage under an eligible employer-sponsored plan under paragraph (e)(3)(i) of this section. The premium for the applicable plan takes into account rating factors (for example, an individual's age) that an Exchange would use to determine the cost of coverage.

(*2*) *Lowest cost bronze plan does not cover all individuals included in the taxpayer's nonexempt family—*(*i*) *In general*. If the Exchange serving the rating area where the individual resides does not offer a single bronze plan that would cover all individuals included in the individual's nonexempt family, the premium for the applicable plan is the sum of the premiums for the lowest cost bronze plans that are offered through the Exchanges serving the rating areas where one or more of the individuals reside and that would, in the aggregate, cover all the individuals in the individual's nonexempt family.

(*ii*) *Simplified method for applicable plan identification*. In lieu of the premium for the applicable plan determined under paragraph (e)(4)(ii)(B)(*2*)(*i*) of this section, a taxpayer may irrevocably elect to use the premium for the lowest cost bronze plan offered by the Exchange serving the rating area where the individual resides that would cover individuals with the characteristics (for example, the individuals' ages) of the individuals in the taxpayer's nonexempt family. For example, if a taxpayer's nonexempt family includes one adult and two children, the taxpayer may elect to use the premium for the lowest cost bronze plan that would cover individuals having the same characteristics as the adult and the two children in the taxpayer's nonexempt family. A taxpayer makes the election by using the simplified method described in this paragraph (e)(4)(ii)(B)(*2*)(*ii*).

(C) *Credit allowable under section 36B*. For purposes of paragraph (e)(4)(ii)(A) of this section, *credit allowable under section 36B* means the maximum amount of the credit that would be allowable to the individual (or to the taxpayer who can properly claim the individual as a dependent) under section 36B if all members of the individual's nonexempt family enrolled in a qualified health plan through the Exchange serving the rating area where the individual resides.

(D) *Required contribution for part-year period*. For each individual described in paragraph (e)(4)(ii)(A) of this section, affordability under paragraph (e)(4) of this section is determined separately for each period described in paragraph (e)(4)(ii)(E) of this section that is less than a 12-month period. Coverage under a plan is affordable for a part-year period if the annualized required contribution for coverage under the plan for the part-year period does not exceed the required contribution percentage of the individual's household income for the taxable year. The annualized required contribution is the required contribution determined under paragraph (e)(4)(ii)(A) of this section for the part-year period times a fraction, the numerator of which is 12 and the denominator of which is the number of months in the part-year period during the individual's taxable year. Only full calendar months are included in the computation under this paragraph (e)(4)(ii)(D).

(iii) *Examples*. The following examples illustrate the provisions of this paragraph (e)(4). Unless stated otherwise, in each example the taxpayer's taxable year is a calendar year, the rate of premium growth has not exceeded the rate of income growth since 2013, and the taxpayer is ineligible for any of the exemptions described in paragraphs (b) through (i) of this section for a month.

Example 1. Unmarried employee with no dependents. (i) Taxpayer G is an unmarried individual with no dependents. G is ineligible to enroll in any minimum essential coverage other than coverage in the individual market for all months in 2016. The annual premium for the lowest cost bronze self-only plan in G's rating area (G's applicable plan) is $5,000. The adjusted annual premium for the second lowest cost silver self-only plan in G's rating area (G's applicable benchmark plan within the meaning of §1.36B–3(f)) is $5,500. In 2016 G's household income is $40,000, which is 358 percent of the Federal poverty line for G's family size for the taxable year.

(ii) Under paragraph (e)(4)(ii)(C) of this section, the credit allowable under section 36B is determined pursuant to section 36B. With household income at 358 percent of the Federal poverty line, G's applicable percentage is 9.5. Because each month in 2016 is a coverage month (within the meaning of §1.36B–3(c)), G's maximum credit allowable under section 36B is the excess of G's premium for the applicable benchmark plan over the product of G's household income and G's applicable percentage ($1,700). Therefore, under paragraph (e)(4)(ii)(A) of this section, G's required contribution is $3,300. Under paragraph (e)(1) of this section, G lacks affordable coverage for 2016 because G's required contribution ($3,300) exceeds 8 percent of G's household income ($3,200).

Example 2. Family. (i) In 2016 Taxpayers M and N are married and file a joint return. M and N have two children, P and Q. M, N, P, and Q are ineligible to enroll in minimum essential coverage other than coverage in the individual market for a month in 2016. The annual premium for M, N, P, and Q's applicable plan is $20,000. The adjusted annual premium for M, N, P, and Q's applicable benchmark plan (within the meaning of §1.36B–3(f)) is $25,000. M and N's household income is $80,000, which is 347 percent of the Federal poverty line for a family size of 4 for the taxable year.

(ii) Under paragraph (e)(4)(ii)(C) of this section, the credit allowable under section 36B is determined pursuant to section 36B. With household income at 347 percent of the Federal poverty line, the applicable percentage is 9.5. Because each month in 2016 is a coverage month (within the meaning of §1.36B–3(c)), the maximum credit allowable under section 36B is the excess of the premium for the applicable benchmark plan over the product of the household income and the applicable percentage ($17,400). Therefore, under paragraph (e)(4)(ii)(A) of this section, the required contribution for M, N, P, and Q is $2,600. Under paragraph (f)(2) of this section, M, N, P, and Q have affordable coverage for 2016 because their required contribution ($2,600) does not exceed 8 percent of their household income ($6,400).

Example 3. Family with some members eligible for government sponsored coverage. (i) In 2016 Taxpayers U and V are married and file a joint return. U and V have two children, W and X. U and V are ineligible to enroll in minimum essential coverage other than coverage in the individual market for all months in 2016; however, W and X are eligible for coverage under CHIP for 2016 at an annual cost of $1,000 per child. The annual premium for U, V, W, and X's applicable plan is $20,000. The adjusted annual premium for the second lowest cost silver plan that would cover U and V (the applicable benchmark plan (within the meaning of §1.36B–3(f)) is $12,500. U and V's household income is $50,000, which is 217 percent of the Federal poverty line for a family size of 4 for the taxable year. W and X do not enroll in CHIP coverage.

(ii) Under paragraph (e)(4)(ii)(C) of this section, the credit allowable under section 36B is determined pursuant to section 36B. With household income at 217 percent of the Federal poverty line, the applicable percentage is 6.89. Each month in 2016 is a coverage month (within the meaning of §1.36B–3(c)) for U and V, but no months in 2016 are coverage months for W and X because they are eligible for CHIP coverage. The maximum credit allowable under section 36B is the excess of the premium for the applicable benchmark plan over the product of the household income and the applicable percentage ($9,055). Therefore, under paragraph (e)(4)(ii)(A) of this section, the required contribution is $10,945. Under paragraph (e)(1) of this section, U, V, W, and X lack affordable coverage for 2016 because their required contribu-

tion ($10,945) exceeds 8 percent of their household income ($4,000).

Example 4. Family with some members enrolled in government sponsored minimum essential coverage. The facts are the same as *Example 3*, except W and X enroll in CHIP coverage on January 1, 2016. Under paragraph (e)(4)(ii)(B), U, V, W, and X are members of U and V's nonexempt family for 2016. Therefore, the annual premium for the applicable plan is the same as in *Example 3* ($20,000). The maximum credit allowable under section 36B is also the same as in *Example 3* ($9,055). Under paragraph (e)(4)(ii)(A) of this section, the required contribution is $10,945. Under paragraph (e)(1) of this section, U and V lack affordable coverage for 2016 because their required contribution ($10,945) exceeds 8 percent of their household income ($4,000).

Example 5. Simplified method for applicable plan identification. (i) In 2016 Taxpayer Y, a 42-year old unmarried individual, lives with her 17-year old nephew, Z. Y properly claims Z as a dependent for 2016. Neither Y nor Z is eligible for minimum essential coverage other than coverage in the individual market in 2016. The Exchange serving the rating area where Y and Z reside does not offer any plan that would cover them both. For 2016, the annual premium for the lowest cost bronze plan covering Y is $5,000, and the annual premium for the lowest cost bronze plan covering Z is $4,500. The premium for the lowest cost bronze plan that would cover individuals with the characteristics of Y and Z that is offered in the Exchange serving the rating area where Y and Z reside is $10,000.

(ii) Under paragraph (e)(4)(ii)(B), Z is included in Y's nonexempt family. Under paragraph (e)(4)(ii)(B)(*2*)(*i*) of this section, the premium for the applicable plan is the sum of the premiums for the lowest cost bronze plans that would cover Y and Z, or $9,500 ($5,000 + $4,500). Alternatively, under paragraph (e)(4)(ii)(B)(*2*)(*ii*) of this section, Y may irrevocably elect to use the premium for the lowest cost bronze plan that would cover individuals with the characteristics of Y and Z that is offered in the Exchange ($10,000) as the premium for the applicable plan in determining qualification for the exemption described in paragraph (e)(1) of this section.

(f) *Household income below filing threshold*—(1) *In general*. An individual is an exempt individual for any taxable year for which the individual's household income is less than the applicable filing threshold.

(2) *Applicable filing threshold*—(i) *In general*. For purposes of this section, *applicable filing threshold* means the amount of gross income that would trigger an individual's requirement to file a Federal income tax return under section 6012(a)(1).

(ii) *Certain dependents*. The applicable filing threshold for an individual who is properly claimed as a dependent by another taxpayer is equal to the other taxpayer's applicable filing threshold.

(g) *Members of Indian tribes*. An individual is an exempt individual for a month that includes a day on which the individual is a member of an Indian tribe. For purposes of this section, *Indian tribe* means a group or community described in section 45A(c)(6).

(h) *Individuals with hardship exemption certification*—(1) *In general*. An individual is an exempt individual for a month that includes a day on which the individual has in effect a hardship exemption certification described in paragraph (h)(2) of this section.

(2) *Hardship exemption certification*. A hardship exemption certification is issued by an Exchange under section 1311(d)(4)(H) of the Affordable Care Act (42 U.S.C. 18031(d)(4)(H)) and 45 CFR 155.605(g) and 45 CFR 155.615(f) and certifies that an individual has suffered a hardship (as that term is defined in 45 CFR 166.605(g)) with respect to the capability to obtain minimum essential coverage.

(i) [Reserved]

(j) *Individuals with certain short coverage gaps*—(1) *In general*. An individual is an exempt individual for a month the last day of which is included in a short coverage gap.

(2) *Short coverage gap*—(i) *In general*. *Short coverage gap* means a continuous period of less than three months in which the individual is not covered under minimum essential coverage. If the individual does not have minimum essential coverage for a continuous period of three or more months, none of the months included in the continuous period is treated as included in a short coverage gap.

(ii) *Coordination with other exemptions*. For purposes of this paragraph (j), an individual is treated as having minimum essential coverage for a month in which an individual is exempt under any of paragraphs (a) through (h) of this section.

(iii) *More than one short coverage gap during calendar year*. If a calendar year includes more than one short coverage gap, the exemption provided by this paragraph (j) only applies to the earliest short coverage gap.

(3) *Continuous period*—(i) *In general*. Except as provided in paragraph (j)(3)(ii) of this section, the number of months included in a continuous period is determined without regard to the calendar years in which months included in that period occur.

(ii) *Continuous period straddling more than one taxable year*. If an individual does not have minimum essential coverage for a continuous period that begins in one taxable year and ends in the next, for purposes of applying this paragraph (j) to the first taxable year, the months in the second taxable year included in the continuous period are disregarded. For purposes of applying this paragraph (j) to the second taxable year, the months in the first taxable year included in the continuous period are taken into account.

(4) *Examples*. The following examples illustrate the provisions of this paragraph (j). Unless stated otherwise, in each example the taxpayer's taxable year is a calendar year and the taxpayer is ineligible for any of the exemptions described in paragraphs (a) through (h) of this section for a month.

Example 1. Short coverage gap. Taxpayer D has minimum essential coverage in 2016 from January 1 through March 2. After March 2, D does not have minimum essential coverage until D enrolls in an eligible employer-sponsored plan effective June 15. Under §1.5000A–1(b), for purposes of section 5000A, D has minimum essential coverage for January, February, March, and June through December. D's continuous period without coverage is 2 months, April and May. April and May constitute a short coverage gap under paragraph (j)(2)(i) of this section.

Example 2. Continuous period of 3 months or more. The facts are the same as in *Example 1*, except D's coverage is not effective until July 1. D's continuous period without coverage is 3 months, April, May, and June. Under paragraph (j)(2)(i) of this section, April, May, and June are not included in a short coverage gap.

Example 3. Short coverage gap following exempt period. Taxpayer E is incarcerated from January 1 through June 2. E enrolls in an eligible employer-sponsored plan effective September 15. Under paragraph (d) of this section, E is exempt for the period January through June. Under paragraph (j)(2)(ii) of this section, E is treated as having minimum essential coverage for this period, and E's continuous period without minimum essential coverage is 2 months, July and August. July and August constitute a short coverage gap under paragraph (j)(2)(i) of this section.

Example 4. Continuous period covering more than one taxable year. Taxpayer F, an unmarried individual with no dependents, has minimum essential coverage for the period January 1 through October 15, 2016. F is without coverage until enrolling in an eligible employer-sponsored plan effective February 15, 2017. F files his Federal income tax return for 2016 on March 10, 2017. Under paragraph (j)(3)(ii) of this section, November and December of 2016 are treated as a short coverage gap. However, November and December of 2016 are included in the continuous period that includes January 2017. The continu-

ous period for 2017 is over 3 months and, therefore, is not a short coverage gap.

Example 5. Enrollment following loss of coverage. The facts are the same as in *Example 4* except F loses coverage on June 15, 2017. F enrolls in a new eligible employer-sponsored plan effective September 15, 2017. The continuous period without minimum essential coverage in July and August of 2017 is two months and, therefore, is a short coverage gap. Because January 2017 was not part of a short coverage gap, the earliest short coverage gap occurring in 2017 is the gap that includes July and August.

Example 6. Multiple coverage gaps. (i) The facts are the same as in *Example 5* except F has minimum essential coverage for November 2016. Under paragraph (j)(3)(ii) of this section, December 2016 is treated as a short coverage gap.

(ii) December 2016 is included in the continuous period that includes January 2017. This continuous period is two months and, therefore, January 2017 is the earliest month in 2017 that is included in a short coverage gap. Under paragraph (j)(2)(iii) of this section, the exemption under this paragraph (j) applies only to January 2017. Thus, the continuous period without minimum essential coverage in July and August of 2017 is not a short coverage gap.

(k) *Claiming exemptions from the shared responsibility payment*—(1) *Exemptions requiring certification by an Exchange*. An individual obtains a religious conscience exemption certification (described in paragraph (a) of this section) or a hardship exemption certification (described in paragraph (h) of this section) from the Exchange serving the rating area where the individual resides. To claim the exemption, the individual includes the information specified in published guidance of general applicability, see §601.601(d)(2) of this chapter, with the Federal income tax return for the taxable year that includes the months for which the exemption is sought.

(2) *Exemptions that may be certified by an Exchange or claimed on a Federal income tax return*—(i) *Exemption certified by an Exchange*. The exemptions for members of health care sharing ministries (described in paragraph (b) of this section), incarcerated individuals (described in paragraph (d) of this section), and members of Indian tribes (described in paragraph (g) of this section) may be certified in the manner and within the time specified in 45 CFR 155.610. To claim the exemption, an individual includes the information specified in published guidance of general applicability, see §601.601(d)(2) of this chapter, with the Federal income tax return for the taxable year that includes the months for which the exemption is sought.

(ii) *Exemption claimed on a Federal income tax return*. Alternatively, an individual, or a taxpayer who may claim the individual as a dependent for the taxable year, may claim the exemptions for members of health care sharing ministries (described in paragraph (b) of this section), incarcerated individuals (described in paragraph (d) of this section), and members of Indian tribes (described in paragraph (g) of this section) without certification by an Exchange by including the information specified in published guidance of general applicability, see §601.601(d)(2) of this chapter, with the Federal income tax return for the taxable year that includes the months for which the exemption is sought.

(3) *Exemptions that are claimed on Federal income tax returns*. The exemptions for individuals who lack affordable coverage (described in paragraph (e) of this section), individuals with household income below the applicable return filing threshold (described in paragraph (f) of this section), and individuals with short coverage gaps (described in paragraph (j) of this section) may be claimed only by including the information specified in published guidance of general applicability, see §601.601(d)(2) of this chapter, with the Federal income tax return for the taxable year that includes the months for which the exemption is sought. Taxpayers are not required to file Federal income tax returns solely to claim the exemption for individuals with household income below the applicable return filing threshold (described in paragraph (f) of this section).

§1.5000A–4 Computation of shared responsibility payment.

(a) *In general*. For each taxable year the shared responsibility payment is the lesser of—

(1) The sum of the monthly penalty amounts for each individual in the shared responsibility family; or

(2) The sum of the monthly national average bronze plan premiums for the shared responsibility family.

(b) *Monthly penalty amount*—(1) *In general. Monthly penalty amount* means, for a month that a nonexempt individual is not covered under minimum essential coverage, 1/12 multiplied by the greater of—

(i) The flat dollar amount; or

(ii) The excess income amount.

(2) *Flat dollar amount*—(i) *In general. Flat dollar amount* means the lesser of—

(A) The sum of the applicable dollar amounts for all individuals included in the taxpayer's shared responsibility family; or

(B) 300 percent of the applicable dollar amount (determined without regard to paragraph (b)(2)(iii) of this section) for the calendar year with or within which the taxable year ends.

(ii) *Applicable dollar amount*. Except as provided in paragraphs (b)(2)(iii) and (b)(2)(iv) of this section, the applicable dollar amount is—

(A) $95 in 2014;

(B) $325 in 2015; or

(C) $695 in 2016.

(iii) *Special applicable dollar amount for individuals under age 18*. If an individual has not attained the age of 18 on the first day of a month, the applicable dollar amount for the individual is equal to one-half of the applicable dollar amount (as expressed in paragraph (b)(2)(ii) of this section) for the calendar year in which the month occurs. For purposes of this paragraph (b)(2)(iii), an individual attains the age of 18 on the anniversary of the date when the individual was born. For example, an individual born on March 1, 1999, attains the age of 18 on March 1, 2017.

(iv) *Indexing of applicable dollar amount*. In any calendar year after 2016, the applicable dollar amount is $695 as increased by the product of $695 and the cost-of-living adjustment determined under section 1(f)(3) for the calendar year. For purposes of this paragraph (b)(2)(iv) of this section, the cost-of-living adjustment is determined by substituting "calendar year 2015" for "calendar year 1992" in section 1(f)(3)(B). If any increase under this paragraph (b)(2)(iv) is not a multiple of $50, the increase is rounded to the next lowest multiple of $50.

(3) *Excess income amount*—(i) *In general. Excess income amount* means the product of—

(A) The excess of the taxpayer's household income over the taxpayer's applicable filing threshold (as defined in §1.5000A–3(f)(2)); and

(B) The income percentage.

(ii) *Income percentage*. For purposes of this section, *income percentage* means—

(A) 1.0 percent for taxable years beginning in 2013;

(B) 1.0 percent for taxable years beginning in 2014;

(C) 2.0 percent for taxable years beginning in 2015; or

(D) 2.5 percent for taxable years beginning after 2015.

(c) *Monthly national average bronze plan premium. Monthly national average bronze plan premium* means, for a month for which a shared responsibility payment is imposed, 1/12 of the annual national average premium for qualified health plans that have a bronze level of coverage, would provide coverage for the taxpayer's shared responsibility family members who do not have minimum essential coverage for the month, and are offered through Exchanges for plan years beginning in the calendar year with or within which the taxable year ends.

(d) *Examples.* The following examples illustrate the provisions of this section. In each example the taxpayer's taxable year is a calendar year and all members of the taxpayer's shared responsibility family are ineligible for any of the exemptions described in §1.5000A–3 for a month.

Example 1. Unmarried taxpayer without minimum essential coverage. (i) In 2016 Taxpayer G is an unmarried individual with no dependents. G does not have minimum essential coverage for any month in 2016. G's household income is $120,000. G's applicable filing threshold is $12,000. The annual national average bronze plan premium for G is $5,000.

(ii) For each month in 2016, under paragraph (b)(2)(ii) of this section, G's applicable dollar amount is $695. Under paragraph (b)(2) of this section, G's flat dollar amount is $695 (the lesser of $695 and $2,085 ($695 x 3)). Under paragraph (b)(3) of this section, G's excess income amount is $2,700 (($120,000 - $12,000) x 0.025). Therefore, under paragraph (b)(1) of this section, the monthly penalty amount is $225 (the greater of $58 ($695/12) or $225 ($2,700/12)).

(iii) The sum of the monthly penalty amounts is $2,700 ($225 x 12). The sum of the monthly national average bronze plan premiums is $5,000 ($5,000/12 x 12). Therefore, under paragraph (a) of this section, the shared responsibility payment imposed on G for 2016 is $2,700 (the lesser of $2,700 or $5,000).

Example 2. Part-year coverage. The facts are the same as in *Example 1*, except G has minimum essential coverage for January through June. The sum of the monthly penalty amounts is $1,350 ($225 x 6). The sum of the monthly national average bronze plan premiums is $2,500 ($5,000/12 x 6). Therefore, under paragraph (a) of this section, the shared responsibility payment imposed on G for 2016 is $1,350 (the lesser of $1,350 or $2,500).

Example 3. Family without minimum essential coverage. (i) In 2016, Taxpayers H and J are married and file a joint return. H and J have three children: K, age 21, L, age 15, and M, age 10. No member of the family has minimum essential coverage for any month in 2016. H and J's household income is $120,000. H and J's applicable filing threshold is $24,000. The annual national average bronze plan premium for a family of 5 (2 adults, 3 children) is $20,000.

(ii) For each month in 2016, under paragraphs (b)(2)(ii) and (b)(2)(iii) of this section, the applicable dollar amount is $2,780 (($695 x 3 adults) + (($695/2) x 2 children)). Under paragraph (b)(2)(i) of this section, the flat dollar amount is $2,085 (the lesser of $2,780 and $2,085 ($695 x 3)). Under paragraph (b)(3) of this section, the excess income amount is $2,400 (($120,000 - $24,000) x 0.025). Therefore, under paragraph (b)(1) of this section, the monthly penalty amount is $200 (the greater of $173.75 ($2,085/12) or $200 ($2,400/12)).

(iii) The sum of the monthly penalty amounts is $2,400 ($200 x 12). The sum of the monthly national average bronze plan premiums is $20,000 ($20,000/12 x 12). Therefore, under paragraph (a) of this section, the shared responsibility payment imposed on H and J for 2016 is $2,400 (the lesser of $2,400 or $20,000).

Example 4. Change in shared responsibility family during the year. (i) The facts are the same as in *Example 3*, except J has minimum essential coverage for January through June. The annual national average bronze plan premium for a family of 4 (1 adult, 3 children) is $18,000.

(ii) For the period January through June 2016, under paragraphs (b)(2)(ii) and (b)(2)(iii) of this section the applicable dollar amount is $2,085 (($695 x 2 adults) + (($695/2) x 2 children)). Under paragraph (b)(2)(i) of this section, the flat dollar amount is $2,085 (the lesser of $2,085 or $2,085 ($695 x 3)).

(iii) For the period July through December 2016, the applicable dollar amount is $2,780 (($695 x 3 adults) + (($695/2) x 2 children)). Under paragraph (b)(2) of this section, the flat dollar amount is $2,085 (the lesser of $2,780 or $2,085 ($695 x 3)). Under paragraph (b)(3) of this section, the excess income amount is $2,400 (($120,000 - $24,000) x 0.025). Therefore, under paragraph (b)(1) of this section, for January through June the monthly penalty amount is $200 (the greater of $173.75 ($2,085/12) or $200 ($2,400/12)). The monthly penalty amount for July through December is $200 (the greater of $173.75 ($2,085/12) or $200 ($2,400/12)).

(iv) The sum of the monthly penalty amounts is $2,400 ($200 x 12). The sum of the monthly national average bronze plan premiums is $19,000 ((($18,000/12) x 6) + (($20,000/12) x 6))). Therefore, under paragraph (a) of this section, the shared responsibility payment imposed on H and J for 2016 is $2,400 (the lesser of $2,400 or $19,000).

Example 5. Eighteenth birthday during the year. (i) In 2016 Taxpayers S and T are married and file a joint return. S and T have one child, U, who turns 18 years old on June 28. No member of the family has minimum essential coverage for any month in 2016. S and T's household income is $60,000. S and T's applicable filing threshold is $24,000. The annual national average bronze plan premium for a family of 3 (2 adults, 1 child) is $15,000.

(ii) For the period January through June 2016, under paragraphs (b)(2)(ii) and (b)(2)(iii) of this section, the applicable dollar amount is $1,737.50 (($695 x 2 adults) + ($695/2) x 1 child)). Under paragraph (b)(2) of this section, the flat dollar amount is $1,737.50 (the lesser of $1,737.50 or $2,085 ($695 x 3)).

(iii) For the period July through December 2016, the applicable dollar amount is $2,085 ($695 x 3). Under paragraph (b)(2) of this section, the flat dollar amount is $2,085 (the lesser of $2,085 or $2,085 ($695 x 3)). Under paragraph (b)(3) of this section, the excess income amount is $900 (($60,000 - $24,000) x 0.025). Therefore, under paragraph (b)(1) of this section, for January through June the monthly penalty amount is $144.79 (the greater of $144.79 ($1,737.50/12) or $75 ($900/12)). The monthly penalty amount for July through December is $173.75 (the greater of $173.75 ($2,085/12) or $75 ($900/12)).

(iv) The sum of the monthly penalty amounts is $1,911.24 (($144.79 x 6) + ($173.75 x 6)). The sum of the monthly national average bronze plan premiums is $15,000 ($15,000/12 x 12). Therefore, under paragraph (a) of this section, the shared responsibility payment imposed on H and J for 2016 is $1,911.24 (the lesser of $1,911.24 or $15,000).

§1.5000A–5 Administration and procedure.

(a) *In general.* A taxpayer's liability for the shared responsibility payment for a month must be reported on the taxpayer's Federal income tax return for the taxable year that includes the month. The time for assessing the shared responsibility payment is the same as that prescribed by section 6501 for the taxable year to which the Federal income tax return on which the shared responsibility payment is to be reported relates. The shared responsibility payment is payable upon notice and demand by the Secretary, and except as provided in paragraph (b) of this section, is assessed and collected in the same manner as an assessable penalty under subchapter B of chapter 68 of the Internal Revenue Code. Therefore, the shared responsibility payment is not subject to deficiency procedures of subchapter B of chapter 63 of the Internal Revenue Code. Interest on this payment accrues in accordance with the rules in section 6601.

(b) *Special rules.* Notwithstanding any other provision of law—

(1) *Waiver of criminal penalties.* In the case of a failure by a taxpayer to timely pay the shared responsibility payment, the taxpayer is not subject to criminal prosecution or penalty for the failure.

(2) *Limitations on liens and levies.* If a taxpayer fails to pay the shared responsibility payment imposed by this section and §§1.5000A–1 through 1.5000A–4, the Secretary will not file notice of lien with respect to any property of the taxpayer, or

levy on any such property with respect to such failure.

(3) *Authority to offset against overpayment*. Nothing in this section prohibits the Secretary from offsetting any liability for the shared responsibility payment against any overpayment due the taxpayer, in accordance with section 6402(a).

(c) *Effective/applicability date*. This section and §§1.5000A–1 through 1.5000A–4 apply for months beginning after December 31, 2013.

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

(Filed by the Office of the Federal Register on January 30, 2013, 11:15 a.m., and published in the issue of the Federal Register for February 1, 2013, 78 F.R. 7314)

Definition of Terms

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

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

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

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

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

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

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

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

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

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

Abbreviations

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

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

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Key to Abbreviations:

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