Internal Revenue
bulletin

Bulletin No. 1999–11
March 15, 1999

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. 99–12, page 6.

Fringe benefits aircraft valuation formula. For purposes of section 1.61–21(g) of the Income Tax Regulations, relating to the rule for valuing noncommercial flights on employer-provided aircraft, the Standard Industry Fare Level (SIFL) cents-per-mile rates and terminal charges in effect for the first half of 1999 are set forth.

REG–104072–97, page 12.

Proposed regulations under section 7701 of the Code recharacterize, for tax purposes, financing arrangements involving fast-pay stock. A public hearing is scheduled for April 8, 1999.

REG–106388–98, page 27.

Proposed regulations under section 25A of the Code relate to the Hope Scholarship Credit and the Lifetime Learning Credit.

REG–106905–98, page 39.

Proposed regulations under section 861 of the Code relate to the allocation of loss recognized on the disposition of stock and other personal property. A public hearing is scheduled for May 26, 1999.

REG–114841–98, page 41.

Proposed regulations under section 663 of the Code provide that substantively separate and independent shares of different beneficiaries are to be treated as separate estates for purposes of computing distributable net income. A public hearing is scheduled for April 22, 1999.

Notice 99–14, page 7.

This notice withdraws guidance proposed in April 1992 under the passive foreign investment company (PFIC) rules of section 1291 of the Code relating to a mark-to-market election for regulated investment companies (RICs) that are shareholders of PFICs.

EMPLOYEE PLANS

REG–209103–89, page 10.

Proposed regulations under section 79 of the Code relate to the uniform premium rates used to calculate the cost of group-term life insurance provided to employees. A public hearing is scheduled for May 6, 1999.

EXEMPT ORGANIZATIONS

Announcement 99–20, page 53.

A list is given of organizations now classified as private foundations.

ADMINISTRATIVE

Rev. Proc. 99–18, page 7.

Election to treat certain debt substitutions as realization events. This procedure provides for an election that will allow taxpayers to treat a debt substitution, in certain circumstances, as a realization event even though it does not result in a significant modification under section 1.1001–3 of the Income Tax Regulations.

REG–114664–97, page 21.

Proposed regulations under section 42 of the Code relate to the low-income housing credit including the procedures for compliance monitoring by state and local housing agencies (Agencies), the requirements for making carryover allocations, and the rules for correction of administrative errors or omissions by Agencies. A public hearing is scheduled for May 27, 1999.

Continued on page 4

Finding Lists begin on page 58.
Announcement Relating to Court Decisions begins on page 5.
Announcement of Declaratory Judgment Proceedings Under Section 7428 begins on page 56.

Department of the Treasury
Internal Revenue Service

Mission of the Service

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

Introduction

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

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

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

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

The Bulletin is divided into four parts as follows:

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

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions, and 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.
With the exception of the Notice of Proposed Rulemaking and the disbarment and suspension list included in this part, none of these announcements are consolidated in the Cumulative Bulletins.

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

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

HIGHLIGHTS
OF THIS ISSUE—Continued

ADMINISTRATIVE—Continued

REG–119192–98, page 45.

Proposed regulations under sections 1201 and 1204 of the Internal Revenue Restructing and Reform Act of 1998 relate to the adoption by the IRS of a balanced system to measure organizational performance within the IRS. A public hearing is scheduled for May 13, 1999.

Announcement 99–21, page 55.

This document provides notice of a public hearing on proposed regulations, REG–246256–96, 1998–34 I.R.B. 9, under section 4958 of the Code relating to the excise tax on excess benefit transactions. The hearing is scheduled for March 16, 1999, at 1 p.m. (EDT), and will continue on March 17, 1999, at 1 p.m., if necessary.

Announcement Relating to Court Decisions

It is the policy of the Internal Revenue Service to announce at an early date whether it will follow the holdings in certain cases. An Action on Decision is the document making such an announcement. An Action on Decision will be issued at the discretion of the Service only on unappealed issues decided adverse to the government. Generally, an Action on Decision is issued where its guidance would be helpful to Service personnel working with the same or similar issues. Unlike a Treasury Regulation or a Revenue Ruling, an Action on Decision is not an affirmative statement of Service position. It is not intended to serve as public guidance and may not be cited as precedent.

Actions on Decisions shall be relied upon within the Service only as conclusions applying the law to the facts in the particular case at the time the Action on Decision was issued. Caution should be exercised in extending the recommendation of the Action on Decision to similar cases where the facts are different. Moreover, the recommendation in the Action on Decision may be superseded by new legislation, regulations, rulings, cases, or Actions on Decisions.

Prior to 1991, the Service published acquiescence or nonacquiescence only in certain regular Tax Court opinions. The Service has expanded its acquiescence program to include other civil tax cases where guidance is determined to be helpful. Accordingly, the Service now may acquiesce or nonacquiesce in the holdings of memorandum Tax Court opinions, as well as those of the United States District Courts, Claims Court, and Circuit Courts of Appeal. Regardless of the court deciding the case, the recommendation of any Action on Decision will be published in the Internal Revenue Bulletin.

The recommendation in every Action on Decision will be summarized as acquiescence, acquiescence in result only, or nonacquiescence. Both "acquiescence" and "acquiescence in result only" mean that the Service accepts the holding of the court in a case and that the Service will follow it in disposing of cases with the same controlling facts. However, "acquiescence" indicates neither approval nor disapproval of the reasons assigned by the court for its conclusions; whereas, "acquiescence in result only" indicates disagreement or concern with some or all of those reasons. Nonacquiescence signifies that, although no further review was sought, the Service does not agree with the holding of the court and, generally, will not follow the decision in disposing of cases involving other taxpayers. In reference to an opinion of a circuit court of appeals, a nonacquiescence indicates that the Service will not follow the holding on a nationwide basis. However, the Service will recognize the precedential impact of the opinion on cases arising within the venue of the deciding circuit.

The announcements published in the weekly Internal Revenue Bulletins are consolidated semiannually and annually. The semiannual consolidation appears in the first Bulletin for July and in the Cumulative Bulletin for the first half of the year, and the annual consolidation appears in the first Bulletin for the following January and in the Cumulative Bulletin for the last half of the year.

The Commissioner ACQUIESCES in the following decision:

Oshkosh Truck Corporation v. United States,
123 F.3d 1477 (Fed. Cir. 1997)[1]

[1] Acquiescence in result only relating to whether the 12-percent excise tax imposed under I.R.C. section 4052 on the first retail sale of specially designed trucks to the United States Army is computed by adding to the vehicle sales price a "presumed markup percentage" as decribed in subsections (b)(3) and (4) of section 4052 and Treas. Reg. Section 145.4052–1(d)(7).

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

Section 61.—Gross Income Defined

26 CFR 1.61–21: Taxation of fringe benefits.

Fringe benefits aircraft valuation formula. For purposes of section 1.61–21(g) of the Income Tax Regulations, relating to the rule of valuing noncommercial flights on employer-provided aircraft, the Standard Industry Fare Level (SIFL) cents-per-mile rates and terminal charges in effect for the first half of 1999 are set forth.

Rev. Rul. 99–12

For purposes of the taxation of fringe benefits under section 61 of the Internal Revenue Code, section 1.61-21(g) of the Income Tax Regulations provides a rule for valuing noncommercial flights on employer-provided aircraft. Section 1.61-21(g)(5) provides an aircraft valuation formula to determine the value of such flights. The value of a flight is determined under the base aircraft valuation formula (also known as the Standard Industry Fare Level formula or SIFL) by multiplying the SIFL cents-per-mile rates applicable for the period during which the flight was taken by the appropriate aircraft multiple provided in section 1.61-21(g)(7) and then adding the applicable terminal charge. The SIFL cents-per-mile rates in the formula and the terminal charge are calculated by the Department of Transportation and are reviewed semi-annually.

The following chart sets forth the terminal charges and SIFL mileage rates:

Period During Which the Flight Was Taken	*Terminal Charge*	*SIFL Mileage Rates*
1/1/99 – 6/30/99	$32.69	Up to 500 miles = $.1788 per mile
		501-1500 miles = $.1364 per mile
		Over 1500 miles = $.1311 per mile

DRAFTING INFORMATION

The principle author of this revenue ruling is Kathleen Edmondson of the Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations). For further information regarding this revenue ruling, contact Ms. Edmondson on (202) 622-6080 (not a toll-free call).

Section 1001.—Determination of Amount of and Recognition of Gain or Loss

26 CFR 1.1001–3: Modification of debt instruments.

The revenue procedure provides for an election that will allow taxpayers to treat a debt substitution, in certain circumstances, as a realization event even though it does not result in a significant modification under section 1.1001–3 of the Income Tax Regulations. See Rev. Proc. 99–18, page 7.

Section 1275.—Other Definitions and Special Rules

26 CFR 1.1275–2: Special rules relating to debt instruments.

The revenue procedure provides for an election that will allow taxpayers to treat a debt substitution, in certain circumstances, as a realization event even though it does not result in a significant modification under section 1.1001–3 of the Income Tax Regulations. See Rev. Proc. 99–18, page 7.

Part III. Administrative, Procedural, and Miscellaneous

Withdrawal of Guidance Under Section 1291 Relating to Mark-to-Market Elections for RICs

Notice 99–14

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Partial withdrawal of proposed regulations.

SUMMARY: This document withdraws §1.1291–8 of the notice of proposed rulemaking (INTL–941–86, 1992–1 C.B. 1124) that was published in the **Federal Register** on April 1, 1992, providing guidance under the passive foreign investment company (PFIC) rules relating to the mark to market election for regulated investment companies (RICs) that are shareholders of PFICs.

DATES: Section 1.1291–8 of the proposed regulations published at 57 FR 11024 (April 1, 1992) is withdrawn February 2, 1999.

FOR FURTHER INFORMATION CONTACT: Robert Laudeman of the Office of Associate Chief Counsel (International), Internal Revenue Service, 1111 Constitution Ave., NW, Washington, DC 20224. Telephone (202) 622-3840, not a toll-free number.

SUPPLEMENTARY INFORMATION:

Background

On April 1, 1992 (57 F.R. 110224), the IRS issued proposed regulations providing, in part, an election under which certain RICs could mark to market their stock in certain PFICs. In the Taxpayer Relief Act of 1997 Congress enacted section 1296(e)(2) of the Internal Revenue Code, which allows certain RICs to elect to mark to market their PFIC stock. Accordingly, the IRS is withdrawing proposed regulations §1.1291-8. Future guidance will be issued providing rules for all PFIC shareholders, including RICs, on how to mark to market certain PFIC stock.

Drafting Information

The principal author of this withdrawal notice is Robert Laudeman, Office of the Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in developing the withdrawal notice.

* * * * *

Partial Withdrawal of Proposed Amendments to the Regulations

Accordingly, under the authority of 26 U.S.C. 7805, §1.1291–8 of the proposed amendments to 26 CFR part 1 published at 57 F.R. 11024 (April 1, 1992), is withdrawn.

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on February 1, 1999, 8:45 a.m., and published in the issue of the Federal Register for February 2, 1999, 64 F.R. 5015)

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26 CFR 601.601: Rules and regulations.
(Also Part I, sections 1001; 1.1001–3, 1.1275–2.)

Rev. Proc. 99–18

SECTION 1. PURPOSE

This revenue procedure provides for an election that will facilitate the substitution of some or all of the debt instruments from two or more outstanding issues of debt with debt instruments from a new issue. Under the election, taxpayers can treat a substitution of debt instruments, in certain circumstances, as a realization event for federal income tax purposes even though it does not result in a significant modification under § 1.1001–3 of the Income Tax Regulations (and, therefore, is not an exchange for purposes of § 1.1001–1(a)). Under section 4 of this revenue procedure, taxpayers do not recognize any realized gain or loss on the date of the substitution. Instead, the gain or loss generally is taken into account as income or deductions over the term of the new debt instruments.

SECTION 2. BACKGROUND

.01 Under § 1.1001–1(a), gain or loss is realized from the exchange of property for other property differing materially either in kind or in extent.

.02 Section 1.1001–3 provides rules to determine whether a modification of the terms of a debt instrument results in an exchange of the original debt instrument for a modified instrument that differs materially either in kind or in extent. Under § 1.1001–3, a modification of a debt instrument results in an exchange for purposes of § 1.1001–1(a) if the modification is significant. A modification that is not significant does not result in an exchange for purposes of § 1.1001–1(a). Section 1.1001–3 applies to any modification of a debt instrument, regardless of the form of the modification (including an exchange of a new instrument for an existing instrument).

.03 Under § 1.1001–3(c), a modification means any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or a holder of a debt instrument, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise.

.04 In general, a modification of a debt instrument is a significant modification under § 1.1001–3 only if, based on all the facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant. Section 1.1001–3(e) provides rules to determine whether certain modifications, such as a change in yield or the timing of payments, constitute significant modifications.

.05 If the terms of a debt instrument are modified to defer one or more payments and the modification does not result in an exchange under § 1.1001–3, § 1.1275–2(j) provides rules to account for the modified debt instrument. Under § 1.1275–2(j), solely for purposes of §§ 1272 and 1273 of the Internal Revenue Code, the debt instrument is treated as retired and then reissued on the date of the modification for an amount equal to the instrument's adjusted issue price on that date. As a result, the debt instrument is retested for original issue discount based on the instrument's adjusted issue price and the remaining payments, as modified, to be made on the instrument. If the debt instrument has original issue discount as a result of the modification, both the issuer and the holder account for the original issue discount over the remaining term of the instrument. *See* §§ 163(e) and 1272.

.06 An issuer may want to refinance and consolidate debt instruments ("old debt") from two or more outstanding issues of debt into debt instruments ("new debt") from a single new issue. In general, if the terms of the new debt are not materially different from the terms of the old debt, substituting the new debt for the old debt does not result in a significant modification of the old debt under § 1.1001–3. Therefore, the substitution of the new debt for the old debt in the consolidation is not a realization event for federal income tax purposes. However, under § 1.1275–2(j), some or all of the new debt may have original issue discount in varying amounts, depending upon the terms of the old debt for which the new debt was substituted. As a result, the new debt may not be fungible.

SECTION 3. SCOPE

This revenue procedure applies to the substitution of new debt for old debt if all of the following conditions are satisfied:

.01 Debt instruments from a single new issue are being substituted for debt instruments from two or more old issues of debt. (It is not necessary, however, for any single holder of the old debt to have held debt instruments from more than one of the old issues.)

.02 The substitution does not result in a significant modification of the old debt under § 1.1001–3 and, therefore, is not a realization event under § 1.1001–1.

.03 The new debt and the old debt are publicly traded (within the meaning of § 1.1273–2(f)).

.04 The old debt was issued at par or with a de minimis amount of original issue discount or premium. (For purposes of this condition, the de minimis amount for premium is determined using the principles of § 1.1273–1(d).)

.05 The new debt is issued at par or with a de minimis amount of original issue discount or premium. (For purposes of this condition, the issue price of the new debt is determined under § 1.1273–2 rather than under § 1.1275–2(j), and the de minimis amount for premium is determined using the principles of § 1.1273–1(d).)

.06 Neither the new debt nor the old debt is—

(1) a contingent payment debt instrument (within the meaning of § 1.1275–4),

(2) a tax-exempt obligation (as defined in § 1275(a)(3)), or

(3) a convertible debt instrument (within the meaning of § 1.1272–1(e)).

.07 All payments on the old debt and the new debt are denominated in, or determined solely by reference to, U.S. dollars, and the functional currency of the business unit issuing the new debt is the U.S. dollar.

.08 The issuer and one or more holders of the old debt make the election provided in section 4.01 of this revenue procedure.

SECTION 4. APPLICATION

.01 *Election.*

(1) *Manner of making the election.* The issuer and the holders make the election under this revenue procedure by agreeing in writing to treat the substitution as a realization event for federal income tax purposes and to comply with the provisions of this revenue procedure. The written agreement must be entered into no later than the last day of the month in which the substitution occurs.

For example, the written agreement to make the election may be evidenced by a statement in the offering documents for the substitution that—

(a) the issuer, by distributing the documents, elects under this revenue procedure to treat the substitution as a realization event for federal income tax purposes,

(b) any holder of old debt that tenders its old debt for new debt as part of the substitution thereby makes the election under this revenue procedure, and

(c) the issuer and the holders who have tendered their old debt for the new debt ("electing holders") will comply with the provisions of this revenue procedure.

(2) *Statement attached to return.* If an election is made under section 4.01(1) of this revenue procedure, the issuer must attach a signed statement to its timely filed (including extensions) federal income tax return for the taxable year in which the substitution occurs. On the statement, the issuer must—

(a) identify the old debt for which new debt was substituted,

(b) identify the new debt that was substituted for the old debt,

(c) indicate the issue price of the new debt, and

(d) indicate that the election was made under this revenue procedure.

.02 *Treatment of substitution.* If an election is made under this revenue procedure, the issuer and the electing holders must report the substitution for federal income tax purposes as a repurchase of the old debt in exchange for the new debt in the taxable year in which the substitution occurs. However, the issuer must account for this deemed exchange under the rules described in section 4.03 of this revenue procedure and each electing holder must account for this deemed exchange under the rules described in section 4.04 of this revenue procedure.

.03 *Issuer's treatment.* The issuer must take into account over the term of the new debt any difference between the adjusted issue prices of the old debt and the issue price of the new debt (as determined under § 1.1273–2). If the aggregate issue price of the new debt that is transferred to electing holders as a substitute for the old debt is greater than the aggregate adjusted issue prices of the old debt for which it is substituted, the issuer treats the difference as a reduction in the aggregate issue price of the new debt. As a result, the difference is taken into account by the issuer over the term of the new debt as increased original issue discount or as reduced bond issuance premium (within the meaning of § 1.163–13). If the aggregate issue price of the new debt that is transferred to electing holders as a substitute for the old debt is less than the aggregate adjusted issue prices of the old debt for which it is substituted, the issuer treats the difference as an increase in the aggregate issue price of the new debt. As a result, the difference is taken into account by the issuer over the term of the new debt as reduced original issue discount or increased bond issuance premium.

.04 *Electing holder's treatment.*

(1) *In general.* Notwithstanding any provision of subtitle A of the Internal Revenue Code (including §§ 356(a) and 1276(a)), an electing holder does not rec-

ognize any gain or loss as a result of the deemed exchange. Instead, the holder's basis (immediately after the substitution) in the new debt is the same as the holder's adjusted basis (determined as of the date of the substitution) in the debt instruments for which the new debt was substituted. In addition, the holder's holding period for the new debt includes the holder's holding period for the old debt.

(2) *Market discount.*

(a) *In general*. If the stated redemption price at maturity of the new debt (as determined under § 1.1273–1(b)) is greater than the holder's basis (immediately after the substitution) in the new debt, the holder treats the difference as market discount on the new debt and the new debt as a market discount bond (unless the amount of the discount is a de minimis amount within the meaning of § 1278(a)(2)(C)). *See* §§ 1276 and 1278 for the treatment of market discount. (The issue date of the old debt rather than the issue date of the new debt is used to determine whether the new debt is a short-term obligation for purposes of § 1278(a)(1)(B)(i).) See section 4.04(2)(b) below for the treatment of any accrued market discount on the old debt.

(b) *Accrued market discount.* The rules in this section 4.04(2)(b) apply if, as of the date of the substitution, there is any accrued market discount on the old debt that has not been taken into account by the holder as ordinary income. If, under section 4.04(2)(a) above, there is no market discount on the new debt or the amount of any market discount on the new debt is a de minimis amount, the amount of accrued market discount on the new debt is zero, and the accrued market discount on the old debt is ignored. If, under section 4.04(2)(a) above, the amount of market discount on the new debt is more than a de minimis amount, the lesser of this market discount and the accrued market discount on the old debt is treated by the holder, as of the date of the substitution, as accrued market discount on the new debt. (Solely for purposes of determining the accruals of any additional market discount on the new debt, the holder's basis is increased by the amount of the accrued market discount on the old debt that is treated as accrued market discount on the new debt.)

(3) *Bond premium.* If the holder's basis in the new debt (immediately after the substitution) is greater than the stated redemption price at maturity of the new debt (as determined under § 1.1273–1(b)), the holder treats the difference as bond premium on the new debt. *See* §§ 1.171–1 through 1.171–5 for the treatment of bond premium.

SECTION 5. EFFECTIVE PERIOD

This revenue procedure applies to substitutions that occur between March 1, 1999, and June 30, 2000.

SECTION 6. REQUEST FOR COMMENTS

The Internal Revenue Service requests comments on this revenue procedure, including comments on whether this revenue procedure should be made permanent. Persons that wish to comment on this revenue procedure may submit comments by May 31, 1999, to: CC:DOM:CORP:R (RP–102721–99), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (RP–102721–99), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington DC. Alternatively, comments may be submitted via the Internet by selecting the "Tax Regs" option of the IRS Home Page or by submitting them directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. Comments will be available for public inspection.

SECTION 7. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget (OMB) in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1647.

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

The collections of information in this revenue procedure are in section 4.01. This information is required to determine whether a taxpayer has made the election under this revenue procedure. The collections of information are required to obtain a benefit. The likely respondents are business or other for-profit institutions.

The estimated total annual reporting and/or recordkeeping burden is 75 hours.

The estimated annual burden per respondent/recordkeeper varies from 1/2 hour to 1 hour, depending on individual circumstances, with an estimated average of 3/4 hour. The estimated number of respondents is 100.

The estimated annual frequency of responses is on occasion.

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

CONTACT PERSON

For further information regarding this revenue procedure, contact William E. Blanchard of the Office of Assistant Chief Counsel (Financial Institutions and Products) on (202) 622-3950 (not a toll free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking and Notice of Public Hearing

Group Term Insurance; Uniform Premiums

REG–209103–89

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations that revise the uniform premium table used to calculate the cost of group-term life insurance coverage provided to an employee by an employer. These proposed regulations provide guidance to employers who must use the uniform premium table to calculate the cost of group-term insurance includible in the gross income of their employees. This document also provides notice of a public hearing on these proposed regulations.

DATES: Comments must be received by April 13, 1999. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for May 6, 1999, must be received by April 15, 1999. The IRS requests comments on the clarity of the proposed rule and how it may be made easier to read.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–209103–89), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (REG–209103–89), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The public hearing will be held in Room 2615, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Betty J. Clary, (202) 622-6070; concerning submissions and the hearing, Michael Slaughter, (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations under section 79 of the Internal Revenue Code. These proposed regulations revise the uniform premium rates used to calculate the cost of group-term life insurance provided to employees. Section 79 generally permits an employee to exclude from gross income the cost of $50,000 of group-term life insurance coverage. The remaining cost of the group-term life insurance is included in the employee's gross income to the extent it exceeds the amount, if any, paid by the employee for the coverage. The cost of the group-term insurance is determined on the basis of five-year age brackets prescribed by regulations.

The uniform premiums are set forth in the regulations in Table I entitled "Uniform Premiums for $1,000 of Group-term Life Insurance Protection." Section 1.79–3(d)(2). A table was initially published on July 6, 1966 (31 F.R. 9199), and the table was revised on December 6, 1983 (48 F.R. 54595). The December 6, 1983 revision was made to reflect changes in mortality since 1966, using 1975-1979 mortality experience reported by the Society of Actuaries. The December 6, 1983 revision extrapolated the reported mortality experience to 1982, and reflected a revised gender mix and load factor. For years after 1988, new factors were added to the table for ages above 64, pursuant to section 5013 of the Technical and Miscellaneous Revenue Act of 1988. See 57 F.R. 33635 (July 30, 1992).

The IRS and Treasury have concluded that the section 79 table should be revised because there has been a significant improvement in mortality since the 1975-1979 period (even after taking into account the projection to 1982). This conclusion is based on information on the group-term life mortality experience of 13 issuers covering the 1985-1989 period, as compiled by the Society of Actuaries, as well as other data on mortality trends. The IRS and Treasury contemplate continuing to monitor future changes in mortality experience and would expect to update the section 79 table when a significant change in the cost of group-term life insurance is evidenced.

Summary of Regulations

These proposed regulations revise the uniform premium table used to calculate the cost of group-term life insurance coverage provided to an employee by an employer. The proposed new table has been developed based on mortality experience for individuals covered by group-term life insurance during the 1985-1989 period, as reflected in a Society of Actuaries report. The mortality rates were adjusted for improvements in mortality from 1988 (the weighted midpoint for the data used in the1985-89 study) through 2000, based on the same rates of mortality improvement that were adopted by the Society of Actuaries Group Annuity Valuation Table Task Force for the period 1988-1994. Separate mortality rates were derived for males and females, and the section 79 table reflects a 50/50 blend of the male and female mortality rates. The resulting mortality projections have been adjusted to reflect a 10 percent load factor. The uniform premium rates under the proposed revision would be lower in all age groups than the rates under the current section 79 regulations.

Comments are requested regarding the proposed premium rates.

Proposed Effective Date

These regulations are proposed to be effective July 1, 1999. A special effective date rule applies to any policy of life insurance issued under a plan in existence before the proposed general July 1, 1999 effective date if the policy would not be treated as carried directly or indirectly by an employer under section 1.79–0 of the Income Tax Regulations using the current section 79 table. In this case, if the special rule applies, the policy would continue to be treated as not carried directly or indirectly by an employer until the first plan year that begins after July 1, 1999.

Because income imputed under section 79 is generally subject to FICA tax which is withheld from the employee's pay, and because the withholding often is applied periodically from payrolls during the year, many employers will need to modify their payroll-based withholding systems and related information collection procedures before the effective date. The proposed July 1, 1999 effective date is intended to provide the benefits of having the lower income inclusions take effect as early as possible while avoiding the additional costs that would arise if employers did not have adequate time to implement the changes before the effective date (which would necessitate special adjustments to correct overwithholding that would have occurred after the effective date and before implementation of the new table).

Comments are requested regarding the proposed effective date.

Special Analyses

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

Comment and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to electronic and written comments (a signed original and eight (8) copies) that are timely submitted to the IRS. The IRS and Treasury specifically request comments on the clarity of the proposed regulations and how it may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for Thursday, May 6, 1999, at 10:00 a.m. in Room 2615, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC. Due to building security procedures, visitors must enter the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written comments and an outline of the topics to be discussed and the time devoted to each topic (a signed original and eight (8) copies) by April 15, 1999.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

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

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Proposed Amendments to the Regulations

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

PART 1–INCOME TAXES

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

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

Par. 2. Section 1.79–3 is amended as follows:

1. Paragraph (d)(2) is revised.

2. Paragraph (e) and (f) are redesignated as paragraph (f) and (g) respectively.

3. New paragraph (e) is added.

The revision and addition read as follows:

§1.79–3 Determination of amount equal to cost of group-term life insurance.

* * * * *

(d) * * *

(2) For the cost of group-term life insurance provided after June 30, 1999, the following table sets forth the cost of $1,000 of group-term life insurance provided for one month, computed on the basis of 5-year age brackets. See 26 CFR 1.79–3(d)(2) in effect prior to [DATE FINAL REGULATIONS ARE EFFECTIVE] and contained in the 26 CFR, part1, edition revised as of April 1, 1998, for a table setting forth the cost of group-term life insurance provided before July 1, 1999. For purposes of Table I, the age of the employee is the employee's attained age on the last day of the employee's taxable year.

TABLE I. – UNIFORM PREMIUMS FOR $1,000 OF GROUP-TERM LIFE INSURANCE PROTECTION

5-year age bracket	Cost per $1,000 of protection for one month
Under 25	$0.05
25 to 29	.06
30 to 34	.08
35 to 39	.09
40 to 44	.10
45 to 49	.15
50 to 54	.23
55 to 59	.43
60 to 64	.66
65 to 69	1.27
70 and above	2.06

* * * * *

(e) *Effective date*—(1) *General effective date for table.* Except as provided in paragraph (e)(2) of this section, the table in paragraph (d)(2) of this section is effective July 1, 1999.

(2) *Effective date for table for purposes of section 1.79–0.* A policy of life insurance issued under a plan in existence on June 30, 1999, which would not be treated as carried directly or indirectly by an employer under §1.79–0, taking into

account the Table I in effect on that date, shall continue to be treated as a policy that is not carried directly or indirectly by the employer until the first plan year beginning after the general effective date in paragraph (e)(1) of this section.

* * * * *

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on January 12, 1999, 8:45 a.m., and published in the issue of the Federal Register for January 13, 1999, 64 F.R. 2164)

Notice of Proposed Rulemaking and Notice of Public Hearing

Recharacterizing Financing Arrangements Involving Fast-Pay Stock

REG–104072–97

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations that recharacterize, for tax purposes, financing arrangements involving fast-pay stock. The regulations are necessary to prevent taxpayers from using fast-pay stock to achieve inappropriate tax avoidance. The regulations affect corporations that issue fast-pay stock, holders of fast-pay stock, and other shareholders that may claim tax benefits purported to result from arrangements involving fast-pay stock. This document also provides notice of a public hearing on the proposed regulations.

DATES: Written comments must be received by April 6, 1999. Outlines of topics to be discussed at the public hearing scheduled for April 8, 1999, at 10 a.m. must be received by March 18, 1999.

ADDRESSES: Send submissions: to CC:DOM:CORP:R (REG–104072–97), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG–104072–97), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments via the Internet by selecting the "Tax Regs" option of the IRS Home Page or by submitting them directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The public hearing will be held in room 2615, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Jonathan Zelnik at (202) 622-3940; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, LaNita VanDyke at (202) 622-7190 (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** for review 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, OP:FS:FP, Washington, DC 20224. Comments on the collection of information should be received by March 8, 1999. Comments are specifically requested concerning:

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

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

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

How the burden of complying with the 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 is in §1.7701(l)–3(f) and §1.7701(l)–3(g). The collection of information is mandatory. The likely respondents are individuals, businesses, and other organizations.

Estimated total annual burden: 50 hours
Estimated average annual burden per respondent: 1 hour
Estimated number of respondents: 50
Estimated annual frequency of responses: Annually

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

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

Background

On February 27, 1997, the IRS issued Notice 97–21, 1997–1 C.B. 407, which relates to financing arrangements involving fast-pay stock. Among other things, the notice informs the public that the IRS and Treasury Department expect to issue regulations recharacterizing these arrangements to prevent tax avoidance. Notice 97–21 requested comments, but none have been received.

Explanation of Provisions

A. *TAX-AVOIDANCE ARRANGEMENTS USING FAST-PAY STOCK*

Notice 97–21 addresses two-party financing arrangements that are structured as multi-party arrangements to let one or more of the parties avoid tax. Instead of one party directly providing financing to the other, they both acquire stock (with different characteristics) in a conduit entity. The arrangement is structured so that the party providing the financing has a decreasing claim on the conduit entity (and its assets) while the party receiving the financing has an increasing claim on the conduit entity (and its assets). Economically, both parties benefit from the conduit entity's income. For tax purposes, however, the entity's income is allocated almost entirely to the party providing the financing, allowing the other party to claim unwarranted tax benefits.

Notice 97–21 describes in detail a typical fast-pay stock financing arrangement. The parties to the arrangement include: (1) a person seeking financing (the sponsor), (2) investors who are willing to provide financing and typically are not subject to federal income tax (the investors), and (3) a corporation that is generally subject to tax only at the shareholder level (a conduit entity). The conduit entity issues a class of self-amortizing stock (the fast-pay stock) to the investors and a class of other stock (the benefited stock) to the sponsor. The fast-pay stock is structured so that during an initial period, the dividends made with respect to the stock are substantial and relatively certain while the dividends made with respect to the benefited stock are insignificant. After the initial period, the dividend rate of the fast-pay stock, the stock's effective redemption value, or both, decline.

Economically, the fast-pay stock is self-amortizing because the distributions made with respect to the fast-pay stock are in part a return on the investors' investment and in part a return of their investment. For tax purposes, however, the parties characterize the fast-pay stock distributions entirely as dividends (that is, entirely as a return on the investment). Consequently, the investors' reported taxable income—overstated dividend income followed by an overstated capital loss on disposition of the fast-pay stock— fails to clearly reflect their economic income. (Investors that are tax-exempt suffer no disadvantage from this arrangement.)

Characterizing the distributions made with respect to the fast-pay stock solely as dividends has the corresponding effect of understating the taxable income on the benefited stock (the stock held by the sponsor) during the initial period. Instead of receiving dividends attributable to its share of the conduit entity's income, the sponsor's economic income takes the form of an increasing ownership interest in the conduit entity. Because the fast-pay stock is economically self-amortizing, each distribution reduces the investors' claim on the conduit entity (and its assets) and increases the sponsor's claim. By treating a fast-pay arrangement according to its form, the sponsor reports taxable income that fails to clearly reflect its economic income. An individual sponsor, for example, reports little or no dividend income. Instead, the individual reports gain on disposing of its benefited stock; thus, deferring tax on its economic income and converting that income from ordinary to capital. A corporate sponsor not only reports little or no dividend income, but can avoid reporting gain on the disposition of its benefited stock, thereby entirely eliminating tax on its economic income. (If a corporate sponsor has a sufficient interest in the conduit entity, the sponsor may succeed to the conduit entity's assets tax-free by liquidating or reorganizing the conduit entity; thus, avoiding a taxable disposition of the benefited stock).

In substance, the investors (the fast-pay shareholders) are financing the sponsor's investment in the conduit entity. Although nominally shareholders in the conduit entity, the investors have a limited, diminishing claim to the entity (and its assets). The sponsor's claim, by contrast, is residual and long-term. Thus, a fast-pay arrangement is effectively a leveraged arrangement in which the sponsor uses untaxed income from the conduit entity to repay the investors.

B. *THE PROPOSED REGULATIONS*

1. *In General*

To prevent the avoidance of tax, the Secretary may issue regulations under section 7701(l) recharacterizing any multiple-party financing transaction as a transaction directly among any two or more of the parties. The proposed regulations exercise this authority by recharacterizing certain fast-pay arrangements. A fast-pay arrangement is any financing arrangement in which a corporation has outstanding two or more classes of stock, one of which is fast-pay stock. The regulations identify fast-pay arrangements and recharacterize certain of them as arrangements directly between the holders of the fast-pay stock and the other shareholders (the benefited shareholders) in the corporation. The regulations also impose reporting requirements on certain corporations with outstanding fast-pay stock and on certain shareholders that participate in fast-pay arrangements. These reporting requirements apply to all fast-pay arrangements, whether or not they are subject to recharacterization.

Notice 97–21 describes specific models for recharacterizing fast-pay arrangements. For purposes of determining the income of the shareholders of a corporation with outstanding fast-pay stock, these models ignore the separate existence of the corporation and treat the fast-pay shareholders and benefited shareholders as owning the corporation's underlying assets. Although this approach prevents tax avoidance, the IRS and Treasury Department have concluded that it may not best reflect the financing relationship between the fast-pay shareholders and the benefited shareholders. In addition, the approach of the notice may be difficult for taxpayers to apply if the corporation has a complex capital structure, multiple assets (including active businesses), or both.

To address these concerns, the proposed regulations treat the fast-pay shareholders as acquiring instruments issued by the benefited shareholders instead of acquiring interests in the assets of the corporation. This approach better reflects the financing relationship between the fast-pay shareholders and the benefited shareholders. It also removes the burden of determining each party's ownership interest in the assets of the corporation. Thus, the regulations provide an approach that is easier to apply and more narrowly tailored than the models described in Notice 97–21.

2. *Fast-Pay Stock and Benefited Stock*

Under the proposed regulations, stock is fast-pay stock if it is structured to provide for dividends that economically represent a return (in whole or in part) of the holder's investment rather than only a return on the holder's investment. Stock is presumed to be fast-pay stock if it has, by design, a dividend rate that is reasonably expected to decline, or an issue price that exceeds the amount at which the holder can be compelled to dispose of the stock. A taxpayer may rebut these presumptions only by clearly showing that no dividend represents an economic return (in whole or in part) of the holder's investment.

Generally, whether stock is fast-pay stock must be determined based on all the facts and circumstances, including any related agreements such as options or forward contracts. A related agreement is any direct or indirect, oral or written, agreement between the holder of the stock and the issuing corporation, or between the holder of the stock and one or more other shareholders in the corporation. The determination that stock is fast-pay stock is made when the stock is issued, and whenever there is a significant modification in the terms of the stock or the related agreements, or a significant change in the relevant facts and circumstances.

The proposed regulations define benefited stock by reference to fast-pay stock. With respect to a class of fast-pay stock, all other stock in the corporation (including any other class of fast-pay stock) is benefited stock. For fast-pay arrangements in which there is more than one class of benefited stock, the parties must apply the general recharacterization rules among the different classes as appropriate to match the arrangement's economic substance.

3. *Fast-Pay Arrangements Subject to Recharacterization*

Under the proposed regulations, if the corporation with outstanding fast-pay stock is either a regulated investment company (RIC) or a real estate investment trust (REIT), the fast-pay arrangement is automatically recharacterized. If the corporation is neither a RIC nor a REIT, the Commissioner may (at the Commissioner's discretion) recharacterize the fast-pay arrangement in cases where the Commissioner determines that a principal purpose for the structure of the fast-pay arrangement is the avoidance of tax. This rule applies to all parties to a fast-pay arrangement, without regard to whether such parties acquired their interests as part of an initial offering or later (by purchase or other transfer).

By not automatically recharacterizing all fast-pay arrangements, the regulations prevent taxpayers from using the recharacterization rules for other tax avoidance purposes. For example, shareholders of a controlled foreign corporation cannot circumvent the purposes of United States tax law (including treaties) by using the recharacterization rules to exploit inconsistencies between the treatment of a fast-pay arrangement by the United States and foreign jurisdictions. It is expected that the Commissioner will closely scrutinize fast-pay arrangements in which the corporation with outstanding fast-pay stock is a foreign corporation.

4. *Model for Recharacterizing Fast-Pay Arrangements*

a. *In General*

The proposed regulations treat the fast-pay shareholders as holding financing instruments issued by the benefited shareholders rather than as holding fast-pay stock in the corporation. The corporation is the paying agent on the financing instruments but has no other relationship to the fast-pay shareholders.

Under the proposed regulations, the financing instruments have the same payment terms as the fast-pay stock. The timing and amount of payments made with respect to the financing instruments, therefore, match the timing and amount of distributions made with respect to the fast-pay stock. Nothing in the regulations characterizes the financing instruments. The character of the financing instruments (for example, stock or debt) must be determined under general tax principles and depends on all the facts and circumstances.

The benefited shareholders are treated as first issuing the financing instruments in exchange for cash equal to the fair market value of the fast-pay stock (taking into account any related agreements), and then as contributing the cash to the corporation (thereby increasing their basis in the benefited stock). Distributions made with respect to the fast-pay stock are treated as first made with respect to the benefited stock, and then as used by the benefited shareholders to make payments on the financing instruments.

b. *Rule for Multiple Classes of Benefited Stock*

The proposed regulations do not describe detailed rules for fast-pay arrangements in which there is more than one class of benefited shareholders. Instead, as mentioned before, the regulations provide a general rule that requires recharacterization among the different classes as appropriate to match the economic substance of the fast-pay arrangement.

c. *Rules for Disposition of Benefited Stock*

The proposed regulations provide special rules for dispositions of benefited stock. On the sale of benefited stock, in addition to any consideration actually received, the seller is treated as receiving the amount necessary to terminate its position with respect to the financing instruments at fair market value. Similarly, the buyer is treated as paying that amount and as issuing new financing instruments to the fast-pay shareholders.

d. *Rule Preserving Pre-effective Date Gain*

The proposed regulations provide a special basis adjustment rule to ensure that unrealized gain on benefited stock is not inappropriately eliminated. Because the regulations do not apply to amounts accrued or paid in taxable years ending before February 27, 1997 (pre-effective years), a benefited shareholder will have economic income, but not taxable income, attributable to pre-effective years if the form of a fast-pay arrangement is respected for those years. This economic income is reflected as unrealized gain in the benefited stock.

Absent a special basis adjustment rule, the general recharacterization rule would eliminate this unrealized gain. Although the regulations do not apply to amounts accrued or paid in pre-effective years, the regulations recharacterize fast-pay arrangements from their inception. Thus, in cases in which the fast-pay arrangement was entered into in a pre-effective year, the general recharacterization rule increases a benefited shareholder's basis in its stock as of the inception of the transaction, even though the regulations do not require the benefited shareholder to include deemed dividend distributions attributable to the pre-effective years. Consequently, this increase in basis without corresponding dividend income eliminates the unrealized gain from the pre-effective years.

To preserve the unrealized gain resulting from the economic income attributable to pre-effective years, the proposed regulations provide a special basis adjustment rule. After taking into account any basis increase under the general rule, a benefited shareholder must decrease its basis in its benefited stock by the amount (if any) that (1) its taxable income attributable to the fast-pay arrangement for pre-effective years, computed by recharacterizing the fast-pay arrangement under the regulations, exceeds (2) its taxable income attributable to the fast-pay arrangement for pre-effective years, computed without applying the recharacterization rules of the regulations. In this way, a benefited shareholder's economic income attributable to taxable years before the effective date of the regulations is not eliminated by the basis provisions of the general recharacterization rules and may be realized when the benefited shareholder disposes of its benefited stock.

e. *Rule Prohibiting the Affirmative Use of These Regulations to Avoid Tax Imposed by the Code*

The proposed regulations prohibit a taxpayer from affirmatively using the automatic recharacterization rules if a principal purpose for using such rules is the avoidance of any tax imposed by the Code. With respect to such a taxpayer, the Commissioner may depart from the automatic recharacterization rules and treat (for all purposes of the Code) the fast-pay arrangement in accordance with its form or its economic substance. This anti-abuse rule applies on a taxpayer-by-taxpayer basis. For example, if a foreign person acquires fast-pay stock in a REIT and a principal purpose for acquiring such stock is to reduce United States withholding taxes by applying the automatic recharacterization rules, the Commissioner may, for purposes of determining the foreign person's United States tax consequences (namely, withholding tax), depart from the automatic recharacterization rules and treat the foreign person as holding fast-pay stock in the REIT.

5. *Withholding*

A corporation that issues fast-pay stock is a withholding agent for payments made (or deemed made) under a fast-pay arrangement. Generally, if a fast-pay arrangement is recharacterized under the automatic recharacterization rules, a withholding agent must withhold in accordance with the transaction as recharacterized. A different rule applies, however, if the withholding agent knows or has reason to know that any taxpayer entered into the fast-pay arrangement with a principal purpose of using the recharacterization rules to avoid tax under section 871(a) or section 881. In that case, for each payment made (or deemed made) to such taxpayer under the arrangement, the withholding agent must withhold under section 1441 or section 1442 the higher of (1) the amount of withholding that applies to such payment determined under the form of the arrangement, or (2) the amount of withholding that applies to such payment determined under the automatic recharacterization rules. Also, when the withholding agent knows or has reason to know that the Commissioner has exercised the discretion to depart from the automatic recharacterization rules for a taxpayer, the withholding agent must withhold on payments made (or deemed made) to that taxpayer in accordance with the characterization of the fast-pay arrangement imposed by the Commissioner.

The withholding agent's liability to withhold on payments to foreign individuals is described in new proposed §1.1441–7(g). The same rules apply to payments (or deemed payments) to foreign corporations under §1.1442–1.

6. *Reporting Requirements*

In general, a corporation that has fast-pay stock outstanding at any time during the taxable year must attach a statement to its federal income tax return. This rule does not apply to a corporation that is a controlled foreign corporation (CFC) as defined in section 957, a foreign personal holding company (FPHC) as defined in section 552, or a passive foreign investment company (PFIC) as defined in section 1297. Instead, certain shareholders (and officers and directors of FPHCs) of those corporations must attach a statement to their returns.

The statement must identify the corporation that has outstanding fast-pay stock and must recite the terms of the fast-pay stock and the date on which the fast-pay stock was issued. In addition, to the extent the filing person knows or has reason to know such information, the statement must contain the names and the taxpayer identification numbers of the shareholders of any class of stock that is not traded on an established securities market as described in §1.7704-1(b).

7. *Election to Limit Taxable Income Attributable to a Recharacterized Fast-Pay Arrangement for Taxable Years Ending After February 26, 1997, and Before the Date These Regulations Are Published as Final Regulations in the Federal Register.*

The regulations are proposed to be effective February 27, 1997, and to cover all taxable years ending after February 26, 1997. Thus, the regulations will apply to all amounts accrued or paid on or after the first day of the first taxable year ending after February 26, 1997.

Because the proposed effective date relates to the date Notice 97–21 was issued to the public, and because the regulations adopt different recharacterization rules from the ones described in the notice, the regulations permit a shareholder of a recharacterized fast-pay arrangement to limit its taxable income attributable to the arrangement for certain taxable years. Specifically, for taxable years ending after February 26, 1997, and before the date these regulations are finalized, a shareholder may limit its taxable income attributable to a fast-pay arrangement recharacterized under the regulations, to the taxable income that would result if the fast-pay arrangement were recharacterized under Notice 97–21. Any amount excluded under the limit must be included as an adjustment to taxable income in the shareholder's first taxable year that includes the date the regulations are finalized. Under the regulations, a shareholder that has elected to apply the limit must include a statement in its books and records identifying each fast-pay arrangement for which the election was made, and the amount excluded from taxable income under the election for each fast-pay arrangement.

Shareholders who take advantage of the limit enjoy only a deferral of taxable income: Any amount excluded under the limit is later included as an adjustment. Thus, the sole benefit of making the election is a timing difference. This result is appropriate because over the life of a fast-pay arrangement a shareholder has the same amount of taxable income whether the fast-pay arrangement is recharacterized under Notice 97–21 or under the regulations. The IRS and Treasury Department invite comments concerning the limit and whether there are fast-pay arrangements in which any difference between a shareholder's taxable income determined under Notice 97–21 and the shareholder's taxable income determined under the regulations is other than a timing difference.

Notice 97–21 describes two types of fast-pay arrangements. Hence, calculating the limit requires appropriately recharacterizing the fast-pay arrangement under the notice. In the first type of fast-pay arrangement that the notice describes, the corporation with outstanding fast-pay stock holds income-producing assets issued by a third party. Notice 97–21 treats the benefited shareholders (one of which is called the "sponsor" in the notice) as acquiring the assets of the corporation directly from the sellers of those assets. The notice treats the fast-pay shareholders (called "investors" in the notice) as acquiring the assets of the corporation either from the sellers of those assets or from the benefited shareholders in an income "stripping" transaction. Thus, both the fast-pay shareholders and benefited shareholders are regarded as owning directly the corporation's assets.

In the second type of fast-pay arrangement that Notice 97–21 describes, the corporation with outstanding fast-pay stock holds a debt instrument issued by the sponsor (a benefited shareholder). In this situation, the notice treats the sponsor as having issued one or more instruments directly to the holders of the fast-pay stock. Thus, for purposes of determining the sponsor's taxable income, the sponsor's obligation under any asset held by the corporation is ignored.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in E.O. 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the understanding of the IRS and Treasury Department that the total number of fast-pay arrangements is fewer than 100, that the number of entities engaging in transactions affected by these regulations is not substantial and, of those entities, few or none are small entities within the meaning of the Regulatory Flexibility Act (5 U.S.C. chapter 6). Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comments on its impact on small businesses.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying. The IRS and Treasury Department specifically request comments on the clarity of the proposed rule and how it may be made easier to understand.

A public hearing has been scheduled for April 8, 1999, beginning at 10 a.m. in room 2615 of the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons that wish to present oral comments at the hearing must submit written comments by April 6, 1999, and submit an outline of the topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by March 18, 1999.

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.

Proposed Effective Date

These regulations are proposed to be effective February 27, 1997, and apply to taxable years ending after February 26, 1997. Thus, all amounts accrued or paid on or after the first day of the first taxable year ending after February 26, 1997, will be subject to the regulations, regardless of when a particular share of the stock or a particular debt instrument was issued.

The statement required under §1.7701(l)–3(f) is proposed to apply to taxable years (of the taxpayer required to file the statement) ending after the date the regulations are published as final regulations in the Federal Register.

Drafting Information

The principal authors of these regulations are Jonathan Zelnik and Marshall Feiring of the Office of the Assistant Chief Counsel (Financial Institutions & Products). However, other personnel from the IRS and Treasury Department participated in their development.

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Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Section 1.7701(l)–3 also issued under 26 U.S.C. 7701(l). * * *

Par. 2. Section 1.1441–7 is amended as follows:

1. Paragraph (g) is redesignated as paragraph (h) and is revised.

2. New paragraph (g) is added.

The addition and revision read as follows:

§1.1441–7 General provisions relating to withholding agents.

* * * * *

(g) *Fast-pay arrangements*—(1) *In general.* A corporation that issues fast-pay stock in a fast-pay arrangement described in §1.7701(l)–3(b)(1) is a withholding agent with respect to fast-pay dividends paid under the arrangement and any deemed payments with respect to the arrangement under the recharacterization rules of §1.7701(l)–3(c). Except as provided in this paragraph (g)(1) or in paragraph (g)(2) of this section, the withholding tax rules under section 1441 and section 1442 apply with respect to a fast-pay arrangement described in §1.7701(l)–3(c)(1)(i) in accordance with the recharacterization rules provided in §1.7701(l)–3(c). In all cases, notwithstanding paragraph (g)(2) of this section, if at any time the withholding agent knows or has reason to know that the Commissioner has exercised the discretion under §1.7701(l)–3(d) to depart from the recharacterization rules of §1.7701(l)–3(c) for a taxpayer, the withholding agent must withhold on payments made (or deemed made) to that taxpayer in accordance with the characterization of the fast-pay arrangement imposed by the Commissioner under §1.7701(l)–3(d).

(2) *Exception.* If at any time the withholding agent knows or has reason to know that any taxpayer entered into a fast-pay arrangement with a principal purpose of applying the recharacterization rules of §1.7701(l)–3(c) to avoid tax under section 871(a) or section 881, then for each payment made or deemed made to such taxpayer under the arrangement, the withholding agent must withhold, under section 1441 or section 1442, the higher of—

(i) The amount of withholding that would apply to such payment determined under the form of the arrangement; or

(ii) The amount of withholding that would apply to deemed payments determined under the recharacterization rules of §1.7701(l)–3(c).

(3) *Liability.* Any person required to deduct and withhold tax under this paragraph (g) is made liable for that tax by section 1461, and is also liable for applicable penalties and interest for failing to comply with section 1461.

(4) *Examples.* The following examples illustrate the rules of this paragraph (g):

Example 1. REIT W issues shares of fast-pay stock to foreign individual A, a resident of Country C. United States source dividends paid to residents of C are subject to a 30 percent withholding tax. W issues all shares of benefited stock to foreign individuals who are residents of Country D. D's income tax convention with the United States reduces the United States withholding tax on dividends to 15 percent. Under §1.7701(l)–3(c), the dividends paid by W to A are deemed to be paid by W to the benefited shareholders. W has reason to know that A entered into the fast-pay arrangement with a principal purpose of using the recharacterization rules of §1.7701(l)–3(c) to reduce United States withholding tax. W must withhold at the 30 percent rate on the dividends deemed paid to its benefited shareholders because the amount of withholding that applies to such payments determined under the form of the arrangement is higher than the amount of withholding that applies to such payments determined under §1.7701(l)–3(c).

Example 2. The facts are the same as in *Example 1* of this paragraph (g)(4) except that W does not know, or have reason to know, that A entered the arrangement with a principal purpose of using the recharacterization rules of §1.7701(l)–3(c) to reduce United States withholding tax. Further, the Commissioner has not exercised the discretion under §1.7701(l)–3(d) to depart from the recharacterization rules of §1.7701(l)–3(c). Accordingly, W must withhold tax at a 15 percent rate on the dividends deemed paid to the benefited shareholders.

(5) *Effective date.* This paragraph (g) applies to payments made (or deemed made) on or after January 6, 1999.

(h) *Effective date.* Except as otherwise provided in paragraph (f)(3) or (g)(5) of this section, this section applies to payments made after December 31, 1999.

Par. 3. Section 1.7701(l)–3 is added to read as follows:

§1.7701(l)–3 Recharacterizing financing arrangements involving fast-pay stock.

(a) *Purpose and scope.* This section is intended to prevent the avoidance of tax by persons participating in fast-pay arrangements (as defined in paragraph (b)(1) of this section) and should be interpreted in a manner consistent with this purpose. This section applies to all fast-pay arrangements. Paragraph (c) of this section recharacterizes certain fast-pay arrangements to ensure the participants are taxed in a manner reflecting the economic substance of the arrangements. Paragraph (f) of this section imposes reporting requirements on certain participants.

(b) *Definitions*—(1) *Fast-pay arrangement.* A fast-pay arrangement is any arrangement in which a corporation has outstanding for any part of its taxable year two or more classes of stock, at least one of which is fast-pay stock.

(2) *Fast-pay stock*—(i) *Defined.* Stock is fast-pay stock if it is structured so that dividends (as defined in section 316) paid by the corporation with respect to the stock are economically (in whole or in part) a return of the holder's investment (as opposed to only a return on the holder's investment). Unless clearly demonstrated otherwise, stock is presumed to be fast-pay stock if—

(A) It is structured to have a dividend rate that is reasonably expected to decline (as opposed to a dividend rate that is reasonably expected to fluctuate or remain constant); or

(B) It is issued for an amount that exceeds (by more than a *de minimis* amount, as determined under the principles of §1.1273–1(d)) the amount at which the holder can be compelled to dispose of the stock.

(ii) Determination. The determination of whether stock is fast-pay stock is based on all the facts and circumstances, including any related agreements such as options or forward contracts. A related agreement is any direct or indirect agreement or understanding, oral or written, between the holder of the stock and the issuing corporation, or between the holder of the stock and one or more other shareholders in the corporation. The determination is made when the stock is issued and whenever there is a significant modification in the terms of the stock or the related agreements, or a significant change in the relevant facts and circumstances.

(3) *Benefited stock defined.* With respect to a class of fast-pay stock, all other stock in the corporation (including any other class of fast-pay stock) is benefited stock.

(c) *Recharacterization of certain fast-pay arrangements*—(1) *Scope.* This paragraph (c) applies to any fast-pay arrangement—

(i) In which the corporation that has outstanding fast-pay stock is a regulated investment company (RIC) (as defined in section 851) or a real estate investment trust (REIT) (as defined in section 856); or

(ii) If the Commissioner determines that a principal purpose for the structure of the fast-pay arrangement is the avoidance of any tax imposed by the Code. Application of this paragraph (c)(1)(ii) is at the Commissioner's discretion, and a determination under this paragraph (c)(1)(ii) applies to all parties to the fast-pay arrangement, including transferees.

(2) *Recharacterization.* A fast-pay arrangement described in paragraph (c)(1) of this section is recharacterized as an arrangement directly between the benefited shareholders and the fast-pay shareholders. The inception and resulting relationships of the recharacterized arrangement are deemed to be as follows:

(i) *Relationship between benefited shareholders and fast-pay shareholders.* The benefited shareholders issue financial instruments (the financing instruments) directly to the fast-pay shareholders in exchange for cash equal to the fair market value of the fast-pay stock at the time of issuance (taking into account any related agreements). The financing instruments have the same payment terms as the fast-pay stock. Thus, the timing and amount of the payments made with respect to the financing instruments always match the timing and amount of the distributions made with respect to the fast-pay stock.

(ii) *Relationship between benefited shareholders and corporation.* The benefited shareholders contribute to the corporation the cash they receive for issuing the financing instruments. Distributions made with respect to the fast-pay stock are distributions made by the corporation with respect to the benefited shareholders' benefited stock.

(iii) *Relationship between fast-pay shareholders and corporation.* For purposes of determining the relationship between the fast-pay shareholders and the corporation, the fast- pay stock is ignored. The corporation is the paying agent of the benefited shareholders with respect to the financing instruments.

(3) *Other rules*—(i) *Character of the financing instruments.* The character of a financing instrument (for example, stock or debt) is determined under general tax principles and depends on all the facts and circumstances.

(ii) *Multiple classes of benefited stock.* If there is more than one class of benefited stock, the recharacterization rules of this paragraph (c) apply among the different classes as appropriate to match the economic substance of the fast-pay arrangement.

(iii) *Sale of benefited stock.* If one person sells benefited stock to another—

(A) In addition to any consideration actually paid and received for the benefited stock, the buyer is deemed to pay and the seller is deemed to receive the amount necessary to terminate the seller's position in the financing instruments at fair market value; and

(B) The buyer is deemed to issue financing instruments to the fast-pay shareholders in exchange for the amount necessary to terminate the seller's position in the financing instruments.

(iv) *Adjustment to basis for amounts accrued or paid in taxable years ending before February 27, 1997.* In the case of a fast-pay arrangement involving amounts accrued or paid in taxable years ending before February 27, 1997, and recharacterized under this paragraph (c), a benefited shareholder must decrease its basis in any benefited stock (as determined under paragraph (c)(2)(ii) of this section) by the amount (if any) that—

(A) Its income attributable to the benefited stock (reduced by deductions attributable to financing instruments) for taxable years ending before February 27, 1997, computed by recharacterizing the fast-pay arrangement under this paragraph (c); exceeds

(B) Its income attributable to such stock for taxable years ending before February 27, 1997, computed without applying the rules of this paragraph (c).

(d) *Prohibition against affirmative use of recharacterization by taxpayers.* A taxpayer may not use the rules of paragraph (c) of this section if a principal purpose for using such rules is the avoidance of any tax imposed by the Code. Thus, with respect to such taxpayer, the Commissioner may depart from the rules of this section and recharacterize (for all purposes of the Code) the fast-pay arrangement in accordance with its form or its economic substance. For example, if a foreign person acquires fast-pay stock in a REIT and a principal purpose for acquiring such stock is to reduce United States withholding taxes by applying the rules of paragraph (c) of this section, the Commissioner may, for purposes of determining the foreign person's United States tax consequences (namely, withholding tax), depart from the rules of paragraph (c) of this section and treat the foreign person as holding fast-pay stock in the REIT.

(e) *Examples.* The following examples illustrate the rules of paragraph (c) of this section:

Example 1. Decline in dividend rate. (i) Facts. Corporation X issues 100 shares of A Stock and 100 shares of B Stock for $1,000 per share. By its terms, a share of B Stock is reasonably expected to pay a $110 dividend in years 1 through 10 and a $30 dividend each year thereafter. If X liquidates, the holder of a share of B Stock is entitled to a preference equal to the share's issue price. Otherwise, the B Stock cannot be redeemed at either X's or the shareholder's option.

(ii) *Analysis.* When issued, the B Stock has a dividend rate that is reasonably expected to decline from an annual rate of 11 percent of its issue price to an annual rate of 3 percent of its issue price. Since the B Stock is structured to have a declining dividend rate, the B Stock is fast-pay stock, and the A Stock is benefited stock.

Example 2. Issued at a premium. (i) *Facts.* The facts are the same as in *Example 1* of this paragraph (e) except that a share of B Stock is reasonably expected to pay an annual $110 dividend as long as it is outstanding, and Corporation X has the right to redeem the B Stock for $400 a share at the end of year 10.

(ii) *Analysis.* The B Stock is structured so that the issue price of the B Stock ($1,000) exceeds (by more than a de minimis amount) the price at which the holder can be compelled to dispose of the stock ($400). Thus, the B Stock is fast-pay stock, and the A Stock is benefited stock.

Example 3. Recharacterization illustrated. (i) *Facts.* On formation, REIT Y issues 100 shares of C Stock and 100 shares of D Stock for $1,000 per share. By its terms, a share of D Stock is reasonably expected to pay a $110 dividend in years 1 through 10 and a $30 dividend each year thereafter. In years 1 through 10, persons holding a majority of the D Stock must consent before Y may take any action that would result in Y liquidating or dissolving, merging or consolidating, losing its REIT status, or selling substantially all of its assets. Thereafter, Y may take these actions without consent so long as the D Stock shareholders receive $400 in exchange for their D Stock.

(ii) *Analysis.* When issued, the D Stock has a dividend rate that is reasonably expected to decline from an annual rate of 11 percent of its issue price to an annual rate of 3 percent of its issue price. In addition, the $1,000 issue price of a share of D Stock exceeds the price at which the shareholder can be compelled to dispose of the stock ($400). Thus, the D Stock is fast-pay stock, and the C Stock is benefited stock. Because Y is a REIT, the fast-pay arrangement is recharacterized under paragraph (c) of this section.

(iii) *Recharacterization.* The fast-pay arrangement is recharacterized as follows:

(A) Under paragraph (c)(2)(i) of this section, the C Stock shareholders are treated as issuing financing instruments to the D Stock shareholders in exchange for $100,000 ($1,000, the fair market value of each share of D Stock, multiplied by 100, the number of shares).

(B) Under paragraph (c)(2)(ii) of this section, the C Stock shareholders are treated as contributing $200,000 to Y (the $100,000 received for the financing instruments, plus the $100,000 actually paid for the C Stock) in exchange for the C Stock.

(C) Under paragraph (c)(2)(ii) of this section, each distribution with respect to the D Stock is treated as a distribution with respect to the C Stock.

(D) Under paragraph (c)(2)(iii) of this section, the C Stock shareholders are treated as making payments with respect to the financing instruments, and Y is treated as the paying agent of the financing instruments for the C Stock shareholders.

Example 4. Transfer of benefited stock illustrated. (i) *Facts.* The facts are the same as in *Example 3* of this paragraph (e). Near the end of year 5, a person holding one share of C Stock sells it for $1,300. The buyer is unrelated to REIT Y or to any of the D Stock shareholders. At the time of the sale, the amount needed to terminate the seller's position in the financing instruments at fair market value is $747.

(ii) *Benefited shareholder's treatment on sale.* Under paragraph (c)(3)(iii)(A) of this section, the seller's amount realized is $2,047 ($1,300, the amount actually received, plus $747, the amount necessary to terminate the seller's position in the financing instruments at fair market value). The seller's gain on the sale of the common stock is $47 ($2,047, the amount realized, minus $2,000, the seller's basis in the common stock). The seller has no income or deduction with respect to terminating its position in the financing instruments.

(iii) *Buyer's treatment on purchase.* Under paragraph (c)(3)(iii)(A) of this section, the buyer's basis in the share of D Stock is $2,047 ($1,300, the amount actually paid, plus $747, the amount needed to terminate the seller's position in the financing instruments at fair market value). Under paragraph (c)(3)(iii)(B) of this section, simultaneous with the sale, the buyer is treated as issuing financing instruments to the fast-pay shareholders in exchange for $747, the amount necessary to terminate the seller's position in the financing instruments at fair market value.

Example 5. Fast-pay arrangement involving amounts accrued or paid in a taxable year ending before February 27, 1997. (i) *Facts.* Y is a calendar year taxpayer. In June 1996, Y acquires shares of REIT T benefited stock for $15,000. In December 1996, Y receives dividends of $100. Under the recharacterization rules of paragraph (c)(2) of this section, Y's 1996 income attributable to the benefited stock is $1,200, Y's 1996 deduction attributable to financing instruments is $500, and Y's basis in the benefited stock is $25,000.

(ii) *Analysis.* Under paragraph (c)(3)(iv) of this section, Y's basis in the benefited stock is reduced by $600. This is the amount by which Y's 1996 income from the fast-pay arrangement as recharacterized under this section ($1,200 of income attributable to the benefited stock less $500 of deductions attributable to the financing instruments), exceeds Y's 1996 income from the fast-pay arrangement as not recharacterized under this section ($100 of income attributable to the benefited stock). Thus, in 1997 when the fast-pay arrangement is recharacterized, Y's basis in the benefited stock is $24,400.

(f) *Reporting requirement*—(1) *Filing requirements*—(i) *In general.* A corporation that has fast-pay stock outstanding at any time during the taxable year must attach the statement described in paragraph (f)(2) of this section to its federal income tax return for such taxable year. This paragraph (f)(1)(i) does not apply to a corporation described in paragraphs (f)(1)(ii), (iii), or (iv) of this section.

(ii) *Controlled foreign corporation.* In the case of a controlled foreign corporation (CFC), as defined in section 957, that has fast-pay stock outstanding at any time during its taxable year (during which time it was a CFC), each controlling United States shareholder (within the meaning of §1.964–1(c)(5)) must attach the statement described in paragraph (f)(2) of this section to the shareholder's Form 5471 for the CFC's taxable year. The provisions of section 6038 and the regulations under section 6038 apply to any statement required by this paragraph (f)(1)(ii).

(iii) *Foreign personal holding company.* In the case of a foreign personal holding company (FPHC), as defined in section 552, that has fast-pay stock outstanding at any time during its taxable year (during which time it was a FPHC), each United States citizen or resident who is an officer, director, or 10-percent shareholder (within the meaning of section 6035(e)(1)) of such FPHC must attach the statement described in paragraph (f)(2) of this section to his or her Form 5471 for the FPHC's taxable year. The provisions of sections 6035 and 6679 and the regulations under sections 6035 and 6679 apply to any statement required by this paragraph (f)(1)(iii).

(iv) *Passive foreign investment company.* In the case of a passive foreign investment company (PFIC), as defined in section 1297, that has fast-pay stock outstanding at any time during its taxable year (during which time it was a PFIC), each shareholder that has elected (under section 1295) to treat the PFIC as a qualified electing fund and knows or has reason to know that the PFIC has outstanding fast-pay stock must attach the statement described in paragraph (f)(2) of this section to the shareholder's Form 8621 for the PFIC's taxable year. Each shareholder owning 10 percent or more of the shares of the PFIC (by vote or value) is presumed to know that the PFIC has issued fast-pay stock. The provisions of sections 1295(a)(2) and 1298(f) and the regulations under those sections (including §1.1295–1T(f)(2)) apply to any statement required by this paragraph (f)(1)(iv).

(2) *Statement.* The statement required under this paragraph (f) must say, "This fast-pay stock disclosure statement is required by §1.7701(l)–3(f) of the income tax regulations." The statement must also identify the corporation that has outstanding fast-pay stock and must contain the date on which the fast-pay stock was issued, the terms of the fast-pay stock, and (to the extent the filing person knows or has reason to know such information) the names and taxpayer identification numbers of the shareholders of any class of stock that is not traded on an established securities market (as described in §1.7704–1(b)).

(g) *Effective date*—(1) *In general.* Except as provided in paragraph (g)(4) of this section (relating to reporting requirements), this section applies to taxable years ending after February 26, 1997. Thus, all amounts accrued or paid during the first taxable year ending after February 26, 1997, are subject to this section.

(2) *Election to limit taxable income attributable to a recharacterized fast-pay arrangement for taxable years ending after February 26, 1997, and before the date these regulations are published as final regulations in the Federal Register*—(i) *Limit and adjustment.* For taxable years ending after February 26, 1997, and before the date these regulations are published as final regulations in the Federal Register, a shareholder may limit its taxable income attributable to a fast-pay arrangement recharacterized under paragraph (c) of this section, to the

taxable income that would result if the fast-pay arrangement were recharacterized under Notice 97–21, 1997–1 C.B. 407, see §601.601(d)(2) of this chapter. Any amount a shareholder excludes from taxable income under this paragraph (g)(2)(i) must be included as an adjustment to taxable income in the shareholder's first taxable year that includes the date these regulations are published as final regulations in the Federal Register. A shareholder that has elected to limit its taxable income under this paragraph (g)(2)(i) must include a statement in its books and records identifying each fast-pay arrangement to which the limit was applied and providing the amount excluded from taxable income for each such fast-pay arrangement.

(ii) The following examples illustrate the rules of this paragraph (g)(2). For purposes of these examples, assume that the last year a shareholder may limit its taxable income under this paragraph (g)(2) is 1998.

Example 1. Fast-pay arrangement recharacterized under Notice 97-21; REIT holds third-party debt. (i) *Facts.*

(A) REIT Y is formed on January 1, 1998, at which time it issues 1,000 shares of fast-pay stock and 1,000 shares of benefited stock for $100 per share. Y and all of its shareholders have calendar taxable years. All shareholders of Y have elected to accrue market discount based on a constant interest rate, to include the market discount in income as it accrues, and to amortize bond premium.

(B) For years 1 through 5, the fast-pay stock has an annual dividend rate of $17 per share ($17,000 for the class); in later years, the fast-pay stock has an annual dividend rate of $1 per share ($1,000 for the class). At the end of year 5, and thereafter, a share of fast-pay stock can be acquired by Y in exchange for $50 ($50,000 for the class).

(C) On the day Y is formed, it acquires a five-year mortgage note (the note) issued by an unrelated third party for $200,000. The note provides for annual interest payments on December 31 of $18,000 (a coupon interest rate of 9.0 percent, compounded annually), and one payment of principal at the end of 5 years. The note can be prepaid, in whole or in part, at any time.

(ii) *Recharacterization under Notice 97–21.* (A) In general. One way to recharacterize the fast-pay arrangement under Notice 97–21 is to treat the fast-pay shareholders and the benefited shareholders as if they jointly purchased the note from the issuer with the understanding that over the five-year term of the note the benefited shareholders would use their share of the interest to buy (on a dollar-for-dollar basis) the fast-pay shareholders' portion of the note. The benefited shareholders' and the fast-pay shareholders' yearly taxable income under Notice 97–21 can then be calculated after determining their initial portions of the note and whether those initial portions are purchased at a discount or premium.

(B) Determining initial portions of the debt instrument. The fast-pay shareholders' and the benefited shareholders' initial portions of the note can be determined by comparing the present values of their expected cash flows. As a class, the fast-pay shareholders expect to receive cash flows of $135,000 (five annual payments of $17,000, plus a final payment of $50,000). As a class, the benefited shareholders expect to receive cash flows of $155,000 (five annual payments of $1,000, plus a final payment of $150,000). Using a discount rate equal to the yield to maturity (as determined under §1.1272–1(b)(1)(i)) of the mortgage note (9.0 percent, compounded annually), the present value of the fast-pay shareholders' cash flows is $98,620, and the present value of the benefited shareholders' cash flows is $101,380. Thus, the fast-pay shareholders initially acquire 49 percent of the note at a $1,380 premium (that is, they paid $100,000 for $98,620 of principal in the note). The benefited shareholders initially acquire 51 percent of the note at a $1,380 discount (that is, they paid $100,000 for $101,380 of principal in the note). Under section 171, the fast-pay shareholders' premium is amortizable based on their yield in their initial portion of the note (8.57 percent, compounded annually). The benefited shareholders' discount accrues based on the yield in their initial portion of the note (9.35 percent, compounded annually).

(C) *Taxable income under Notice 97–21.* Under Notice 97-21, the fast-pay shareholders' 1998 taxable income attributable to the fast-pay arrangement is $8,574 ($8.57 per $100 invested), computed by subtracting the amortizable premium ($302) from the interest income from their portion of the note ($8,876). The benefited shareholders' 1998 taxable income attributable to the fast-pay arrangement is $9,353 ($9.35 per $100 invested), computed by adding the accrued discount ($229) to the interest income from their portion of the note ($9,124).

(iii) *Taxable income under the recharacterization of this section.* Assume the financing instruments are debt instruments. Under the recharacterization rules of paragraph (c) of this section, the fast-pay shareholders' 1998 taxable income attributable to the fast-pay arrangement is $8,574 ($8.57 per $100 invested), which is the interest income from the financing instruments. The benefited shareholders' 1998 taxable income attributable to the fast-pay arrangement is $9,426 ($9.43 per share of benefited stock), computed by subtracting the interest income accrued on the financing instruments ($8,574) from the dividend income actually and deemed paid on the benefited stock ($18,000).

(iv) *Limit on taxable income under this paragraph (g)(2).* (A) Fast-pay shareholders. For 1998, the fast-pay shareholders have the same taxable income under the recharacterization of Notice 97–21 ($8,574) as they have under the recharacterization of paragraph (c) of this section ($8,574). Thus, the limit under paragraph (g)(2)(i) of this section is unavailable to the fast-pay shareholders.

(B) *Benefited shareholders.* For 1998, the benefited shareholders have taxable income attributable to the fast-pay arrangement of $9,353 ($9.35 per $100 invested) under the recharacterization of Notice 97–21, and taxable income of $9,426 ($9.43 per share of benefited stock) under the recharacterization of paragraph (c) of this section. Thus, under paragraph (g)(2)(i) of this section, a benefited shareholder may elect to limit its taxable income attributable to the fast-pay arrangement to $9.35 for each share of benefited stock. Any amount an electing shareholder excludes from taxable income($0.08 per share of benefited stock) must later be included as an adjustment. (If all benefited shareholders elect the limit, then as a class the later adjustment to taxable income is $73.)

Example 2. REIT holds debt issued by a benefited shareholder. (i) *Facts.* The facts are the same as in *Example 1* of this paragraph (g)(2) except that corporation Z holds 800 shares (80 percent) of the benefited stock, and Z, instead of a third party, issues the mortgage note acquired by Y.

(ii) *Recharacterization under Notice 97–21.* Because Y holds a debt instrument issued by Z, the fast-pay arrangement is recharacterized under Notice 97–21 as an arrangement in which Z issued one or more instruments directly to the fast-pay shareholders and the other benefited shareholders. Consistent with this recharacterization, Z is treated as issuing a debt instrument to the fast-pay shareholders for $100,000. The debt instrument provides for five annual payments of $17,000 and an additional payment of $50,000 in year five. Thus, the debt instrument's yield to maturity is 8.57 percent per annum, compounded annually. Z is also treated as issuing a debt instrument to the other benefited shareholders for $20,000 (200 shares multiplied by $100, or 20 percent of the $100,000 paid to Y by the benefited shareholders as a class). This debt instrument provides for five annual payments of $200 and an additional payment of $30,000 in year five. The debt instrument's yield to maturity is 9.30 percent per annum, compounded annually. For 1998, Z's interest expense is $10,435 ($8,574 attributable to the debt instruments held by the fast-pay shareholders, and $1,861 attributable to the debt instruments held by the other benefited shareholders).

(iii) *Recharacterization under this section.* Assume the financing instruments are debt instruments. Under the recharacterization rules of paragraph (c) of this section, for 1998, Z has dividend income of $14,400 (800 shares multiplied by $18, or 80 percent of $18,000), and total interest expense of $24,859 ($18,000 of interest accrued on the note held by Y, and $6,859 of interest accrued on the financing instruments).

(iv) *Limit on taxable income under this paragraph (g)(2).* For 1998, Z has a taxable loss attributable to the fast-pay arrangement of $10,435 under the recharacterization of Notice 97-21, and a taxable loss of $10,459 ($14,400 of dividends, minus $24,859 of total interest expense) under the recharacterization of paragraph (c) of this section. Thus, for 1998, Z's taxable loss attributable to the fast-pay arrangement is $10,459 (the amount determined under paragraph (c) of this section), and the limit of paragraph (g)(2)(i) of this section is unavailable to Z.

(3) *Rule to comply with this section.* To comply with this section for each taxable year in which it failed to do so, a tax-

payer should file an amended return. For taxable years ending before the date these regulations are published as final regulations, a taxpayer that has complied with Notice 97–21, 1997–1 C.B. 407, (see §601.601(d)(2) of this chapter) is considered to have complied with this section.

(4) *Reporting requirements.* The reporting requirements of paragraph (f) of this section apply to taxable years (of the person required to file the statement) ending after the date these regulations are published as final regulations in the Federal Register.

John Dalrymple,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on January 5, 1999, 8:45 a.m., and published in the issue of the Federal Register for January 6, 1999, 64 F.R. 805)

Notice of Proposed Rulemaking and Notice of Public Hearing

Compliance Monitoring and Miscellaneous Issues Relating to the Low-Income Housing Credit

REG–114664–97

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed amendments to various existing final regulations concerning the low-income housing tax credit including the procedures for compliance monitoring by state and local housing agencies (Agencies), the requirements for making carryover allocations, and the rules for Agencies' correction of administrative errors or omissions. In addition, regulations are being proposed involving the independent verification of information on sources and uses of funds submitted by taxpayers to Agencies. These amendments and proposed regulations affect owners of low-income housing projects who have claimed the credit and the Agencies who administer the credit. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written and electronic comments must be received by May 6, 1999. Outlines of topics to be discussed at the public hearing scheduled for May 27, 1999, must be received by April 8, 1999.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–114664–97), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG–114664–97), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments. html. The public hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Paul Handleman, (202) 622-3040; concerning submissions, the hearing, and/or to be placed on the building access list to attend the hearing, LaNita Van Dyke, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in §§1.42–5 and 1.42–13 previously have been reviewed and approved by the Office of Management and Budget for review under control numbers 1545-1291 and 1545-1357, respectively; all of these paperwork requirements will be consolidated under control number 1545-1357. The new collections of information contained in this notice of proposed rulemaking have been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)).

Comments on the collections 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, OP:FS:FP, Washington, DC 20224. Comments on the collections of information should be received by March 9, 1999.

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 (see below);

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 requirement for the collections of information in this notice of proposed rulemaking is in §§1.42–5, 1.42–13, and 1.42–17. The information is required by the IRS to verify compliance with the requirements of section 42. The collections of information are mandatory. The likely respondents/recordkeepers are individuals, state and local governments, businesses or other for-profit institutions, nonprofit institutions, and small businesses or organizations.

Estimated total annual reporting and recordkeeping burden for §1.42–5: 102,500 hours.

For §1.42–5, the estimated annual burden per respondent varies from .5 hour to 3 hours for taxpayers and 250 to 5,000 hours for Agencies, with an estimated average of 1 hour for taxpayers and 1,500 hours for Agencies.

Estimated number of respondents for §1.42–5 : 20,000 taxpayers and 55 Agencies.

Estimated total annual reporting and recordkeeping burden for §1.42–13: 289 hours.

For §1.42–13, the estimated annual burden per respondent varies from .5 hour to

10 hours for taxpayers and Agencies, with an estimated average of 3.5 hours for taxpayers and 3 hours for Agencies.

Estimated number of respondents for §1.42–13: 43 taxpayers and 43 Agencies.

Estimated total annual reporting and recordkeeping burden for §1.42–17: 2,110 hours.

For §1.42–17, the estimated annual burden per respondent varies from .5 hour to 2 hours for taxpayers and .5 hour to 5 hours for Agencies, with an estimated average of 1 hour for taxpayers and 2 hours for Agencies.

Estimated number of respondents for §1.42–17: 2,000 taxpayers and 55 Agencies.

Estimated annual frequency of responses: once a year.

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

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

Background

On March 28, 1997, the General Accounting Office (GAO) submitted a report to Congress, "Tax Credits: Opportunities to Improve Oversight of the Low-Income Housing Program," (GAO/GGD/RCED-97–55), recommending certain revisions to existing Agency procedures for compliance with the low-income housing credit and requirements under qualified allocation plans for verifying taxpayers' sources and uses of funds for low-income housing projects. Consistent with these proposals, the proposed regulations amend existing regulation §1.42–5 to require Agencies: (i) to report annually their compliance monitoring activities to the IRS; (ii) to conduct on-site habitability inspections of low-income housing projects; and (iii) to review local government reports on building code violations. In addition, the proposed regulations provide that qualified allocation plans require taxpayers to submit independent verification on sources and uses of funds for low-income projects.

The proposed regulations also contain amendments to the Income Tax Regulations (26 CFR part 1) including §1.42–6 (carryover allocations), §1.42–11 (provision of services), §1.42–12 (effective dates and transitional rules), and §1.42–13 (correction of administrative errors and omissions) that are issued under the authority granted by section 42(n).

Explanation of Provisions

Compliance Monitoring

Section 42(m)(1)(B)(iii) provides that an allocation plan is not qualified unless it contains a procedure that the Agency (or an agent of, or private contractor hired by, the Agency) will follow in monitoring compliance with the provisions of section 42. The Agency is to notify the IRS of any noncompliance of which the Agency becomes aware.

Section 42(m)(1)(B)(iii) is effective on January 1, 1992, and applies to all buildings for which the low-income housing credit determined under section 42 is, or has been, allowable at any time. Allocation plans must have complied with the requirements of §1.42–5 by June 30, 1993. Section 42(m)(1)(B)(iii) and §1.42–5 do not require monitoring for whether a low-income housing project is in compliance with the requirements of section 42 prior to January 1, 1992. However, if an Agency becomes aware of noncompliance that occurred prior to January 1, 1992, the Agency is required to notify the IRS of that noncompliance.

The current compliance monitoring regulations require an Agency, at a minimum, to review tenant income certifications and rent charges of projects using one of the following three monitoring options: (1) review the owners' annual income certifications, including the documentation supporting the certifications for at least 50 percent of the Agency's low-income projects, and tenant rent records in at least 20 percent of the low-income units in these projects; (2) make annual on-site inspections of at least 20 percent of the projects, and review the low-income certification, the documentation supporting the certification, and rent record for each tenant in at least 20 percent of the low-income units in those projects; or (3) obtain from all project owners tenant income and rent records for each low-income unit and, for at least 20 percent of the projects, review the annual tenant income certification, backup income documentation, and rent record for each low-income tenant in at least 20 percent of the low-income units in those projects.

The GAO report recommended that an Agency conduct regular on-site inspections of projects and obtain building code inspection reports performed by the local government unit. The GAO found that desk audits (monitoring options 1 and 3 above) failed to detect violations involving the physical condition of buildings. In addition, site visits allow an Agency to directly assess the compliance status of projects and the physical condition of buildings. Consistent with these proposals, the proposed regulations remove the three monitoring options and require, at least once every three (3) years, that each Agency conduct on-site inspections of all buildings in each low-income housing project and, for each tenant in at least 20 percent of the project's low-income units selected by the Agency, review the low-income certification, the documentation supporting such certification, and the rent record. The proposed regulations also require, at a minimum, by the end of the calendar year following the year the last building in a project is placed in service, that the Agency conduct on-site inspections of the projects and review the low-income certification, the documentation supporting such certification, and the rent record for each tenant in the project. As part of the inspection requirements, the proposed regulations also require the Agency to determine whether the project is suitable for occupancy, taking into account local health, safety, and building codes. Agencies may delegate this determination only to a state or local government unit responsible for making building code inspections. The three-year inspection requirement is proposed to be effective on the date the final regulations are published in the **Federal Register.** The placed-in-service year inspection requirement is proposed to be effective for buildings placed in service on or after the date the final regulations are published in the **Federal Register.**

The current compliance monitoring regulations require the owner of a project, at a minimum, to certify annually that for the preceding 12-month period each building in the project was suitable for occupancy, taking into account local health, safety, and building codes. Based on the GAO recommendation, the proposed regulations revise this certification by also requiring the owner of the project to certify that for the preceding 12-month period the state or local government unit responsible for making building code inspections did not issue a report of a violation for the project. If the governmental unit issued a report of a violation, the owner will be required to attach a copy of the report of the violation to the annual certification submitted to the Agency.

The proposed regulations also adopt the GAO recommendation that Agencies report annually to the IRS on compliance monitoring activities. It is anticipated Form 8610, "Annual Low-Income Housing Credit Agencies Report," will be revised to require an Agency to confirm annually that it has satisfied the new compliance monitoring requirements involving: (1) the once every three-year onsite inspections and review of the low-income certification, the documentation supporting such certification, and the rent record for each tenant in at least 20 percent of the low-income units selected by the Agency; and (2) the on-site inspections relating to the placed-in-service year and review of the low-income certification, the documentation supporting such certification, and the rent record for each low-income tenant in the project.

The current compliance monitoring regulations require Agencies to report a correction of noncompliance or failure to certify if the correction occurs within the correction period defined in §1.42–5(e)(4). The proposed regulations clarify that the Agency is required to file Form 8823, "Low-Income Housing Credit Agencies Report of Noncompliance," with the IRS reporting the correction of the noncompliance or failure to certify regardless of when the correction occurs during the compliance period. This requirement is proposed to be effective on the date the final regulations are published in the **Federal Register.**

Sources and Uses of Funds

The GAO report recommended that IRS regulations be amended to establish clear requirements to ensure independent verification of taxpayer's key information on sources and uses of funds submitted to an Agency. Without assurance of reliable and complete cost and financing information, Agencies are vulnerable to providing more (or fewer) tax credits to projects than are actually needed. Under section 42(m)(2)(A), the housing credit dollar amount allocated to a project should not exceed the amount the Agency determines is necessary for the financial feasibility of the project and its viability as a qualified low-income housing project throughout the credit period. In making this determination, section 42(m)(2)(B) requires that the Agency must consider: (i) the sources and uses of funds and the total financing planned for the project, (ii) any proceeds or receipts expected to be generated by reason of tax benefits, (iii) the percentage of the housing credit dollar amount used for project costs other than the costs of intermediaries, and (iv) the reasonableness of the developmental and operational costs of the project. The requirement in section 42(m)(2)(B)(iii) is not to be applied so as to impede the development of projects in hard-to-develop areas.

In its report, the GAO determined that an Agency must make three critical judgments in awarding credits: (1) the reasonableness of developer costs because the Agency is to award no more credits to a project than a specified percentage of certain Agency-approved project development costs; (2) the reasonableness of the financing arrangements for the project because the Agency is required to base an award of credit on the financial need of a project subject to the limit computed on Agency-approved development costs; and (3) criteria for pricing the credit (for example, use of an appropriate rate to convert credits into an equity investment amount).

So that an Agency may more accurately determine the amount of credits to be awarded, the GAO proposed three alternative recommendations: (1) an examination or audit, which would provide a reasonable basis for an independent public accountant to issue an opinion on the overall reliability of a project's financial information taken as a whole; (2) a review, which would consist of inquiries and application of analytical procedures that might bring to the accountant's attention significant matters affecting a project's financial information but would not provide assurance that the accountant would become aware of all significant matters that would be disclosed in an audit; or (3) agreed-upon procedures, which would provide an accountant with a basis to issue a report of findings based on the specified procedures but not a basis to issue an opinion on the reliability of the financial information.

Because the first alternative provides the most reliable independent verification on sources and uses of funds, the proposed regulations require that a taxpayer must obtain an opinion by a certified public accountant, based upon the accountant's audit or examination, on the financial determinations and certifications provided by the taxpayer to the Agency, including the costs that may qualify for inclusion in eligible basis under section 42(d) and the amount of the credit under section 42. This opinion must be submitted to the Agency before the Agency issues the Form 8609, "Low-Income Housing Credit Allocation Certification." This requirement is proposed to be effective on the date the final regulations are published in the **Federal Register.**

Buildings Qualifying for Carryover Allocations

The proposed regulations amend the carryover allocation regulations by requiring the Agency to file a form (to be prescribed by the IRS) that summarizes the carryover allocation document described in §1.42–6(d)(2) with the Agency's Form 8610 for the year the allocation is made. The new form will be filed with the Form 8610 in lieu of the original carryover allocation document. Taxpayers must continue to file a copy of the carryover allocation document with the Form 8609 for the building for the first year the credit is claimed.

Correction of Administrative Errors and Omissions

Housing credit agencies may correct administrative errors and omissions with respect to allocations and recordkeeping if the correction occurs within a reasonable period of time after discovery of the error or omission. The current administrative error and omission regulations define an administrative error or omission as a mistake that results in a document that inaccurately reflects the intent of the Agency at the time the document is originally completed or, if the mistake affects a taxpayer, a document that inaccurately reflects the intent of the Agency and the affected taxpayer at the time the document is originally completed. However, an administrative error or omission does not include a misinterpretation of the applicable rules and regulations under section 42. Agencies must obtain prior approval from the Secretary to correct an administrative error or omission if the correction is not made before the close of the calendar year of the error or omission and the correction: (1) is a numerical change to the housing credit dollar amount allocated for the building or project; (2) affects the determination of any component of the state's housing credit ceiling under section 42(h)(3)(C); or (3) affects the state's unused housing credit carryover that is assigned to the Secretary under section 42(h)(3)(D).

The proposed regulations would provide automatic approval for correcting an administrative error or omission in an allocation document (a Form 8609, or a carryover allocation document under the requirements of section 42(h)(1)(E) or (F) and §1.42–6(d)(2)) that either did not accurately reflect the number of buildings constructed by the affected taxpayer, or transposed the information for one or more buildings with other buildings in a project.

If the automatic approval provision applies to the administrative error or omission, the proposed regulations require the Agency to amend the allocation document. If correcting the administrative error or omission requires adding a Building Identification Number (B.I.N.) to the amended allocation document, the proposed regulations require that the Agency must include any B.I.N.(s) already existing for the buildings in the document and, if possible, number the additional B.I.N.(s) sequentially from the existing B.I.N.(s). In addition, the Agency must file the amended allocation document with an amended Form 8610. This provision is proposed to be effective on the date the final regulations are published in the **Federal Register.**

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collections of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that any burden on taxpayers is minimal. Furthermore, an Agency is not a "small entity" for purposes of the Regulatory Flexibility Act (5 U.S.C. chapter 6). Accordingly, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. The IRS and Treasury specifically request comments on the clarity of the proposed rule and how it may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for Thursday, May 27, 1999, at 10 a.m. in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

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

Persons that wish to present oral comments at the hearing must submit written and electronic 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 April 8, 1999.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Paul F. Handleman, Office of the Assistant Chief Counsel (Passthroughs and Special Industries), IRS. 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 * * *

Section 1.42–17 also issued under 26 U.S.C. 42(n); * * *

Par. 2. Section 1.42-5 is amended by:

1. Revising paragraphs (c)(1)(v), (c)(1)(vi) and (c)(2)(ii).

2. Removing the language "If a monitoring procedure includes the review provision described in paragraph (c)(2)(ii)(B) of this section, the" from the second sentence in paragraph (c)(2)(iii) and adding "The" in its place.

3. Removing the language "paragraph (c)(2)(ii)(A), (B), and (C) of this section" from the first sentence in paragraph (c)(4)(i) and adding "paragraph (c)(2)(ii) of this section" in its place.

4. Removing the language "An Agency chooses the review requirement of paragraph (c)(2)(ii)(A) of this section and some of the buildings selected for review are" from the first sentence in the example in paragraph (c)(4)(iii) and adding "An Agency selects for review" in its place.

5. Adding paragraph (c)(5).

6. Revising the last sentence in paragraph (d).

7. Removing the language "(c)(2)(ii)(A), (B), or (C) of this section (whichever is applicable)" from paragraph (e)(2) and adding the language "(c)(2)(ii) of this section" in its place.

8. Adding a sentence at the end of paragraph (e)(3)(i).

9. Removing the language "paragraph (e)(3) of this section" in the third sentence in paragraph (f)(1)(i) and adding "paragraphs (c)(5) and (e)(3) of this section" in its place.

10. Adding two sentences at the end of paragraph (h).

The revisions and additions read as follows:

§1.42–5 Monitoring compliance with low-income housing credit requirements.

* * * * *

(c) * * *

(1) * * *

(v) All units in the project were for use by the general public (as defined in §1.42–9) and used on a nontransient basis (except for transitional housing for the homeless provided under section 42(i)(3)(B)(iii) or single-room-occupancy units rented on a month-by-month basis under section 42(i)(3)(B)(iv));

(vi) Each building in the project was suitable for occupancy, taking into account local health, safety, and building codes, and the State or local government unit responsible for making building code inspections did not issue a report of a violation for any building in the project. If a report of a violation was issued by the governmental unit, the owner must attach a copy of the report of the violation to the annual certification submitted to the Agency under paragraph (c)(1) of this section;

(2) * * *

(ii) Require that with respect to each low-income housing project—

(A) The Agency conduct on-site inspections of all buildings in the project by the end of the calendar year following the year the last building in the project is placed in service and review the low-income certification, the documentation supporting such certification, and the rent record for each low-income tenant; and

(B) At least once every three (3) years, the Agency conduct on-site inspections of all buildings in the project, and, for each tenant in at least 20 percent of the project's low-income units selected by the Agency, review the low-income certification, the documentation supporting such certification, and the rent record; and

* * * * *

(5) *Agency reports of compliance monitoring activities.* The Agency must report its compliance monitoring activities annually on Form 8610, "Annual Low-Income Housing Credit Agencies Report."

(d) * * * In addition, in connection with the on-site inspections required by paragraph (c)(2)(ii) of this section, the Agency must determine whether the project is suitable for occupancy, taking into account local health, safety, and building codes. Notwithstanding paragraph (f) of this section, this determination may be delegated only to a State or local government unit responsible for making building code inspections.

(e) * * *

(3) * * *

(i) * * * For noncompliance or failure to certify that is corrected after the end of the correction period, the Agency is required to file Form 8823 with the Service reporting the correction of the noncompliance or failure to certify regardless of when the correction occurs during the 15-year compliance period under section 42(i)(1).

* * * * *

(h) * * * In addition, the requirement in paragraph (c)(2)(ii)(A) of this section (involving on-site inspections relating to the placed-in-service year and review of the low-income certifications, the documentation supporting such certifications, and the rent records) is effective for buildings placed in service on or after the date the final regulations are published in the **Federal Register.** The requirements in paragraph (c)(1)(vi) of this section (involving whether a State or local government unit responsible for making building code inspections issued a report or a violation for the project), paragraph (c)(2)(ii)(B) of this section (the low-income certifications, the documentation supporting such certifications, and the rent records), paragraph (c)(5) of this section (involving the requirement to report the Agency's compliance monitoring activities to the Service), paragraph (d) of this section (involving habitability requirements), and paragraph (e)(3) of this section (involving the requirement to report corrected noncompliance or failure to certify after the end of the correction period) are effective on the date the final regulations are published in the **Federal Register.**

Par. 3. Section 1.42-6 is amended by removing the first sentence in paragraph (d)(4)(ii) and adding two sentences in its place to read as follows:

§1.42–6 Buildings qualifying for carryover allocations.

* * * * *

(d) * * *

(4) * * *

(ii) *Agency.* The Agency must retain the original carryover allocation document made under paragraph (d)(2) of this section and file the form (to be prescribed by the IRS) that summarizes the carryover allocation document. This form is filed with the Agency's Form 8610 that accounts for the year the allocation is made. * * *

* * * * *

Par. 4. Section 1.42–11 is amended by revising the last sentence in paragraph (b)(3)(ii)(A) to read as follows:

§1.42–11 Provision of services.

* * * * *

(b) * * *

(3) * * *

(ii) * * * (A) * * * For a building described in section 42(i)(3)(B)(iii) (relating to transitional housing for the homeless) or section 42(i)(3)(B)(iv) (relating to single room occupancy), a supportive service includes any service provided to assist tenants in locating and retaining permanent housing.

* * * * *

Par. 5. Section 1.42–12 is amended by adding paragraph (c) to read as follows:

§1.42–12 Effective dates and transitional rules.

* * * * *

(c) The rule set forth in §1.42–6(d)(4)(ii) relating to the requirement that state and local housing agencies file the form to be prescribed by the Internal Revenue Service that summarizes the carryover allocation document is effective for forms the due date of which are on or after March 8, 1999**.**

Par. 6. Section 1.42–13 is amended by:

1. Revising the introductory text of paragraph (b)(3)(iii).

2. Adding paragraphs (b)(3)(vi), (b)(3)(vii), and (b)(3)(viii).

3. Adding a sentence at the end of paragraph (d).

The revisions and additions read as follows:

§1.42–13 Rules necessary and appropriate; housing credit agencies' correction of administrative errors and omissions.

* * * * *

(b) * * *

(3) * * *

(iii) *Secretary's prior approval required.* Except as provided in paragraph (b)(3)(vi) of this section, an Agency must obtain the Secretary's prior approval to correct an administrative error or omission, as described in paragraph (b)(2) of this section, if the correction is not made before the close of the calendar year of the error or omission and the correction—

* * * * *

(vi) *Secretary's automatic approval*. The Secretary grants automatic approval to correct an administrative error or omission described in paragraph (b)(2) of this section if—

(A) The correction is not made before the close of the calendar year of the error or omission and the correction is a numerical change to the housing credit dollar amount allocated for the building or multiple-building project;

(B) The administrative error or omission resulted in an allocation document (the Form 8609, "Low-Income Housing Credit Allocation Certification," or the allocation document under the requirements of section 42(h)(1)(E) or (F) and §1.42–6(d)(2)) that either did not accurately reflect the number of buildings constructed by the affected taxpayer (for example, the affected taxpayer built 10 buildings instead of 8 buildings having the same total number of units), or transposed the information for one or more buildings with other buildings in the multiple-building project;

(C) The administrative error or omission does not affect the Agency's ranking of the building(s) or project and the total amount of credit the Agency allocated to the building(s) or project;

(D) The Agency corrects the administrative error or omission no later than one year after the building(s) were placed in service by the affected taxpayer; and

(E) The Agency corrects the administrative error or omission by following the procedures described in paragraph (b)(3)(vii) of this section.

(vii) *How Agency corrects errors or omissions subject to automatic approval.* An Agency corrects an administrative error or omission described in paragraph (b)(3)(vi) of this section by—

(A) Amending the allocation document described in paragraph (b)(3)(vi)(B) of this section to correct the administrative error or omission. The Agency will indicate on the amended allocation document that it is making the "correction under §1.42–13(b)(3)(vii)". If correcting the allocation document requires including any additional B.I.N.(s) in the document, the document must include any B.I.N.(s) already existing for the buildings. If possible, the additional B.I.N.(s) should be sequentially numbered from the existing B.I.N.(s);

(B) Amending, if applicable, the form to be prescribed by the Service that summarizes the allocation document (see §1.42–6 (d)(4)(ii)) and attaching a copy of this form to an amended Form 8610, "Annual Low-Income Housing Credit Agencies Report," for the year the allocation was made. The Agency will indicate on the forms that it is making the "correction under §1.42–13(b)(3)(vii)";

(C) Amending, if applicable, the Form 8609 and attaching the original of this amended form to an amended Form 8610 for either the year the allocation was made or the year the building was placed in service by the affected taxpayer. The Agency will indicate on the forms that it is making the "correction under §1.42–13(b)(3)(vii)";

(D) Filing the amended Form 8610 with the Service. When completing the amended Form 8610, the Agency should follow the specific instructions for the Form 8610 under the heading "Amended Report"; and

(E) Mailing a copy of any amended allocation document and any amended Form 8609 to the affected taxpayer.

(viii) *Other approval procedures.* The Secretary may grant automatic approval to correct other administrative errors or omissions as designated in one or more documents published either in the **Federal Register** or in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter).

* * * * *

(d) * * * Paragraphs (b)(3)(vi), (vii), and (viii) of this section are effective on the date the final regulations are published in the **Federal Register.**

Par. 7. Section 1.42–17 is added to read as follows:

§1.42–17 Qualified Allocation Plan.

(a) *Requirements*—(1) *In general.* [Reserved]

(2) *Selection criteria.* [Reserved]

(3) *Agency evaluation.* Section 42(m)(2)(A) requires that the housing credit dollar amount allocated to a project should not exceed the amount the Agency determines is necessary for the financial feasibility of the project and its viability as a qualified low-income housing project throughout the credit period. In making this determination, the Agency must consider—

(i) The sources and uses of funds and the total financing planned for the project. The taxpayer must certify to the Agency the full extent of all federal, state, and local subsidies that apply (or which the taxpayer expects to apply) to the project. The taxpayer must also certify to the Agency all other sources of funds and all development costs for the project. The taxpayer's certification should be sufficiently detailed to enable the Agency to ascertain the nature of the costs that will comprise the total financing package, including subsidies and the anticipated syndication or placement proceeds to be raised. Development cost information, whether or not includible in eligible basis under section 42(d), that should be provided to the Agency includes, but is not limited to, site acquisition costs, construction contingency, general contractor's overhead and profit, architect and engineer's fees, permit and survey fees, insurance premiums, real estate taxes during construction, title and recording fees, construction period interest, financing fees, organizational costs, rent-up and marketing costs, accounting and auditing costs, working capital and operating deficit reserves, syndication and legal fees, developer fees, and other costs;

(ii) Any proceeds or receipts expected to be generated by reason of tax benefits;

(iii) The percentage of the housing credit dollar amount used for project costs other than the costs of intermediaries. This requirement should not be applied so as to impede the development of projects in hard-to-develop areas under section 42(d)(5)(C); and

(iv) The reasonableness of the developmental and operational costs of the project.

(4) *Timing of Agency evaluation.* The financial determinations and certifications required under paragraph (a)(3) of this section must be made at each of the following times:

(i) The time of the application for the housing credit dollar amount.

(ii) The time of the allocation of the housing credit dollar amount.

(iii) The date the building is placed in service.

(iv) After the building is placed in service, and before the Agency issues the Form 8609, "Low-Income Housing Credit Allocation Certification."

(5) *Special rule for final determinations and certifications.* For the Agency's evaluation under paragraph (a)(4)(iv) of this section, the taxpayer must obtain an opinion by a certified public accountant, based upon the accountant's audit or examination, on the financial determinations and certifications in paragraphs (a)(3)(i) through (iii) of this section, including the costs that may qualify for inclusion in eligible basis under section 42(d) and amount of the credit under section 42.

(6) *Bond financed projects.* A project qualifying under section 42(h)(4) is not entitled to any credit unless the governmental unit that issued the bonds (or on behalf of which the bonds were issued), or the Agency responsible for issuing the Form(s) 8609 to the project, makes determinations under rules similar to the rules in paragraphs (a)(3), (4), and (5) of this section.

(b) *Effective date.* This section is effective on the date final regulations are published in the **Federal Register.**

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on January 7, 1999, 8:45 a.m., and published in the issue of the Federal Register for January 8, 1999, 64 F.R. 1143)

Notice of Proposed Rulemaking and Notice of Public Hearing

Education Tax Credits

REG–106388–98

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and requests to hold a videoconference public hearing.

SUMMARY: This document contains proposed regulations relating to the Hope Scholarship Credit and the Lifetime Learning Credit in section 25A of the Internal Revenue Code. These proposed regulations provide guidance to individuals who may claim the Hope Scholarship Credit or the Lifetime Learning Credit for certain postsecondary educational expenses. This document also announces that a public hearing will be held on the proposed regulations upon request and that persons outside the Washington, DC, area who wish to testify at the hearing may request that the IRS videoconference the hearing to their sites.

DATES: Written or electronically generated comments must be received by April 6, 1999. Requests to videoconference the hearing to other sites must be received by March 8, 1999.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–106388–98), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG–106388–98), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The IRS will publish the time and date of the public hearing and the locations of any videoconferencing sites in the **Federal Register.**

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Donna Welch, (202) 622-4910; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, contact Michael L. Slaughter, (202) 622-7190 (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 for review 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, OP:FS:FP, Washington, DC 20224. Comments on the collection of information should be received by March 8, 1999. Comments are specifically requested concerning:

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

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

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

How the burden of complying with the 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 this proposed regulation is in §1.25A–1(d) and (f). Taxpayers must elect to claim an education credit by attaching Form 8863, "Education Credits (Hope and Lifetime Learning Credits)," to a timely filed (including extensions) federal income tax return for the taxable year in which a credit is claimed. This collection of information is required in order for a taxpayer to elect to claim an education credit. This information will be used to carry out the internal revenue laws. The likely respondents are individuals.

The reporting burden contained in §1.25A–1(d) and (f) is reflected in the burden of Form 8863, "Education Credits (Hope and Lifetime Learning Credits)," and Form 1040, "U.S. Individual Income Tax Return."

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

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

Background

The Taxpayer Relief Act of 1997 (Public Law 105-34 (111 Stat. 788) (TRA '97)) added section 25A to the Internal Revenue Code to provide the Hope Scholarship Credit and the Lifetime Learning Credit (education credits). In general, the Hope Scholarship Credit and the Lifetime Learning Credit allow taxpayers to claim a nonrefundable credit against their federal income taxes for certain postsecondary educational expenses. On November 17, 1997, the IRS published Notice 97–60 (1997–46 I.R.B. 8) to provide general guidance on the higher education tax incentives enacted by TRA '97, including the Hope Scholarship Credit and the Lifetime Learning Credit. This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) to provide detailed guidance on the education credits in section 25A.

TRA '97 also added section 6050S to the Code, which requires eligible educational institutions to file information returns to assist taxpayer and the IRS in determining the education credit that taxpayers may claim under section 25A. The IRS has published several notices outlining the limited information returns that are required for 1998 and 1999. On December 22, 1997, the IRS published Notice 97–73 (1997–51 I.R.B. 16), which describes the information that must be reported for 1998. On September 8, 1998, the IRS published Notice 98–46 (1998–36 I.R.B. 21), which extends the application of Notice 97–73 to information returns required under section 6050S for 1999. Finally, on December 7, 1998, the IRS published Notice 98–59 (1998–49 I.R.B. 16), which modified the two prior Notices by providing that an eligible educational institution is not required to file information returns under section 6050S for 1998 or 1999 with respect to either: (1) students who are enrolled during the year only in courses for which the student receives no academic credit from the educational institution; or (2) nonresident alien students, unless requested to do so by the student. The IRS and the Treasury Department intend to issue separate regulations on the information reporting required under section 6050S for years after 1999.

Explanation of Provisions

1. *Calculation of Education Credit and General Eligibility Requirements*

Under the proposed regulations, a taxpayer may claim a nonrefundable education credit equal to the total of the Hope Scholarship Credit and the Lifetime Learning Credit allowed for the taxpayer, the taxpayer's spouse, and any claimed dependents. An education credit in excess of a taxpayer's tax liability for the taxable year can not be refunded. As with other personal credits, section 25A does not allow a carryforward of an unused education credit or a carryforward of excess qualified expenses.

The proposed regulations provide rules for the coordination of the Hope Scholarship Credit and the Lifetime Learning Credit. The proposed regulations provide that, in the same taxable year, a taxpayer may claim a Hope Scholarship Credit for each eligible student's qualified tuition and related expenses and a Lifetime Learning Credit for one or more other students' qualified tuition and related expenses. The regulations provide that a taxpayer may claim either the Hope Scholarship Credit or the Lifetime Learning Credit, but not both, for the qualified tuition and related expenses of the same student in the same taxable year. A Hope Scholarship Credit may be claimed for the qualified tuition and related expenses (up to a specified limit described below) of each eligible student. The Lifetime Learning Credit may be claimed for the aggregate amount of qualified tuition and related expenses (up to a specified limit described below) of those students for whom no Hope Scholarship Credit is claimed.

Consistent with the income limitations in section 25A(d), the proposed regulations provide that the education credit allowed is phased out for taxpayers with modified adjusted gross income between $40,000 and $50,000 ($80,000 and $100,000 for taxpayers filing a joint return) for the taxable year. For taxable years beginning after 2001, these amounts will be adjusted for inflation. Based on the definition in section 25A(d)(3), the regulations define *modified adjusted gross income* as the adjusted gross income (as defined in section 62) of the taxpayer for the taxable year increased by any amount excluded from gross income under section 911, 931, or 933 (relating to income earned abroad or from certain U.S. possessions or Puerto Rico). The amount of an otherwise allowable education credit for a taxable year that is reduced solely by reason of the modified adjusted gross income limitation can not be carried forward and claimed in a subsequent taxable year.

Consistent with the requirements in section 25A(e)(1), the proposed regulations provide that a taxpayer must elect to claim the education credit. The election must be made by attaching Form 8863, "Education Credits (Hope and Lifetime Learning Credits)," to the taxpayer's federal income tax return for the taxable year in which the credit is claimed. Consistent with the identification requirements in section 25A(g)(1), the regulations provide that a taxpayer must include on the federal income tax return the name and taxpayer identification number of each student for whom the credit is claimed.

Consistent with the requirements in section 25A(e)(2), the proposed regulations provide that no education credit is allowed for a taxable year for the qualified tuition and related expenses of a student if: (1) during the taxable year, a distribution is made to, or on behalf of, the student from an education individual retirement account described in section 530(b); and (2) any portion of the distribution is excluded from gross income under section 530(d)(2).

The proposed regulations provide guidance on the rules for claiming an education credit in the case of a dependent. The regulations provide that, if the student is a claimed dependent of another taxpayer, only that taxpayer may claim the education credit for the student's qualified tuition and related expenses. The regulations explain that, if the taxpayer is eligible to, but does not, claim the student as a dependent, only the student may claim the education credit for the student's qualified tuition and related expenses.

2. *Definitions*

The proposed regulations provide that a *claimed dependent* is a dependent (as defined in section 152) for whom a deduction under section 151 is allowed on the taxpayer's federal income tax return for the taxable year in which the credit is claimed.

Based on the requirements of section 25A(f)(2), the proposed regulations provide that an *eligible educational institution* means a college, university, vocational school, or other postsecondary educational institution that: (1) is described in section 481 of the Higher Education Act of 1965 (HEA) (20 U.S.C. 1088) as in effect on August 5, 1997 (generally all accredited public, nonprofit, and proprietary postsecondary institutions); and (2) participates in a federal student financial aid program under title IV of the HEA (20 U.S.C. 1070 et seq.) or is certified by the Department of Education as eligible to participate in such a program but chooses not to participate.

The proposed regulations provide that *academic period* means a quarter, semester, trimester, or other period of study (such as a summer school session) as reasonably determined by the eligible educational institution. Neither section 25A nor its legislative history defines the term *academic period.* Additionally, the Department of Education does not have a recognized definition of *academic period.* The definition in the regulation is intended to include institutions that use traditional academic terms and institutions that do not use academic terms, but for example use clock hours or credit hours. The IRS and Treasury invite comments on this definition of *academic period* as well as suggestions on alternative definitions.

Based on the definition in section 25A(f)(1), the proposed regulations define *qualified tuition and related expenses* as the tuition and fees required for the enrollment or attendance of a student for courses of instruction at an eligible educational institution. This definition is generally consistent with the definition of *tuition and fees* contained in section 472(1) of the HEA (20 U.S.C. 1087ll(1)). See H.R. Conf. Rep. No. 599, 105th Cong., 2d Sess., at p. 321 (1998). The regulations provide that, in general, the test for determining whether a fee is treated as a qualified tuition and related expense is whether the fee is required to be paid to the eligible educational institution by students as a condition of the students' enrollment or attendance at the institution. The regulations specifically provide that qualified tuition and related expenses include fees for books, supplies, and equipment used in a course of study only if the fees must be paid to the eligible educational institution for the enrollment or attendance of the student at the institution. Similarly, the regulations provide that, in general, qualified tuition and related expenses include nonacademic fees (fees charged by an eligible educational institution that are not used directly for, or allocated to, an academic course of study) only if the fees must be paid to the eligible educational institution for the enrollment or attendance of the student at the institution.

However, based on the legislative history to section 25A, the proposed regulations provide that qualified tuition and related expenses do not include the costs of room and board, insurance, medical expenses (such as student health fees), transportation, and similar personal, living, or family expenses, regardless of whether the fees must be paid to the eligible educational institution for the enrollment or attendance of the student at the institution. See H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess., at p. 343, 346 (1997). Further, based on the limitations in section 25A(f)(1)(B) and (c)(2)(B), the regulations provide that qualified tuition and related expenses do not include expenses that relate to any course of instruction or other education that involves sports, games, hobbies, or any noncredit course, unless the course is part of the student's degree program or, in the case of the Lifetime Learning Credit, is taken by the student to acquire or improve job skills.

3. *Hope Scholarship Credit*

The Hope Scholarship Credit is a per student credit that may be claimed for each eligible student. Consistent with the provisions of section 25A(b)(1), the proposed regulations provide that for taxable years beginning before 2002 the maximum Hope Scholarship Credit amount is $1,500 (100 percent of the first $1,000 of the qualified tuition and related expenses paid during the taxable year for education furnished to an eligible student during any academic period beginning in the taxable year or treated as beginning in the taxable year, plus 50 percent of the next $1,000 of such expenses paid with respect to that student). For taxable years beginning after 2001, the $1,000 amounts will be adjusted for inflation. Consistent with the provisions of section 25A(b)(2)(A), the regulations provide that the Hope Scholarship Credit is allowed for only two taxable years for each eligible student.

Based on the requirements in section 25A(b)(2) and (3), the proposed regulations define an *eligible student* for purposes of the Hope Scholarship Credit as a student who meets all of the following requirements: (1) for at least one academic period during the taxable year, the student enrolls at an eligible educational institution in a program leading toward a postsecondary degree, certificate, or other recognized postsecondary educational credential (*degree requirement*); (2) for at least one academic period during the taxable year, the student enrolls for at least half of the normal full-time work load for the course of study the student is pursuing (*work load requirement*); (3) as of the beginning of the taxable year, the student has not completed the first two years of postsecondary education at an eligible educational institution (*year of study requirement*); and (4) the student has not been convicted of a federal or state felony offense for the possession or distribution of a controlled substance as of the end of the taxable for which the credit is claimed (*felony drug conviction restriction*).

The proposed regulations explain that the student meets the *work load requirement* if the student is enrolled for at least half of the normal full-time work load, as determined by the eligible educational institution. The regulations provide that the educational institution's standards for a half-time work load must equal or exceed the standards established by the Department of Education under the HEA and set forth in 34 CFR 674.2(b) for a half-time undergraduate student.

The proposed regulations explain that whether a student has completed the first two years of postsecondary education as of the beginning of the taxable year is based on whether the eligible educational institution the student is enrolled in awards the student two years of academic credit for postsecondary course work completed by the student prior to the beginning of the taxable year. However, the regulations provide that any academic credit awarded by the educational institution solely on the basis of the student's performance on proficiency examinations is not taken into account.

The proposed regulations provide that the Hope Scholarship Credit is effective for expenses paid after December 31, 1997, for education furnished in academic periods beginning after that date.

4. *Lifetime Learning Credit*

The Lifetime Learning Credit is a per taxpayer credit, rather than a per student credit. For taxable years beginning before 2003, the maximum Lifetime Learning Credit amount is $1,000 (20 percent of up to $5,000 of the aggregate qualified tuition and related expenses paid during the taxable year for education furnished to the taxpayer, the taxpayer's spouse, and any claimed dependent during any academic period beginning in the taxable year or treated as beginning in the taxable year). For taxable years beginning on or after 2003, the maximum credit amount is $2,000 (20 percent of up to $10,000 of the aggregate qualified tuition and related expenses paid during the taxable year for education furnished to the taxpayer, the taxpayer's spouse, and any claimed dependent during any academic period beginning in the taxable year or treated as beginning in the taxable year).

In contrast to the Hope Scholarship Credit, the Lifetime Learning Credit is allowed for an unlimited number of years for each student and does not have a degree requirement, year of study requirement, work load requirement, or a felony drug conviction restriction. See H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess., at p. 346–347 (1997). Therefore, a taxpayer may claim a Lifetime Learning Credit for a student's qualified tuition and related expenses even if the taxpayer could not claim a Hope Scholarship Credit for those expenses.

Based on the provisions of section 25A(c)(2)(B) and the legislative history to section 25A, the proposed regulations provide that, for purposes of claiming a Lifetime Learning Credit, amounts that a taxpayer is required to pay for a course at an eligible educational institution are qualified tuition and related expenses if the course is either part of a postsecondary degree program or is part of a nondegree program that is taken by the student to acquire or improve job skills. The legislative history explains that the Lifetime Learning Credit is available with respect to any course of instruction at any eligible educational institution (whether the student is enrolled on a full-time, half-time, or less than half-time basis) to acquire or improve job skills of the student. See H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess., at p. 346–347 (1997).

The proposed regulations provide that the Lifetime Learning Credit is effective for expenses paid after June 30, 1998, for education furnished in academic periods beginning after that date.

5. *Special Rules Relating to Characterization and Timing of Payments*

The proposed regulations provide guidance on qualified tuition and related expenses paid by a third party. The regulations provide that, solely for purposes of section 25A, if a third party makes a payment directly to an eligible educational institution to pay for a student's qualified tuition and related expenses, the student is treated as receiving the payment from the third party, and, in turn, paying the qualified tuition and related expenses to the institution.

Consistent with the provisions of section 25A(g)(3), the proposed regulations provide that qualified tuition and related expenses paid by a student are treated as paid by the taxpayer if the student is a claimed dependent of the taxpayer.

The proposed regulations provide rules for adjustments to qualified tuition and related expenses for certain excludable educational assistance. Consistent with the provisions of section 25A(g)(2) and the legislative history, the regulations provide that the amount of otherwise allowable qualified tuition and related expenses paid during a taxable year must be reduced by the following amounts paid to, or on behalf of, a student during the taxable year: (1) a qualified scholarship that is excludable from gross income under section 117; (2) a veterans' or member of the armed forces' educational assistance allowance under chapter 30, 31, 32, 34, or 35 of title 38, U.S.C., or chapter 1606 of title 10, U.S.C.; (3) employer-provided educational assistance that is excludable from gross income under section 127; and (4) any other educational assistance that is excludable from gross income (other than as a gift, bequest, devise, or inheritance within the meaning of section 102(a)). See H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess., at p. 343, 347 (1997).

The proposed regulations provide rules for allocating scholarships and fellowship grants among expenses. The regulations provide that a scholarship or fellowship grant is treated as a qualified scholarship excludable from income under section 117 (and thereby reduces the amount of qualified tuition and related expenses that a taxpayer may otherwise include in claiming an education credit) unless either: (1) the student reports the grant as income on the student's federal income tax return; or (2) the grant must be applied, by its terms, to expenses other than qualified tuition and related expenses within the meaning of section 117(b)(2), such as room and board.

The proposed regulations provide guidance on the timing rules for claiming an education credit. Consistent with the general rule in section 25A(b)(1) and (c)(1), the regulations provide that an education credit generally is allowed only for payments of qualified tuition and related expenses that cover an academic period beginning in the same taxable year as the year the payment is made. However, consistent with the specific prepayment rule in section 25A(g)(4), the regulations provide that, if qualified tuition and related expenses are paid during a taxable year to cover an academic period that begins during the first three months of the taxpayer's next taxable year, an education credit is allowed only in the taxable year in which the expenses are paid. Note, however, that because the Hope Scholarship Credit does not apply to expenses paid before January 1, 1998, and the Lifetime Learning Credit does not apply to expenses paid before July 1, 1998, the prepayment rule does not apply for tuition paid in 1997 to cover an academic period beginning in 1998.

Consistent with the legislative history to section 25A, the proposed regulations provide that an education credit may be claimed for the qualified tuition and related expenses paid with the proceeds of a loan only in the taxable year in which the expenses are paid, and not in the taxable year in which the loan is repaid. See H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess., at p. 342, 346 (1997). In order to provide taxpayers with a date certain for payment, the regulations provide that loan proceeds disbursed directly to an educational institution are treated as paid on the date of the disbursement. However, if the taxpayer does not know the date of the disbursement, the taxpayer must treat qualified tuition and related expenses as paid on the last date prescribed for payment by the educational institution.

Consistent with the directive in section 25A(i), the proposed regulations provide rules for refunds of qualified tuition and related expenses. The regulations provide that, if a payment and a refund of qualified tuition and related expenses occur in the same taxable year, the amount of qualified tuition and related expenses for the taxable year is calculated by adding all qualified tuition and related expenses paid for the taxable year, and subtracting any refund of the expenses received from the eligible educational institution during the same taxable year.

The proposed regulations provide that, if, in a taxable year, a taxpayer (or the taxpayer's spouse or a claimed dependent) receives a refund from an eligible educational institution of qualified tuition and related expenses paid in a prior taxable year and the refund is received before the taxpayer files a federal income tax return for the prior taxable year, the amount of the qualified tuition and related expenses for the prior taxable year must be reduced by the amount of the refund.

Similar to the tax benefit rule, the proposed regulations provide that, if, in a taxable year, a taxpayer (or the taxpayer's spouse or a claimed dependent) receives a refund of qualified tuition and related expenses for which the taxpayer claimed an education credit in a prior taxable year, the tax for the subsequent taxable year is increased by the recapture amount. The recapture amount is the difference between the credit claimed in the prior taxable year and the redetermined credit. The redetermined credit is computed by reducing the amount of the qualified tuition and related expenses for which a credit was claimed in the prior taxable year by the amount of the refund of the qualified tuition and related expenses (redetermined qualified expenses), and computing the credit using the redetermined qualified expenses and the relevant facts and circumstance of the prior taxable year, such as modified adjusted gross income.

The proposed regulations provide that, if, in a taxable year, any excludable educational assistance is received for the qualified tuition and related expenses paid during a prior taxable year, the educational assistance is treated as a refund of qualified tuition and related expenses. In this situation, if a taxpayer (or the taxpayer's spouse or a claimed dependent) receives any excludable educational assistance before the taxpayer files a federal income tax return for the prior taxable year, the amount of the qualified tuition and related expenses for the prior taxable year is reduced by the amount of the excludable educational assistance. However, if a taxpayer (or the taxpayer's spouse or claimed dependent) receives excludable educational assistance after the taxpayer has filed a federal income tax return for the prior taxable year, any education credit claimed for the prior taxable year is subject to recapture.

6. *Proposed Effective Date*

These regulations are proposed to be effective on the date they are published in the **Federal Register** as final regulations. Taxpayers may rely on these proposed regulations for guidance pending the issuance of final regulations. If, and to the extent, future guidance is more restrictive than the guidance in the proposed regulations, the future guidance will be applied without retroactive effect.

Special Analyses

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

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written and electronic comments that are submitted timely to the IRS. The IRS and Treasury specifically request comments on the clarity of the proposed regulations and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing will be scheduled in the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. The IRS recognizes that persons outside the Washington, DC, area may also wish to testify at the public hearing through videoconferencing. Requests to include videoconferencing sites must be received by March 8, 1999. If the IRS receives sufficient indications of interest to warrant videoconferencing to a particular city, and if the IRS has videoconferencing facilities available in that city on the date the public hearing is to be scheduled, the IRS will try to accommodate the requests.

The IRS will publish the time and date of the public hearing and the locations of any videoconferencing sites in an announcement in the **Federal Register.**

Drafting Information

The principal author of the regulations is Donna Welch, Office of Assistant Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and the Treasury Department participated in the development of the regulations.

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Section 1.25A–0 also issued under section 26 U.S.C. 25A(i).

Section 1.25A–1 also issued under section 26 U.S.C. 25A(i).

Section 1.25A–2 also issued under section 26 U.S.C. 25A(i).

Section 1.25A–3 also issued under section 26 U.S.C. 25A(i).

Section 1.25A–4 also issued under section 26 U.S.C. 25A(i).

Section 1.25A–5 also issued under section 26 U.S.C. 25A(i). * * *

Par. 2. Sections 1.25A–0 through 1.25A–5 are added to read as follows:

§1.25A–0 Table of contents.

This section lists captions contained in §§1.25A–1, 1.25A–2, 1.25A–3, 1.25A–4, and 1.25A–5.

§1.25A–1 Calculation of education credit and general eligibility requirements.

(a) Amount of education credit.
(b) Coordination of Hope Scholarship Credit and Lifetime Learning Credit.
(1) In general.
(2) Hope Scholarship Credit.
(3) Lifetime Learning Credit.
(4) Examples.
(c) Limitation based on modified adjusted gross income.
(1) In general.
(2) Modified adjusted gross income defined.
(3) Inflation adjustment.
(d) Election.
(e) Coordination with Education IRA.
(f) Identification requirement.
(g) Claiming the credit in the case of a dependent.
(1) In general.
(2) Examples.
(h) Married taxpayers.
(i) Nonresident alien taxpayers and dependents.

§1.25A–2 Definitions.

(a) Claimed dependent.
(b) Eligible educational institution.
(1) In general.
(2) Rules on federal financial aid programs.
(c) Academic period.
(d) Qualified tuition and related expenses.
(1) In general.
(2) Required fees.
(i) In general.
(ii) Books, supplies, and equipment.
(iii) Nonacademic fees.
(3) Personal expenses.
(4) Treatment of comprehensive fees.
(5) Hobby courses.
(6) Examples.

§1.25A–3 Hope Scholarship Credit.

(a) Amount of the credit.
(1) In general.
(2) Maximum credit.
(b) Per student credit.
(1) In general.
(2) Example.
(c) Credit allowed for only two taxable years.
(d) Eligible student.
(1) Eligible student defined.
(i) Degree requirement.
(ii) Work load requirement.
(iii) Year of study requirement.
(iv) No felony drug conviction.
(2) Examples.
(e) Academic period for prepayments.
(1) In general.
(2) Example.
(f) Effective date.

§1.25A–4 Lifetime Learning Credit.

(a) Amount of the credit.
(1) Taxable years beginning before January 1, 2003.
(2) Taxable years beginning after December 31, 2002.
(3) Coordination with the Hope Scholarship Credit.
(4) Examples.
(b) Credit allowed for unlimited number of taxable years.
(c) Both degree and nondegree courses are eligible for the credit.
(1) In general.
(2) Examples.
(d) Effective date.

§1.25A–5 Special rules relating to characterization and timing of payments.

(a) Payments of educational expenses by a third party.
(1) In general.
(2) Example.
(b) Expenses paid by dependent.
(1) In general.
(2) Example.
(c) Adjustment to qualified tuition and related expenses for certain excludable educational assistance.
(1) In general.
(2) No adjustment for excludable educational assistance attributable to expenses paid in a prior year.

(3) Allocation of scholarships and fellowship grants.
(4) Examples.
(d) No double benefit.
(e) Timing rules.
(1) In general.
(2) Prepayment rule.
(i) In general.
(ii) Example.
(3) Expenses paid with loan proceeds.
(f) Refund of qualified tuition and related expenses.
(1) Payment and refund of qualified tuition and related expenses in the same taxable year.
(2) Payment of qualified tuition and related expenses in one taxable year and refund in subsequent taxable year before return filed for prior taxable year.
(3) Payment of qualified tuition and related expenses in one taxable year and refund in subsequent taxable year.
(i) In general.
(ii) Recapture amount.
(4) Excludable educational assistance received in a subsequent taxable year treated as refund.
(5) Examples.

§1.25A–1 Calculation of education credit and general eligibility requirements.

(a) *Amount of education credit.* An individual taxpayer is allowed a nonrefundable education credit against income tax imposed by chapter 1 of the Internal Revenue Code for the taxable year. The amount of the education credit is the total of the Hope Scholarship Credit (as described in §1.25A–3) plus the Lifetime Learning Credit (as described in §1.25A–4). For limitations on the credits allowed by subpart A of part IV of subchapter A of chapter 1, see section 26.

(b) *Coordination of Hope Scholarship Credit and Lifetime Learning Credit*—(1) *In general.* In the same taxable year, a taxpayer may claim a Hope Scholarship Credit for each eligible student's qualified tuition and related expenses (as defined in §1.25A-2(d)) and a Lifetime Learning Credit for one or more other students' qualified tuition and related expenses. However, a taxpayer may not claim both a Hope Scholarship Credit and a Lifetime Learning Credit with respect to the same student in the same taxable year.

(2) *Hope Scholarship Credit.* Subject to certain limitations, a Hope Scholarship Credit may be claimed for the qualified tuition and related expenses paid during a taxable year with respect to each eligible student (as defined in §1.25A–3(d)). Qualified tuition and related expenses paid during a taxable year with respect to any student for whom a Hope Scholarship Credit is claimed may not be taken into account in computing the amount of the Hope Scholarship Credit with respect to any other student or the Lifetime Learning Credit.

(3) *Lifetime Learning Credit.* Subject to certain limitations, a Lifetime Learning Credit may be claimed for the aggregate amount of qualified tuition and related expenses paid during a taxable year with respect to students for whom no Hope Scholarship Credit is claimed.

(4) *Examples.* The following examples illustrate the rules of this paragraph (b):

Example 1. In 1999, Taxpayer A pays qualified tuition and related expenses for his dependent, B, to attend College Y during 1999. Assuming all other relevant requirements are met, Taxpayer A may claim either a Hope Scholarship Credit or a Lifetime Learning Credit with respect to dependent B, but not both. See §1.25A–3(a) and §1.25A–4(a).

Example 2. In 1999, Taxpayer C pays $2,000 in qualified tuition and related expenses for her dependent, D, to attend College Z during 1999. In 1999, Taxpayer C also pays $500 in qualified tuition and related expenses to attend a computer course during 1999 to improve Taxpayer C's job skills. Assuming all other relevant requirements are met, Taxpayer C may claim a Hope Scholarship Credit for the $2,000 of qualified tuition and related expenses attributable to dependent D (see §1.25A–3(a)) and a Lifetime Learning Credit for the $500 of qualified tuition and related expenses incurred to improve her job skills.

Example 3. The facts are the same as in *Example 2,* except that Taxpayer C pays $3,000 in qualified tuition and related expenses for her dependent, D, to attend College Z during 1999. Although a Hope Scholarship Credit is available only with respect to the first $2,000 of qualified tuition and related expenses paid with respect to D (see §1.25A–3(a)), Taxpayer C may not add the $1,000 of excess expenses to her $500 of qualified tuition and related expenses in computing the amount of the Lifetime Learning Credit.

(c) *Limitation based on modified adjusted gross income*—(1) *In general.* The education credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified adjusted gross income between $40,000 and $50,000 ($80,000 and $100,000 for married individuals who file a joint return). Thus, taxpayers with modified adjusted gross income above $50,000 (or $100,000 for joint filers) may not claim an education credit.

(2) *Modified adjusted gross income defined.* The term *modified adjusted gross income* means the adjusted gross income (as defined in section 62) of the taxpayer for the taxable year increased by any amount excluded from gross income under section 911, 931, or 933 (relating to income earned abroad or from certain U.S. possessions or Puerto Rico).

(3) *Inflation adjustment.* For taxable years beginning after 2001, the amounts in paragraph (c)(1) of this section will be increased for inflation occurring after 2000 in accordance with section 1(f)(3). If any amount adjusted under this paragraph (c)(3) is not a multiple of $1,000, the amount will be rounded to the next lowest multiple of $1,000.

(d) *Election.* No education credit is allowed unless a taxpayer elects to claim the credit on the taxpayer's timely filed (including extensions) federal income tax return for the taxable year in which the credit is claimed. The election is made by attaching Form 8863, "Education Credits (Hope and Lifetime Learning Credits)," (or its successor) to that federal income tax return.

(e) *Coordination with Education IRA.* No education credit is allowed for a taxable year for the qualified tuition and related expenses of a student if—

(1) During the taxable year, a distribution is made to, or on behalf of, the student from an education individual retirement account described in section 530(b) (Education IRA); and

(2) Any portion of the distribution is excluded from gross income under section 530(d)(2).

(f) *Identification requirement.* No education credit is allowed unless a taxpayer includes on the federal income tax return claiming the credit the name and the taxpayer identification number of the student for whom the credit is claimed. For rules relating to assessment for an omission of a correct taxpayer identification number, see section 6213(b) and (g)(2)(J).

(g) *Claiming the credit in the case of a dependent*—(1) *In general.* If a student is a claimed dependent of another taxpayer, only that taxpayer may claim the education credit for the student's qualified tuition and related expenses. However, if the taxpayer is eligible to, but does not, claim the student as a dependent, only the student may claim the education credit for the student's qualified tuition and related expenses.

(2) *Examples.* The following examples illustrate the rules of this paragraph (g):

Example 1. In 1999, Taxpayer A pays qualified tuition and related expenses for his dependent, B, to attend University Y during 1999. Taxpayer A claims B as a dependent on his federal income tax return. Therefore, assuming all other relevant requirements are met, Taxpayer A is allowed an education credit on his federal income tax return, and B is not allowed an education credit on B's federal income tax return. The result would be the same if B paid the qualified tuition and related expenses. See §1.25A–5(b).

Example 2. In 1999, Taxpayer C has one dependent, D. In 1999, D pays qualified tuition and related expenses to attend University Z during 1999. Although Taxpayer C is eligible to claim D as a dependent on her federal income tax return, she does not do so. Therefore, assuming all other relevant requirements are met, D is allowed an education credit on D's federal income tax return, and Taxpayer C is not allowed an education credit on her federal income tax return, with respect to D's education expenses. The result would be the same if C paid the qualified tuition and related expenses on behalf of D. See §1.25A–5(a).

(h) *Married taxpayers.* If a taxpayer is married (within the meaning of section 7703), no education credit is allowed unless the taxpayer and the taxpayer's spouse file a joint federal income tax return for the taxable year.

(i) *Nonresident alien taxpayers and dependents.* If a taxpayer or the taxpayer's spouse is a nonresident alien for any portion of the taxable year, no education credit is allowed unless the nonresident alien is treated as a resident alien by reason of an election under section 6013(g) or (h). In addition, if a student is a nonresident alien, a taxpayer may not claim an education credit with respect to the qualified tuition and related expenses of the student unless the student is a dependent as defined in section 152. Among other requirements under section 152, the nonresident alien student must be a resident of a country contiguous to the United States in order to be treated as a dependent.

§1.25A–2 Definitions.

(a) *Claimed dependent.* A *claimed dependent* means a dependent (as defined in section 152) for whom a deduction under section 151 is allowed on a taxpayer's federal income tax return for the taxable year.

(b) *Eligible educational institution*—(1) *In general.* In general, an *eligible educational institution* means a college, university, vocational school, or other postsecondary educational institution that is—

(i) Described in section 481 of the Higher Education Act of 1965 (20 U.S.C. 1088) as in effect on August 5, 1997, (generally all accredited public, nonprofit, and proprietary postsecondary institutions); and

(ii) Participating in a federal financial aid program under title IV of the Higher Education Act of 1965 (20 U.S.C. 1070 et seq.) or is certified by the Department of Education as eligible to participate in such a program but chooses not to participate.

(2) *Rules on federal financial aid programs.* For rules governing an educational institution's eligibility to participate in federal financial aid programs, see 20 U.S.C. 1070 et seq.; 20 U.S.C. 1094; and 34 CFR 600 and 668.

(c) *Academic period. Academic period* means a quarter, semester, trimester, or other period of study (such as a summer school session) as reasonably determined by an eligible educational institution.

(d) *Qualified tuition and related expenses*—(1) *In general. Qualified tuition and related expenses* means tuition and fees required for the enrollment or attendance of a student for courses of instruction at an eligible educational institution.

(2) *Required fees*—(i) *In general.* Except as provided in paragraph (d)(3) of this section, the test for determining whether any fee is a qualified tuition and related expense is whether the fee is required to be paid to the eligible educational institution as a condition of the student's enrollment or attendance at the institution.

(ii) *Books, supplies, and equipment.* Qualified tuition and related expenses include fees for books, supplies, and equipment used in a course of study only if the fee must be paid to the eligible educational institution for the enrollment or attendance of the student at the institution.

(iii) *Nonacademic fees.* Except as provided in paragraph (d)(3) of this section, qualified tuition and related expenses include fees charged by an eligible educational institution that are not used directly for, or allocated to, an academic course of instruction only if the fee must be paid to the eligible educational institution for the enrollment or attendance of the student at the institution.

(3) *Personal expenses.* Qualified tuition and related expenses do not include the costs of room and board, insurance, medical expenses, transportation, and similar personal, living, or family expenses, regardless of whether the fee must be paid to the eligible educational institution for the enrollment or attendance of the student at the institution.

(4) *Treatment of comprehensive fees.* If a student is required to pay a comprehensive fee to an eligible educational institution that includes charges for tuition, fees, and personal expenses described in paragraph (d)(3) of this section, the portion of the comprehensive fee that is allocable to personal expenses is not a qualified tuition and related expense. The allocation must be made by the institution using a reasonable method.

(5) *Hobby courses.* Qualified tuition and related expenses do not include expenses that relate to any course of instruction or other education that involves sports, games, or hobbies, or any noncredit course, unless the course or other education is part of the student's degree program or, in the case of the Lifetime Learning Credit, is taken by the student to acquire or improve job skills.

(6) *Examples.* The following examples illustrate the rules of this paragraph (d). In each example, assume that all other relevant requirements to claim an education credit are met. The examples are as follows:

Example 1. University V offers a degree program in dentistry. In addition to tuition, all students enrolled in the program are required to pay a fee to University V for the rental of dental equipment. Because the equipment rental fee must be paid to University V for enrollment and attendance, the tuition and the equipment rental fee are qualified tuition and related expenses.

Example 2. First-year students at College W are required to obtain books and other reading materials used in its mandatory first-year curriculum. The books and other reading materials are not required to be purchased from College W and may be borrowed from other students or purchased from off-campus bookstores, as well as from College W's bookstore. College W bills students for any books and materials purchased from College W's bookstore. The fee that College W charges for the first-year books and materials purchased at its bookstore is not a qualified tuition and related expense because the books and materials are not required to be purchased from College W for enrollment or attendance at the institution.

Example 3. All students who attend College X are required to pay a separate student activity fee in addition to their tuition. The student activity fee is used solely to fund on-campus organizations and activities run by students, such as the student newspaper and the student government (no portion of the fee covers personal expenses). Although labeled as a student activity fee, the fee is required for enrollment or attendance at College X. Therefore, the fee is a qualified tuition and related expense.

Example 4. The facts are the same as in *Example 3,* except that College X offers an optional athletic fee that students may pay to receive discounted tickets to sports events. The athletic fee is not required for enrollment or attendance at College X. Therefore, the fee is not a qualified tuition and related expense.

Example 5. College Y requires all students to live on campus. It charges a single comprehensive fee to cover tuition, required fees not allocable to personal expenses, and room and board. Based on College Y's reasonable allocation, sixty percent of the comprehensive fee is allocable to tuition and other required fees not allocable to personal expenses, and the remaining forty percent of the comprehensive fee is allocable to charges for room and board. Therefore, only sixty percent of College Y's comprehensive fee is a qualified tuition and related expense.

Example 6. As a degree student at College Z, Student A is required to take a certain number of courses outside of her chosen major in Economics. To fulfill this requirement, Student A enrolls in a square dancing class offered by the Physical Education Department. Because Student A receives credit toward her degree program for the square dancing class, the tuition for the square dancing class is included in qualified tuition and related expenses.

§1.25A–3 Hope Scholarship Credit.

(a) *Amount of the credit*—(1) *In general.* Subject to the phase out of the education credit described in §1.25A–1(c), the Hope Scholarship Credit amount is the total of—

(i) 100 percent of the first $1,000 of qualified tuition and related expenses paid during the taxable year for education furnished to an eligible student (as defined in paragraph (d) of this section) who is the taxpayer, the taxpayer's spouse, or any claimed dependent during any academic period beginning in the taxable year (or treated as beginning in the taxable year, see §1.25A–5(e)(2)); plus

(ii) 50 percent of the next $1,000 of such expenses paid with respect to that student.

(2) *Maximum credit.* For taxable years beginning before 2002, the maximum Hope Scholarship Credit allowed for each eligible student is $1,500. For taxable years beginning after 2001, the amounts in paragraph (a)(1) of this section to determine the maximum credit will be increased for inflation occurring after 2000 in accordance with section 1(f)(3). If any amount adjusted under this paragraph (a)(2) is not a multiple of $100, the amount will be rounded to the next lowest multiple of $100.

(b) *Per student credit*—(1) *In general.* A Hope Scholarship Credit may be claimed for the qualified tuition and related expenses of each eligible student (as defined in paragraph (d) of this section).

(2) *Example.* The following example illustrates the rule of this paragraph (b). In the example, assume that all the requirements to claim an education credit are met. The example is as follows:

Example. In 1999, Taxpayer A has two dependents, B and C, both of whom are eligible students. Taxpayer A pays $1,600 in qualified tuition and related expenses for dependent B to attend a community college. Taxpayer A pays $5,000 in qualified tuition and related expenses for dependent C to attend University X. Taxpayer A may claim a Hope Scholarship Credit of $1,300 ($1,000 + (.50 × $600)) for dependent B, and the maximum $1,500 Hope Scholarship Credit for dependent C, for a total Hope Scholarship Credit of $2,800.

(c) *Credit allowed for only two taxable years.* For each eligible student, the Hope Scholarship Credit may be claimed for no more than two taxable years.

(d) *Eligible student*—(1) *Eligible student defined.* For purposes of the Hope Scholarship Credit, the term *eligible student* means a student who satisfies all of the following requirements—

(i) *Degree requirement.* For at least one academic period that begins during the taxable year, the student enrolls at an eligible educational institution in a program leading toward a postsecondary degree, certificate, or other recognized postsecondary educational credential;

(ii) *Work load requirement.* For at least one academic period that begins during the taxable year, the student enrolls for at least half of the normal full-time work load for the course of study the student is pursuing. The standard for what is half of the normal full-time work load is determined by each eligible educational institution. However, the standard for half-time may not be lower than standards for half-time established by the Department of Education under the Higher Education Act of 1965 and set forth in 34 CFR 674.2(b) for a half-time undergraduate student;

(iii) *Year of study requirement.* As of the beginning of the taxable year, the student has not completed the first two years of postsecondary education at an eligible educational institution. Whether a student has completed the first two years of postsecondary education at an eligible educational institution as of the beginning of a taxable year is determined based on whether the institution in which the student is enrolled in a degree program (as described in paragraph (d)(1)(i) of this section) awards the student two years of academic credit at that institution for postsecondary course work completed by the student prior to the beginning of the taxable year. Any academic credit awarded by the eligible educational institution solely on the basis of the student's performance on proficiency examinations is disregarded in determining whether the student has completed two years of postsecondary education; and

(iv) *No felony drug conviction.* The student has not been convicted of a federal or state felony offense for possession or distribution of a controlled substance as of the end of the taxable year for which the credit is claimed.

(2) *Examples.* The following examples illustrate the rules of this paragraph (d). In each example, assume that the student has not been convicted of a felony drug offense, that the institution is an eligible educational institution unless otherwise stated, that the qualified tuition and related expenses are paid during the same taxable year that the academic period begins, and that a Hope Scholarship Credit has not previously been claimed for the student (see paragraph (c) of this section). The examples are as follows:

Example 1. Student A graduates from high school in June 1998 and enrolls full-time in an undergraduate degree program at College U for the 1998 Fall semester. For the 1999 Spring semester, Student A again enrolls at College U on a full-time basis. For the 1999 Fall semester, Student A enrolls in less than half the normal full-time course work for her degree program. Because Student A is enrolled in an undergraduate degree program on at least a half-time basis for at least one academic period that begins during 1998 and at least one academic period that begins during 1999, Student A is an eligible student for taxable years 1998 and 1999 (including the 1999 Fall semester when Student A enrolls at College U on less than a half-time basis).

Example 2. Prior to 1998, Student B attended college for several years on a full-time basis. Student B transfers to College V for the 1998 Spring semester. College V awards Student B credit for some (but not all) of the courses he previously completed, and College V classifies Student B as a first-semester sophomore. During both the Spring and Fall semesters of 1998, Student B enrolls in half the normal full-time work load for his degree program. Because College V does not classify Student B as having completed the first two years of postsecondary education as of the beginning of 1998, Student B is an eligible student for taxable year 1998.

Example 3. The facts are the same as in *Example 2.* After taking classes on a half-time basis for the 1998 Spring and Fall semesters, Student B enrolls in a full-time work load at College V for the 1999 Spring semester. College V classifies Student B as a second-semester sophomore for the 1999 Spring semester and as a first-semester junior for the 1999 Fall semester. Because College V does not classify Student B as having completed the first two years of postsecondary education as of the beginning of 1999, Student B is an eligible student for taxable year 1999.

Example 4. At the time that Student C enrolls in a degree program at College W for the 1998 Fall semester, Student C takes examinations to demonstrate her proficiency in several subjects. On the basis of Student C's performance on these examinations, College W classifies Student C as a second-semester sophomore as of the beginning of the 1998 Fall semester. Student C takes a full-time work load during the 1998 Fall semester and during the 1999 Spring and Fall semesters. Because Student C was not enrolled in a college or other eligible educational institution prior to 1998 (but rather was classified as a second-semester sophomore by College W as of the start of the 1998 Fall semester solely because of proficiency examinations), Student C is not treated as having completed the first two years of postsecondary education at an eligible educational institution as of the beginning of 1998 or as of the beginning of 1999. Therefore, Student C is an eligible student for both taxable years 1998 and 1999.

Example 5. During the 1998 Fall semester, Student D is a high school student who takes classes on a half-time basis at College X. Student D is not enrolled as part of a degree program at College X because College X does not admit students to a degree program unless the student has a high school diploma or equivalent. Because Student D is not enrolled in a degree program at College X during 1998, Student D is not an eligible student for taxable year 1998.

Example 6. The facts are the same as in *Example 5.* During the 1999 Spring semester, Student D again attends College X but not as part of a degree program. Student D graduates from high school in June 1999. For the 1999 Fall semester, Student D enrolls in College X as part of a degree program, and College X awards Student D credit for her prior course work at College X. During the 1999 Fall semester, Student D takes more than half the normal full-time work load of courses for her degree program at College X. Because Student D is enrolled in a degree program at College X for the 1999 Fall term on more than a half-time basis, Student D is an eligible student for all of taxable year 1999. Therefore, the qualified tuition and required fees paid for classes taken at College X during both the 1999 Spring semester (during which Student D was not enrolled in a degree program) and the 1999 Fall semester are taken into account in computing any Hope Scholarship Credit.

Example 7. Student E completed two years of undergraduate study at College S located in Country S. College S is not an eligible educational institution for purposes of the education credits. At the end of 1998, Student E moves to the United States and enrolls in an undergraduate degree program at College Z on a full-time basis for the 1999 Spring semester. College Z awards Student E two years of academic credit for his previous course work at College S and classifies Student E as a first-semester junior for the 1999 Spring semester. Student E is treated as having completed the first two years of postsecondary education at an eligible educational institution as of the beginning of 1999. Therefore, Student E is not an eligible student for taxable year 1999.

Example 8. Student F was born and raised in Country R, and she received a degree in 1998 from College R located in Country R. College R is not an eligible educational institution for purposes of the education credits. During 1999, Student F moves to the United States and enrolls for the 1999 Fall semester on a full-time basis in a graduate-degree program at College Y. By admitting Student F to its graduate degree program, College Y treats Student F as having completed the first two years of postsecondary education as of the beginning of 1999. Therefore, Student F is not an eligible student for taxable year 1999.

(e) *Academic period for prepayments*—(1) *In general.* For purposes of determining whether a student meets the requirements in paragraph (d) of this section for a taxable year, if qualified tuition and related expenses are paid during one taxable year for an academic period that begins during January, February or March of the next taxable year (for taxpayers on a fiscal taxable year, use the first three months of the next taxable year), the academic period is treated as beginning during the taxable year in which the payment is made.

(2) *Example.* The following example illustrates the rule of this paragraph (e). In the example, assume that all the requirements to claim a Hope Scholarship Credit are met. The example is as follows:

Example. Student G graduates from high school in June 1998. After graduation, Student G works full-time for several months to earn money for college. Student G enrolls full-time in an undergraduate degree program at University W, an eligible educational institution, for the 1999 Spring semester, which begins in January 1999. Student G pays tuition to University W for the 1999 Spring semester in December 1998. Because the tuition paid by Student G in 1998 relates to an academic period that begins during the first three months of 1999, Student G's eligibility to claim a Hope Scholarship Credit in 1998 is determined as if the 1999 Spring semester began in 1998. Thus, assuming Student G has not been convicted of a felony drug offense as of December 31, 1998, Student G is an eligible student for 1998.

(f) *Effective date.* The Hope Scholarship Credit is applicable for qualified tuition and related expenses paid after December 31, 1997, for education furnished in academic periods beginning after December 31, 1997.

§1.25A–4 Lifetime Learning Credit.

(a) *Amount of the credit*—(1) *Taxable years beginning before January 1, 2003.* Subject to the phase out of the education credit described in §1.25A–1(c), for taxable years beginning before 2003, the Lifetime Learning Credit amount is 20 percent of up to $5,000 of qualified tuition and related expenses paid during the taxable year for education furnished to the taxpayer, the taxpayer's spouse, and any claimed dependent during any academic period beginning in the taxable year (or treated as beginning in the taxable year, see §1.25A–5(e)(2)).

(2) *Taxable years beginning after December 31, 2002.* Subject to the phase out of the education credit described in §1.25A–1(c), for taxable years beginning after 2002, the Lifetime Learning Credit amount is 20 percent of up to $10,000 of qualified tuition and related expenses paid during the taxable year for education furnished to the taxpayer, the taxpayer's spouse, and any claimed dependent during any academic period beginning in the taxable year (or treated as beginning in the taxable year, see §1.25A–5(e)(2)).

(3) Coordination with the Hope Scholarship Credit. Expenses paid with respect to a student for whom the Hope Scholarship Credit is claimed are not eligible for the Lifetime Learning Credit.

(4) *Examples.* The following examples illustrate the rules of this paragraph (a). In each example, assume that all the requirements to claim a Lifetime Learning

Credit or a Hope Scholarship Credit, as applicable, are met. The examples are as follows:

Example 1. In 1999, Taxpayer A pays qualified tuition and related expenses of $3,000 for dependent B to attend an eligible educational institution, and he pays qualified tuition and related expenses of $4,000 for dependent C to attend an eligible educational institution. Taxpayer A does not claim a Hope Scholarship Credit with respect to either B or C. Although Taxpayer A paid $7,000 of qualified tuition and related expenses during the taxable year, Taxpayer A may claim the Lifetime Learning Credit with respect to only $5,000 of such expenses. Therefore, the maximum Lifetime Learning Credit Taxpayer A may claim for 1999 is $1,000 (.20 x $5,000).

Example 2. In 1999, Taxpayer D pays $6,000 of qualified tuition and related expenses for dependent E, and $2,000 of qualified tuition and related expenses for dependent F, to attend eligible educational institutions. Dependent F has already completed the first two years of postsecondary education. For 1999, Taxpayer D claims the maximum $1,500 Hope Scholarship Credit with respect to dependent E. In computing the amount of the Lifetime Learning Credit, Taxpayer D may not include any of the $6,000 of qualified tuition and related expenses paid on behalf of dependent E but may include the $2,000 of qualified tuition and related expenses of dependent F.

(b) *Credit allowed for unlimited number of taxable years.* There is no limit to the number of taxable years that a taxpayer may claim a Lifetime Learning Credit with respect to any student.

(c) *Both degree and nondegree courses are eligible for the credit*—(1) *In general.* For purposes of the Lifetime Learning Credit, amounts paid for a course at an eligible educational institution are qualified tuition and related expenses if the course is either part of a postsecondary degree program or is not part of a postsecondary degree program but is taken by the student to acquire or improve job skills.

(2) *Examples.* The following examples illustrate the rule of this paragraph (c). In each example, assume that all the requirements to claim a Lifetime Learning Credit are met. The examples are as follows:

Example 1. Taxpayer A, a professional photographer, enrolls in an advanced photography course at a local community college. Although the course is not part of a degree program, Taxpayer A enrolls in the course to improve her job skills. The course fee paid by Taxpayer A is a qualified tuition and related expense for purposes of the Lifetime Learning Credit.

Example 2. Taxpayer B, a stockbroker, plans to travel abroad on a "photo-safari" for his next vacation. In preparation for the trip, Taxpayer B enrolls in a noncredit photography class at a local community college. Because Taxpayer B is not taking the photography course as part of a degree program or to acquire or improve his job skills, amounts paid by Taxpayer B for the course are not qualified tuition and related expenses for purposes of the Lifetime Learning Credit.

(d) *Effective date.* The Lifetime Learning Credit is applicable for qualified tuition and related expenses paid after June 30, 1998, for education furnished in academic periods beginning after June 30, 1998.

§1.25A–5 Special rules relating to characterization and timing of payments.

(a) *Payments of educational expenses by a third party*—(1) *In general.* Solely for purposes of section 25A, if a third party (someone other than the taxpayer, the taxpayer's spouse, or a claimed dependent) makes a payment directly to an eligible educational institution to pay for a student's qualified tuition and related expenses, the student is treated as receiving the payment from the third party, and, in turn, paying the qualified tuition and related expenses to the institution.

(2) *Example.* The following example illustrates the rule of this paragraph (a). In the example, assume that all the requirements to claim an education credit are met. The example is as follows:

Example. Grandparent D makes a direct payment to an eligible educational institution for Student E's qualified tuition and related expenses. Student E is not a claimed dependent in 1999. For purposes of claiming an education credit, Student E is treated as receiving the money from her grandparent and, in turn, paying her qualified tuition and related expenses.

(b) *Expenses paid by dependent*—(1) *In general.* Qualified tuition and related expenses paid by a student are treated as paid by a taxpayer if the student is a claimed dependent of the taxpayer for the taxable year in which the expenses are paid.

(2) *Example.* The following example illustrates the rule of this paragraph (b). In the example, assume that all the requirements to claim an education credit are met. The example is as follows:

Example. Under a court-approved divorce decree, Parent A is required to pay Student C's college tuition. Parent A makes a direct payment to an eligible educational institution for Student C's 1999 tuition. Under paragraph (a) of this section, Student C is treated as receiving the money from Parent A and, in turn, paying his qualified tuition and related expenses. Under the divorce decree, Parent B has custody of Student C for 1999. Parent B properly claims Student C as a dependent on Parent B's 1999 federal income tax return. Parent B may claim an education credit for the qualified tuition and related expenses paid directly to the institution by Parent A.

(c) *Adjustment to qualified tuition and related expenses for certain excludable educational assistance*—(1) *In general.* In determining the amount of an education credit, qualified tuition and related expenses paid during the taxable year must be reduced by any amount paid to, or on behalf of, a student during the taxable year with respect to attendance at an eligible educational institution during an academic period beginning in that taxable year that is—

(i) A qualified scholarship that is excludable from income under section 117;

(ii) A veterans' or member of the armed forces' educational assistance allowance under chapter 30, 31, 32, 34 or 35 of title 38, United States Code, or under chapter 1606 of title 10, United States Code;

(iii) Employer-provided educational assistance that is excludable from income under section 127; or

(iv) Any other educational assistance that is excludable from gross income (other than as a gift, bequest, devise, or inheritance within the meaning of section 102(a)).

(2) *No adjustment for excludable educational assistance attributable to expenses paid in a prior year.* A reduction is not required under paragraph (c)(1) of this section if the amount of excludable educational assistance received during the taxable year is treated as a refund of qualified tuition and related expenses paid in a prior taxable year. See paragraph (f)(4) of this section.

(3) *Allocation of scholarships and fellowship grants.* For purposes of paragraph (c)(1) of this section, a scholarship or fellowship grant is treated as a qualified scholarship excludable from income under section 117 unless—

(i) The student reports the grant as income on the student's federal income tax return; or

(ii) The grant must be applied, by its terms, to expenses other than qualified tuition and related expenses within the meaning of section 117(b)(2), such as room and board.

(4) *Examples.* The following examples illustrate the rules of this paragraph (c). In each example, assume that all the requirements to claim an education credit are met. The examples are as follows:

Example 1. University X charges Student A, who lives on X's campus, $3,000 for tuition and $5,000 for room and board. University X awards a $2,000 scholarship to Student A, which University X applies against Student A's $8,000 total bill. The terms of the scholarship permit it to be used to pay any of a student's costs of attendance at University X, including tuition and room and board. Student A pays the $6,000 balance of her bill from University X with a combination of savings and amounts she earns from a summer job. University X does not require A to pay any additional fees beyond the $3,000 in tuition in order to enroll in classes. Student A does not report any portion of the scholarship as income on Student A's federal income tax return. The scholarship is a qualified scholarship that is excludable from Student A's income under section 117 and is allocable first to Student A's qualified tuition and related expenses. Therefore, for purposes of calculating an education credit, Student A is treated as having paid only $1,000 ($3,000 tuition – $2,000 scholarship) in qualified tuition and related expenses to University X.

Example 2. The facts are the same as in *Example 1,* except that in addition to the scholarship that University X awards to Student A, University X also provides Student A with a student loan and pays Student A for working in a work/study job in the campus dining hall. The loan is not excludable educational assistance. In addition, wages paid to a student who is performing services for the payor are neither a qualified scholarship nor otherwise excludable from gross income. Therefore, Student A is not required to reduce her qualified tuition and related expenses by the amounts she receives from the student loan or as wages from her work/study job.

Example 3. In 1999, Student B pays University Y $1,000 in tuition for the 1999 Spring semester. University Y does not require Student B to pay any additional fees beyond the $1,000 in tuition in order to enroll in classes. Student B is an employee of Company Z. At the end of the academic period and during the same taxable year that Student B paid tuition to University Y, Student B provides Company Z with proof that he has satisfactorily completed his courses at University Y. Pursuant to an educational assistance program described in section 127(b), Company Z reimburses Student B for all of the tuition paid to University Y. Because the reimbursement from Company Z is employer-provided educational assistance that is excludable from Student B's gross income under section 127, the reimbursement reduces Student B's qualified tuition and related expenses. Therefore, for purposes of calculating an education credit, Student B is treated as having paid no qualified tuition and related expenses to University Y during 1999.

Example 4. The facts are the same as in *Example 3,* except that the reimbursement from Company Z is not pursuant to an educational assistance program described in section 127(b), is not otherwise excludable from Student B's gross income, and is taxed as additional wages to Student B. Because the reimbursement is not excludable employer-provided educational assistance, Student B is not required to reduce his qualified tuition and related expenses by the $1,000 reimbursement he received from his employer. Therefore, for purposes of calculating an education credit, Student B is treated as paying $1,000 in qualified tuition and related expenses to University Y during 1999.

(d) *No double benefit.* Qualified tuition and related expenses do not include any expense for which a deduction is allowed under section 162 or any other provision of chapter 1 of the Internal Revenue Code.

(e) *Timing rules*—(1) *In general.* Except as provided in paragraph (e)(2) of this section, an education credit is allowed only for payments of qualified tuition and related expenses for an academic period beginning in the same taxable year as the year the payment is made. Except for certain individuals who do not use the cash receipts and disbursements method of accounting, qualified tuition and related expenses are treated as paid in the year in which the expenses are actually paid. See §1.461–1(a)(1).

(2) *Prepayment rule*—(i) *In general.* If qualified tuition and related expenses are paid during one taxable year for an academic period that begins during the first three months of the taxpayer's next taxable year (i.e., in January, February, or March of the next taxable year for calendar year taxpayers), an education credit is allowed with respect to the qualified tuition and related expenses only in the taxable year in which the expenses are paid.

(ii) *Example.* The following example illustrates the rule of this paragraph (e)(2). In the example, assume that all the requirements to claim an education credit are met. The example is as follows:

Example. In December 1998, Taxpayer A, a calendar year taxpayer, pays College Z $1,000 in qualified tuition and related expenses to attend the 1999 Spring semester, which begins in January 1999. Taxpayer A may claim an education credit only in 1998 for payments made in 1998 for the 1999 Spring semester.

(3) *Expenses paid with loan proceeds.* An education credit may be claimed for the qualified tuition and related expenses paid with the proceeds of a loan only in the taxable year in which the expenses are paid, and may not be claimed in the taxable year in which the loan is repaid. Loan proceeds disbursed directly to an eligible educational institution will be treated as paid on the date of disbursement. If a taxpayer does not know the date of disbursement, the taxpayer must treat the qualified tuition and related expenses as paid on the last date for payment prescribed by the institution.

(f) *Refund of qualified tuition and related expenses*—(1) *Payment and refund of qualified tuition and related expenses in the same taxable year.* With respect to any student, the amount of qualified tuition and related expenses for a taxable year is calculated by adding all qualified tuition and related expenses paid for the taxable year, and subtracting any refund of such expenses received from the eligible educational institution during the same taxable year.

(2) *Payment of qualified tuition and related expenses in one taxable year and refund in subsequent taxable year before return filed for prior taxable year.* If, in a taxable year, a taxpayer, (or the taxpayer's spouse or a claimed dependent) receives a refund from an eligible educational institution of qualified tuition and related expenses paid in a prior taxable year and the refund is received before the taxpayer files a federal income tax return for the prior taxable year, the amount of the qualified tuition and related expenses for the prior taxable year is reduced by the amount of the refund.

(3) *Payment of qualified tuition and related expenses in one taxable year and refund in subsequent taxable year*—(i) *In general.* If, in a taxable year (refund year), a taxpayer (or the taxpayer's spouse or a claimed dependent) receives a refund of qualified tuition and related expenses for which the taxpayer claimed an education credit in a prior taxable year, the tax imposed by chapter 1 of the Internal Revenue Code for the refund year is increased by the recapture amount.

(ii) *Recapture amount.* The recapture amount is the difference between the credit claimed in the prior taxable year and the redetermined credit. The redetermined credit is computed by reducing the amount of the qualified tuition and related expenses for which a credit was claimed in the prior taxable year by the amount of the refund of the qualified tuition and related expenses (redetermined qualified expenses), and computing the credit using the redetermined qualified expenses and the relevant facts and circumstances of the prior taxable year, such as modified adjusted gross income (redetermined credit). Any redetermination of the tax liability for the prior taxable year (by audit or amended return) will be taken into account in computing the redetermined credit.

(4) *Excludable educational assistance received in a subsequent taxable year treated as a refund.* If, in a taxable year, any excludable educational assistance (described in paragraph (c)(1) of this section) is received for the qualified tuition and related expenses paid during a prior taxable year (or attributable to enrollment at an eligible educational institution during a prior taxable year), the educational assistance is treated as a refund of qualified tuition and related expenses for purposes of paragraphs (f)(2) and (3) of this section. If a taxpayer (or the taxpayer's spouse or a claimed dependent) receives any excludable educational assistance before the taxpayer files a federal income tax return for the prior taxable year, the amount of the qualified tuition and related expenses for the prior taxable year is reduced by the amount of the excludable educational assistance as provided in paragraph (f)(2) of this section. If a taxpayer (or the taxpayer's spouse or a claimed dependent) receives excludable educational assistance after the taxpayer has filed a federal income tax return for the prior taxable year, any education credit claimed for the prior taxable year is subject to recapture as provided in paragraph (f)(3) of this section.

(5) *Examples.* The following examples illustrate the rules of this paragraph (f). In each example, assume that all the requirements to claim an education credit are met. The examples are as follows:

Example 1. In January 1998, Student A, a full-time freshman at University X, pays $2,000 for qualified tuition and related expenses for a 16-hour work load for the 1998 Spring semester. Prior to beginning classes, Student A withdraws from 6 course hours. On February 15, 1998, Student A receives an $800 refund from University X. In September 1998, Student A pays University X $1,000 to enroll half-time for the 1998 Fall semester. Prior to beginning classes, Student A withdraws from a 2-hour course, and she receives a $200 refund in October 1998. Student A computes the amount of qualified tuition and related expenses she may claim for 1998 by:

(i) Adding all qualified expenses paid during the taxable year ($2,000 + 1,000 = $3,000);

(ii) Adding all refunds of qualified tuition and related expenses received during the taxable year ($800 + $200 = $1,000); and, then

(iii) Subtracting (ii) from (i) ($3,000 – $1,000 = $2,000). Therefore, Student A's qualified tuition and related expenses for 1998 are $2,000.

Example 2. (i) In December 1998, Student B, a senior at College Y, pays $2,000 for qualified tuition and related expenses for a 16-hour work load for the 1999 Spring semester. Prior to beginning classes, Student B withdraws from a 4-hour course. On January 15, 1999, Student B files her 1998 income tax return and claims a $400 Lifetime Learning Credit for the $2,000 qualified expenses paid in 1998.

(ii) She calculates the increase in tax for 1999 by:

(A) Calculating the redetermined qualified expenses ($2,000 – $500 = $1,500);

(B) Calculating the redetermined credit for the redetermined qualified expenses ($1,500 × .20 = $300); and

(C) Subtracting the redetermined credit from the credit claimed in 1998 ($400 – $300 = $100).

(iii) Therefore, Student B must increase the tax on her 1999 federal income tax return by $100.

Example 3. In September 1998, Student C pays College Z $1,200 in qualified tuition and related expenses to attend evening classes during the 1998 Fall semester. Student C is an employee of Company R. On January 15, 1999, Student C files a federal income tax return for 1998 claiming a Lifetime Learning Credit of $240 (.20 × $1,200). Pursuant to an educational assistance program described in section 127(b), Company R reimburses Student C in February 1999 for the $1,200 of qualified tuition and related expenses paid by Student C in 1998. The $240 education credit claimed by Student C for 1998 is subject to recapture. Because Student C paid no net qualified tuition and related expenses in 1998, the redetermined credit for 1998 is zero. Student C must increase the amount of Student C's 1999 taxes by the recapture amount, which is $240 (the education credit claimed for 1998 ($240) minus the redetermined credit for 1998 ($0)). Because the $1,200 reimbursement is taken into account in calculating the $240 recapture amount for 1999, the reimbursement does not reduce the amount of any qualified tuition and related expenses that Student C paid in 1999.

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on January 5, 1999, 8:45 a.m., and published in the issue of the Federal Register for January 6, 1999, 64 F.R. 794)

Notice of Proposed Rulemaking and Notice of Public Hearing

Allocation of Loss With Respect to the Distributions of Stock and Other Personal Property

REG–106905–98

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Partial withdrawal of notice of proposed rulemaking; notice of proposed rulemaking by cross-reference to temporary regulations; and notice of public hearing

SUMMARY: This document contains proposed Income Tax Regulations relating to the allocation of loss recognized on the disposition of stock and other personal property. The loss allocation regulations primarily will affect taxpayers that claim the foreign tax credit and that incur losses with respect to personal property and are necessary to modify existing guidance. Prior proposed regulations are withdrawn. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments must be received by May 5, 1999. Outlines of oral comments to be discussed at the public hearing scheduled for May 26, 1999, must be received by May 5, 1999.

ADDRESSES: Send submissions to CC:DOM:CORP:R (REG–106905–98), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG–106905–98), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas. gov/prod/tax_regs/comments.html. The public hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. FOR FURTHER INFORMATION CONTACT: Concerning the regulations in general, Seth B. Goldstein of the Office of Associate Chief Counsel (International), (202) 622-3810; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Michael Slaughter, (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Temporary regulations published in T.D. 8805, 1999–5 I.R.B. 14, provide guidance concerning the allocation of loss with respect to personal property. The text of those temporary regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the proposed regulations. Proposed §1.865–1, published on July 8, 1996 (REG–209750–95 [formerly INTL–4– 95, 1996–2 C.B. 484], 61 F.R. 35696), is withdrawn.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory impact analysis is not required.

An initial regulatory flexibility analysis has been prepared for this notice of proposed rulemaking under 5 U.S.C. § 603. A summary of the analysis is set forth below under the heading 'Summary of Initial Regulatory Flexibility Analysis.' Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

Summary of Initial Regulatory Flexibility Analysis

These proposed regulations under sections 861 and 865 of the Internal Revenue Code address the allocation of loss with respect to personal property and are necessary for the proper computation of the foreign tax credit limitation under section 904 of the Internal Revenue Code. These regulations are promulgated under sections 861, 865(j)(1) and 7805 of the Internal Revenue Code. If adopted, these proposed regulations will affect small entities such as small businesses but not other small entities such as government or tax exempt organizations, which do not pay taxes. The IRS and Treasury Department are not aware of any federal rules that duplicate, overlap or conflict with these regulations. None of the significant alternatives considered in drafting these regulations would have significantly altered the economic impact of these regulations on small entities. There are no alternative rules that are less burdensome to small entities but that accomplish the purpose of the statute. The IRS and Treasury Department request comments from small entities concerning this analysis.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments that are submitted timely to the IRS (a signed original and eight (8) copies). In particular, the IRS requests comments on the clarity of the proposed regulations and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for May 26, 1999, beginning at 10 a.m. in room 2615 of the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit 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 5, 1999. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Seth B. Goldstein, of the Office of the Associate Chief Counsel (International), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

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Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

Authority: 26 U.S.C. 7805 * * * Section 1.865–1 also issued under 26 U.S.C. 865. * * *

Par. 2. Section 1.861–8 is amended by revising paragraph (e)(8) to read as follows:

§1.861–8 Computation of taxable income from sources within the United States and from other sources and activities.

* * * * *

(e) * * *

(8) [The text of this proposed paragraph (e)(8) is the same as the text of §1.861–8T(e)(8) published in T.D. 8805.]

* * * * *

Par. 3. Section 1.865–1 is added immediately following §1.864–8T, to read as follows:

§1.865–1 Loss with respect to personal property other than stock. [The text of this proposed §1.865–1 is the same as the text of §1.865–1T published in T.D. 8805.]

Par. 4. Section 1.865–2 is amended by adding paragraphs (b)(4)(iii) and (b)(4)(iv) *Example 3* through *Example 6* to read as follows:

§1.865–2 Loss with respect to stock.

* * * * *

(b) * * *

(4) * * *

(iii) [The text of this proposed paragraph (b)(4)(iii) is the same as the text of §1.865–2T(b)(4)(iii) published in T.D. 8805.]

(iv) * * *

Example 3 through *Example 6* [The text of this proposed paragraph (b)(4)(iv) *Example 3* through *Example 6* is the same as the text of §1.865–2T(b)(4)(iv) *Example 3* through *Example 6* published in T.D. 8805**.**]

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Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on January 8, 1999, 8:45 a.m., and published in the issue of the Federal Register for January 11, 1999, 64 F.R. 1571)

Notice of Proposed Rulemaking and Notice of Public Hearing

Separate Share Rules Applicable to Estates

REG–114841–98

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations that provide that substantively separate and independent shares of different beneficiaries are to be treated as separate estates for purposes of computing the distributable net income. These proposed regulations also provide that a surviving spouse's statutory elective share of a decedent's estate is a separate share. Further, a revocable trust that elects to be treated as part of a decedent's estate is a separate share. Section 1307 of the Taxpayer Relief Act of 1997 amended section 663 of the Internal Revenue Code by extending the separate share rules to estates. These proposed regulations affect estates of decedents. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written and electronic comments must be received by April 6, 1999. Outlines of topics to be discussed at the public hearing scheduled for April 22, 1999, at 10 a.m. must be received by April 1, 1999.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–114841–98), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG–114841–98), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The public hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Laura Howell, (202) 622-3060; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Michael L. Slaughter, Jr., (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Prior to amendment by Section 1307 of the Taxpayer Relief Act of 1997, Public Law 105–34, August 5, 1997, (TRA 1997), section 663(c) of the Internal Revenue Code (Code) provided that, for the purpose of determining the amount of distributable net income in the application of sections 661 and 662, in the case of a single trust having more than one beneficiary, substantially separate and independent shares of different beneficiaries (or classes of beneficiaries) of the trust shall be treated as separate trusts. The application of the separate share rule is mandatory where separate shares exist. Section 1.663(c)–1(d) and H.R. Conf. Rep. No. 2014, 105th Cong. 1st Sess. 712–13 and fn. 18.

Section 1307 of TRA 1997 amended section 663(c) of the Code by extending the separate share rule to estates. Prior to this amendment, a distribution to an estate beneficiary in the ordinary course of administration often resulted in the beneficiary being taxed on a disproportionate share of the estate's income. The extension of the separate share rule to estates promotes fairness by more rationally allocating the income of the estate among the estate and its beneficiaries thereby reducing the distortion that may occur when a disproportionate distribution of estate assets is made to one or more estate beneficiaries in a year when an estate has distributable net income. Under the separate share rule, a beneficiary is taxed only on the amount of income that belongs to that beneficiary's separate share.

In addition, section 1305 of TRA 1997 added section 645 to the Code (originally enacted as section 646 and redesignated as section 645 by the Internal Revenue Service Restructuring and Reform Act of 1998). Under section 645, both the executor (if any) of an estate and the trustee of a qualified revocable trust may elect to treat the revocable trust as part of the decedent's probate estate for income tax purposes. The legislative history for section 1305 provides that the separate share rule applicable to estates will apply when a qualified revocable trust elects to be treated as part of the decedent's estate.

Explanation of Provisions

The proposed regulations conform the current regulations to the statutory changes. In addition, the proposed regulations address two specific matters involving separate share treatment of interests in estates: the treatment of the spousal elective share and the treatment of an electing revocable trust under section 645 of the Code.

General Separate Share Rule

If an estate has multiple beneficiaries, substantially separate and independent shares of different beneficiaries (or classes of beneficiaries) are to be treated as separate estates only for purposes of computing distributable net income. There are separate shares in an estate when the governing instrument of the estate and applicable local law create separate economic interests in one beneficiary or class of beneficiaries such that the economic interests of those beneficiaries (e.g., rights to income or gains from specified items of property) are not affected by the economic interests accruing to another separate beneficiary or class of beneficiaries. Thus, there are separate shares in an estate when a beneficiary or class of beneficiaries has an interest in a decedent's estate (whether corpus or income, or both) that no other beneficiary or class of beneficiaries has in the decedent's estate. The application of the separate share rule to estates is mandatory where separate shares exist. The separate share rule requires that the estate's income and deductions be allocated among the separate shares as if they were separate estates. The section 661 deduction to the estate and the section 662 inclusion in the gross income of the beneficiary are limited by the distributable net income allocable to each separate share.

These proposed regulations do not change the rules involving specific gifts and bequests described in section 663(a).

Surviving Spouse's Elective Share

Most non-community property states have some form of elective share statute which replaces common law dower and curtesy (the common law protection for surviving spouses). Generally, an elective share statute gives the surviving spouse the right to claim a share of the deceased spouse's estate if the surviving spouse is disinherited or dissatisfied with what the spouse would have received under the will or otherwise. In most states the elective share consists of a fraction, ranging from one-fourth to one-half of the decedent's estate. Elective share statutes vary as to when the share vests and whether the share includes a portion of the estate income, as well as whether the share participates in the appreciation or depreciation of the estate's assets.

Rev. Rul. 64–101 (1964–1 C.B. 77) addresses the Florida statutory dower interest which, at the time of the revenue ruling, entitled the widow to the dower interest and mesne profits thereon. The ruling holds that the value of assets transferred to the widow as dower is not a distribution to a beneficiary subject to sections 661(a) and 662(a) of the Code. Instead, the transfer of assets is governed by section 102.

Rev. Rul. 71–167 (1971–1 C.B. 163) modifies Rev. Rul. 64–101 by holding that the amount distributed to the widow representing mesne profits is subject to sections 661(a) and 662(a) of the Code. Therefore, an amount corresponding to the allowable deduction to the estate under section 661(a) is includible in the gross income of the widow under section 662(a).

Recently, two cases, *Deutsch v. Commissioner*, TCM 1997-470, and *Brigham v. United States*, 983 F. Supp. 46, (D. Mass. 1997), have addressed how to treat payments to the surviving spouse in satisfaction of the spouse's elective share amount. In *Deutsch*, the surviving spouse elected to take against the decedent's will as provided by the Florida elective share statute. Under the statute, the surviving spouse was entitled to 30 percent of the net estate based upon date of death values, but was not entitled to any income of the estate, and did not participate in appreciation or depreciation of the estate assets. The Tax Court, noting Rev. Rul. 64–101, held that payments to the surviving spouse in satisfaction of her elective share amount were not subject to sections 661(a) and 662(a). Rather, the payments were governed by section 102.

In *Brigham*, the surviving spouse elected to take against the decedent's will as provided by the New Hampshire elective share statute. Under the statute, the surviving spouse was entitled to one-third of the personalty and one-third of the real estate. The court held that the payments made to the surviving spouse in satisfaction of her elective share amount were subject to sections 661(a) and 662(a). Thus, the court held that all of the estate's distributable net income was taxable to the surviving spouse because she was the only beneficiary to receive a distribution for the year in question and her distribution exceeded the amount of the estate's distributable net income.

In light of the uncertainty concerning the proper treatment of payments in satisfaction of a surviving spouse's elective share, and also given that Rev. Ruls. 64–101 and 71–167 are outdated because dower has been replaced by elective share statutes in most states, the Internal Revenue Service and Treasury have concluded that regulatory guidance is needed to provide uniform treatment.

These proposed regulations provide that the surviving spouse's elective share constitutes a separate share of the estate for the sole purpose of determining the amount of distributable net income in application of sections 661(a) and 662(a). Therefore, only the income that is (1) allocable to the surviving spouse's separate share for a taxable year, and (2) distributed to the surviving spouse in satisfaction of the elective share will be treated as a distribution subject to sections 661(a) and 662(a). This approach results in the surviving spouse being taxed on the estate's income earned during administration only to the extent of the surviving spouse's right to share in the estate's income under state law. Comments are requested on whether there are situations in which an elective share or dower interest would not be a separate share under the separate economic interest test set forth in the proposed regulations.

Electing Revocable Trust To Be a Part Of Estate

These proposed regulations provide that a qualified revocable trust that elects to be treated as part of the decedent's estate constitutes a separate share for the sole purpose of determining the amount of distributable net income in the application of sections 661 and 662. A separate proposed regulation project will provide further guidance concerning qualified revocable trusts that are treated as part of an estate.

Proposed Effective Date

These regulations apply to estates of decedents dying after the date that the Treasury decision adopting these rules as final regulations is published in the **Federal Register.**

Effect on Other Documents

When these regulations are finalized, Rev. Rul. 64–101 (1964–1 C.B. 77) and Rev. Rul. 71–167 (1971–1 C.B. 163) will be obsolete.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12886. 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 on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any electronic and written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. The IRS and Treasury specifically request comments on the clarity of the proposed regulation and how it may be made easier to understand. All comments will be available for public inspection and copying. We especially request comments concerning the treatment of pecuniary bequests (including formula pecuniary bequests) as separate shares.

A public hearing has been scheduled for April 22, 1999, beginning at 10 a.m. The hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written or electronic comments by April 6, 1999, and submit an outline of topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by April 1, 1999.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

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

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

Authority: 26 U.S.C. 7805 * * *
Section 1.663(c)–1 also issued under 26 U.S.C. 663(c).
Section 1.663(c)–2 also issued under 26 U.S.C. 663(c).
Section 1.663(c)–3 also issued under 26 U.S.C. 663(c).
Section 1.663(c)–4 also issued under 26 U.S.C. 663(c).
Section 1.663(c)–5 also issued under 26 U.S.C. 663(c).
Section 1.663(c)–6 also issued under 26 U.S.C. 663(c). * * *

Par. 2. Section 1.663(c)–1 is amended as follows:

1. The section heading is revised.

2. The first sentence of paragraph (a) is amended by removing the language "trust" and adding the language "trust (or estate)" in its place and removing the language "trusts" and adding the language "trusts (or estates)" in its place. The second sentence of paragraph (a) is amended by removing the language "trusts" and adding the language "trusts (or estates)" in its place.

3. Paragraph (b)(2) is removed.

4. Paragraphs (b)(3) and (b)(4) are redesignated as paragraphs (b)(2) and (b)(3).

5. Paragraph (b) introductory text, is amended by removing the language "trusts" and adding the language "trusts (or estates)" each place it appears.

6. Paragraph (c) and the last sentence of paragraph (d) are amended by removing the language "trust" and adding the language "trust (or estate)" in its place.

The revision reads as follows:

§1.663(c)–1 Separate shares treated as separate trusts or as separate estates; in general.

* * * * *

Par. 3. Section 1.663(c)–2 is revised to read as follows:

§1.663(c)–2 Computation of distributable net income.

The amount of distributable net income for any share under section 663(c) is computed for each share as if each share constituted a separate trust or estate. Accordingly, any deduction or any loss which is applicable solely to one separate share of the trust or estate is not available to any other share of the same trust or estate.

Par. 4. Section 1.663(c)–3 is amended by revising the section heading and removing paragraph (f) to read as follows:

§1.663(c)–3 Applicability of separate share rule to trusts.

* * * * *

§1.663(c)–4 [Redesignated as §1.663(c)–5]

Par. 5. Section 1.663(c)–4 is redesignated as §1.663(c)–5 and a new §1.663(c)–4 is added to read as follows:

§1.663(c)–4 Applicability of separate share rule to estates.

(a) *General rule.* The applicability of the separate share rule to estates provided by section 663(c) will generally depend upon whether the governing instrument and applicable local law create separate economic interests in one beneficiary or class of beneficiaries of the decedent's estate such that the economic interests of the beneficiary or class of beneficiaries are not affected by economic interests accruing to another beneficiary or class of beneficiaries. A separate share should be allocated only the share of the estate's income and deductions that the beneficiary (or beneficiaries) of such separate share is (or are) entitled to (if any) under the terms of the governing instrument or local law.

The separate share rule does not affect rules under section 663(a) concerning specific gifts and bequests.

(b) *Examples of separate shares.* Separate shares include—

(1) A surviving spouse's elective share;

(2) A revocable trust that elects to be part of the decedent's estate under section 645;

(3) The residuary estate, or some portion of the residuary estate, if the requirements of paragraph (a) of this section are met; and

(4) A gift or bequest of a specific sum of money or of specific property that is paid or credited in more than three installments, if the requirements of paragraph (a) of this section are met.

(c) *Shares with multiple beneficiaries and beneficiaries of multiple shares.* A share may be considered as separate even though more than one beneficiary has an interest in it. For example, two beneficiaries may have equal, disproportionate, or indeterminate interests in one share which is economically separate and independent from another share in which one or more beneficiaries have an interest. Moreover, the same person may be a beneficiary of more than one separate share.

Par. 6. Newly designated §1.663(c)–5 is amended by:

1. Revising the section heading and introductory text.

2. Redesignating the "*Example*." as "*Example 1*." and redesignating paragraphs (a), (b), (c), (d), and (e) in newly designated *Example 1* as paragraphs (i), (ii), (iii), (iv), and (v).

3. Adding *Example 2, Example 3*, and *Example 4*.

The revisions and addition read as follows:

§1.663(c)-–5 Examples.

Section 663(c) may be illustrated by the following examples:

Example 1. * * *

Example 2. (i) *Facts.* (A) Testator died domiciled in State X on January 30, 1999, leaving an estate of $40,000,000 after debts, expenses, and estate taxes, and survived by a spouse and three adult children from a previous marriage. Testator's will directed the executrix to pay the surviving spouse $1,000,000 in cash and divide the residue, after payment of debts, expenses, and estate taxes, equally among Testator's three children.

(B) The surviving spouse filed an election under State X's elective share statute. The court determined that the surviving spouse's election was valid and ordered the executrix to pay the elective share. Under State X's elective share statute, a surviving spouse is entitled to one-fourth of a decedent's estate after debts, expenses, and estate taxes if the decedent had children. Further, the surviving spouse is entitled to a proportional amount of the estate net income and participates proportionally in appreciation or depreciation of the estate's assets.

(C) The executrix elected the calendar year for the estate. On June 30, 1999, the executrix distributed $5,000,000 to the surviving spouse in partial satisfaction of the elective share. During the 1999 taxable year, the estate received dividend income of $2,000,000 and paid expenses of $50,000. For the 1999 taxable year, the value of the estate neither appreciated nor depreciated. The executrix made no other distributions during the 1999 taxable year.

(ii) *Holding.* Separate share treatment applies to each of the three residuary bequests, and to the surviving spouse's elective share.

(iii) *Application.* (A) After determining the income and expenses for the estate, the executrix allocated a portion of the income and expenses to each separate share based upon each share's percentage of the estate. Thus, while the surviving spouse's elective share initially constituted 25% of the estate, after the partial distribution of $5,000,000 made on June 30, 1999, the elective share constituted a smaller percentage of the estate. Accordingly, the percentage of the estate's income and expenses allocated to the elective share after June 30, 1999, was correspondingly reduced in accordance with the executrix's determination of the proper allocation of income and expenses to the elective share.

(B) For the 1999 taxable year, the estate is treated as having distributed to the surviving spouse the distributable net income that was allocated to the elective share. In accordance with section 662, the surviving spouse must include in gross income for the 1999 taxable year an amount equal to the distributable net income allocated to the surviving spouse's separate share and distributed to the surviving spouse for the 1999 taxable year. The estate will, accordingly, be allowed a deduction under section 661 for the amount of distributable net income allocated to the elective share and distributed to the surviving spouse.

Example 3. (i) *Facts.* (A) Assume the same facts as in *Example 2* except that Testator died domiciled in State Y leaving an estate of $60,000,000 after debts, expenses, and estate taxes. Under State Y's elective share statute, the surviving spouse is entitled to the date of death value of one-third of the decedent's estate after debts, expenses, and taxes. The statute also provides that the surviving spouse is not entitled to any of the estate's income and does not participate in appreciation or depreciation of the estate's assets. Further, under the statute, the surviving spouse is entitled to interest on the elective share from the date of the court order directing the executrix to make payments.

(B) The executrix elected the calendar year for the estate. During the 1999 taxable year, the estate received dividend income of $3,000,000, and paid administration expenses of $60,000 and paid the surviving spouse $1,000,000 of interest payments on the elective share. Also, during the 1999 taxable year, the executrix distributed $5,000,000 to the surviving spouse in partial satisfaction of the elective share. The executrix made no other distributions during the 1999 taxable year.

(ii) *Holding.* Separate share treatment applies to each of the three residuary bequests and to the surviving spouse's elective share.

(iii) *Application.* The distributable net income of each child's residuary bequest is $980,000 (a 33.33% share of estate income less a 33.33% share of estate expenses). Because the surviving spouse was not entitled to any estate income under state law, no income is allocated to the spouse's separate share. The distribution in satisfaction of the spouse's elective share does not consist of any distributable net income and is not included in the spouse's gross income under section 662. The $1,000,000 of interest payment to the surviving spouse must be included in gross income of the spouse under section 61. Therefore, the estate is treated as having distributed to the surviving spouse $5,000,000 of amounts other than 1999 estate income. Accordingly, the estate is not allowed a deduction under section 661 for the distribution made to the surviving spouse. The taxable income of the estate for the 1999 taxable year is $2,939,400 ($3,000,000 (dividend income) minus $60,000 (expenses) and $600 (personal exemption)). The $1,000,000 interest payment is a nondeductible personal interest expense described in section 163(h).

Example 4. (i) *Facts.* (A) Testator died domiciled in State Z on February 14, 1999, survived by a spouse and two children. Testator's will contains a nonproportional funding fractional formula marital bequest for the surviving spouse with a residuary credit shelter trust for the lifetime benefit of the surviving spouse, and remainder to the two children on the surviving spouse's death. The date of death value of the estate is $1,650,000.

(B) The executrix elected the calendar year for the estate. Under the fractional formula, the marital bequest constitutes 60% of the estate and the credit shelter trust constitutes 40% of the estate. Accordingly, the executrix claims a marital deduction of $990,000 on the estate tax return for the amount passing to the spouse under the fractional formula. On December 31, 1999, the executrix made a partial proportionate distribution of $1,000,0000, $600,000 to the surviving spouse outright and $400,000 to the credit shelter trust. As of December 31, 1999, prior to the distribution, the value of Testator's estate had appreciated to $2,000,000.

(C) During the 1999 taxable year, the estate made no other distributions, received dividend income of $20,000, and paid expenses of $8,000.

(ii) *Holding.* Separate share treatment applies to the fractional formula marital bequest and the credit shelter trust.

(iii) *Application.* (A) Because Testator provided for a fractional formula marital bequest in the will, the income and any appreciation in the value of the estate assets is proportionately allocated between the marital bequest share and the credit shelter trust share. Therefore, the distributable net income must be allocated 60% for the marital separate share and 40% for the credit shelter separate share.

(B) The distributable net income allocable to the marital share is $7,200 (60% of estate income less 60% of estate expenses). Correspondingly, the distributable net income allocable to the credit shelter share is $4,800 (40% of estate income less 40% of estate expenses). Because the $600,000 amount distributed in partial satisfaction of the marital bequest exceeds the distributable net income of $7,200 allocated to the marital share, the estate is treated as having distributed to the surviving spouse $7,200 of 1999 distributable net income and $592,800 of other amounts. Similarly, because the $400,000 distributed in partial satisfaction of the amount payable to the credit shelter trust exceeds the distributable net income of $4,800 allocated to the credit shelter trust share, the estate is treated as having distributed to the credit shelter trust $4,800 of 1999 distributable net income and $395,200 of other amounts. Accordingly, the estate is allowed a deduction of $12,000 under section 661 for the 1999 taxable year. The taxable income of the estate is $0, computed as follows:

Dividends		$20,000
Deductions:		
Distribution to surviving spouse share	$7,200	
Distribution to credit shelter trust share	4,800	
Expenses	8,000	
Personal exemption	600	
		20,600
		(600)

(C) In accordance with section 662, the surviving spouse must include in gross income for the 1999 taxable year an amount equal to the distributable net income of the marital bequest share ($7,200) that was distributed to the surviving spouse. The credit shelter trust must include in gross income for the 1999 taxable year an amount equal to the distributable net income of the credit shelter trust share ($4,800) that was distributed to the credit shelter trust.

Par. 7. Section 1.663(c)–6 is added to read as follows:

§1.663(c)–6 Effective date.

Sections 1.663(c)–1 through 1.663(c)–5 concerning the application of the separate share rules to estates apply to estates of decedents dying after the final regulations are published in the **Federal Register.**

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on January 5, 1999, 8:45 a.m., and published in the issue of the Federal Register for January 6, 1999, 64 F.R. 790)

Notice of Proposed Rulemaking and Notice of Public Hearing

Establishment of a Balanced Measurement System

REG–119192–98

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 adoption by the IRS of a balanced system to measure organizational performance within the IRS. These proposed regulations further implement a requirement that all employees be evaluated on whether they provided fair and equitable treatment to taxpayers and bar use of records of tax enforcement results to evaluate or to impose or suggest goals for any employee of the IRS. These regulations implement sections 1201 and 1204 of the Internal Revenue Restructuring and Reform Act of 1998. These regulations affect internal operations of the IRS and the systems that agency employs to evaluate the performance of organizations within IRS and individuals employed by IRS. This document also provides notice of public hearing on these proposed regulations.

DATES: Written comments and electronic comments must be received by March 5, 1999. Outlines of oral comments to be presented at the public hearing scheduled for Thursday, May 13, 1999 at 10 a.m. must be received by Thursday, April 22, 1999.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–119192–98), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG–119192–98), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The public hearing will be held in room 2615, at 10 a.m., Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Julie Barry (202) 401-4013; concerning submission of comments, the hearing, or to be placed on the building access list to attend the hearing, the Regulations Unit, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed regulations to establish a Balanced System for Measuring Organizational and Individual Performance Within the Internal Revenue Service (26 CFR Part 801).

Section 1201 of the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA), Public Law No. 105–206 (112 Stat. 685, 713 *et seq.* (1998)), requires the Internal Revenue Service to establish a performance management system for those employees covered by 5 U.S.C § 4302 that, *inter alia,* establishes "goals or objectives for individual, group, or organizational performance (or any combination thereof), consistent with the Internal Revenue Service's performance planning procedures, including those established under the Government Performance and Results Act of 1993, division E of the Clinger-Cohen Act of 1966 . . . , Revenue Procedure 64-22 . . . , and taxpayer service surveys." It further requires the IRS to use "such goals and objectives to make performance distinctions among employees or groups of employees," and to use "performance assessments as a basis for granting employee awards, adjusting an employee's rate of basic pay, and other appropriate personnel actions. . . ." Finally, section 1201 expressly requires that any performance management system adopted by the IRS conform to the requirements of section 1204 of RRA.

Section 1204 of RRA provides that the IRS shall not use "records of tax enforcement results" in the evaluation of IRS employees or to suggest or impose production goals for such employees. It further provides that the IRS shall use the "fair and equitable treatment of taxpayers by employees as one of the standards for evaluating employee performance." Finally, section 1204 requires that "each appropriate supervisor" certify quarterly in a letter to the Commissioner "whether or not tax enforcement results are being used in a manner prohibited by" that section.

Antecedents to Sections 1201 and 1204

Until the recent change, the Mission Statement for the IRS had provided, in part: "The purpose of the Internal Revenue Service is to collect the proper amount of tax revenue at the least cost. . . ." Consistent with this Mission Statement, the IRS has long adhered to the principle that all IRS officials with discretion to make decisions regarding enforcement matters in individual cases should do so only on the basis of the correct application of the law to the facts of each individual case. It has also sought to give the taxpayers maximum efficiencies in its day-to-day operations and has applied many modern management techniques to measure and encourage such efficiencies.

In order to achieve these dual goals, the IRS has adopted a number of systems by which it sets goals for and measures the success of its various operating units, and directs the activities of its employees. The ultimate objective of these measurement systems is to help the IRS achieve its overall mission.

Measuring Organizational Performance

In General. The Government Performance and Results Act of 1993, Public Law No. 103–62 (107 Stat. 285 (Aug. 3, 1993)) (GPRA), requires the IRS and other federal agencies to establish a hierarchy of performance measures and goals applicable to various organizational units within their agencies. These performance measures and goals should be expressed in objective, quantifiable and measurable forms to define the level of performance to be achieved by a program activity.

As indicated by the General Accounting Office ("Executive Guide: Effectively Implementing the Government Performance and Results Act," (GAO/GGD–96–118 at 24)):

> [L]eading organizations . . . strive to align their activities and resources to achieve mission-related goals[;] they also seek to establish clear hierarchies of performance goals and measures. Under these hierarchies, the organizations try to link the goals and performance measures for each organizational level to successive levels and ultimately to the organization's strategic goals. They have recognized that without clear, hierarchically linked performance measures, managers and staff throughout the organization will lack straightforward roadmaps showing how their daily activities can contribute to attaining organizationwide strategic goals and mission.

The legislative history underlying passage of GPRA indicates that not only must performance goals be established on an hierarchal basis throughout an organization, but those goals must reflect the full range of the organization's objectives. As the Senate Report accompanying the Act indicates (S. Rep. No. 103–58, 103d Cong., 1st Sess. at 29 (1993)):

> The Committee believes agencies should develop a range of related performance indicators, such as quantity, quality, timeliness, cost, and outcome. A range is important because most program activities require managers to balance their priorities among several subgoals. . . . . Reliance on any single one of these measures could create a perverse incentive for managers to achieve one subgoal at the expense of the others.

As a government agency responsible for collecting 95 percent of the nation's revenues, the IRS adopted, pursuant to GPRA and other statutes[1], a number of performance measures that focus on the amount of adjustments proposed by examination units or the dollars collected by collection offices. For example, the budgets submitted by the IRS since the mid-1990's have contained performance measures that were heavily focused upon enforcement revenue collected or protected. The two performance measures for field examination units contained in the FY 1997 budget request were examination dollars recommended and examination dollars recommended per employee (FTE). A similarly enforcement-focused set of measures applied to field collection functions: dollars collected, dollars collected per FTE, and average cycles per TDA/TDI (tax delinquency account/tax delinquency investigation) disposition.

Measures of Special Compliance Programs.

The IRS, apart from requirements imposed upon it by statutes and regulations of general applicability, has periodically been required by Congress to establish and to report on other performance measures. For example, in connection with expected additional funding promised for FY 1995 through FY 1999 pursuant to a Compliance Initiative, the IRS made a commitment to generate $9.179 billion in additional enforcement revenues. It was expected both to track how those additional funds were employed and to provide "quarterly reports . . . identifying the progress being made through these enhanced activities to collect taxes due." S. Rep. No. 103–286, 103d Cong., 2d Sess. at 40 (1994); see H. R. Rep. No. 103–534, 103d Cong., 2d Sess. at 33 (1994); "IRS FY 1995 Compliance Initiatives Final Report," Document 9383 (Rev. 1-96), Catalog Number 21508R.

More recently, the appropriation for the IRS for FY 1998 provided additional monies for "funding essential earned income tax credit compliance and error reduction initiatives." The Conference Report accompanying that appropriation bill stated (H. R. Conf. Rep. No. 105–284, 105th Cong.,1st Sess. at 64 (1997)) that "the IRS should establish a method to track the expenditure of funds and measure the impact [of the additional funding] on compliance. The IRS shall submit quarterly reports to the Committee on Appropriations which identify the expenditures and the change in the rates of compliance." In the absence of accurate information regarding compliance rates, the IRS has attempted to comply with this congressional requirement by reporting, inter alia, on amounts of revenue protected or collected by various EITC compliance programs. See, *e.g.*, "IRS Tracking Earned Income Tax Credit Appropriation," Document 9383 (Rev. 6–98), Catalog Number 21508R.

Measuring the Performance of Employees

The IRS also must comply with a variety of government-wide mandates to measure the performance of individual employees. The civil service rules require that the IRS evaluate the performance of employees on an annual basis. Performance evaluations also figure in recommendations for awards, incentives, allowances or bonuses, an assessment of an employee's qualifications for promotion, reassignment or other change in duties, and the ranking of other than full-time permanent personnel for purposes of release/recall schedules. While these individual performance ratings are based upon the elements set forth in various workplans and job elements, a manager's success in achieving organizational goals will inevitably play an important role in any evaluation of his or her performance. Other employees' performance with respect to items set forth in their job elements will be viewed in light of these goals.

Past Criticisms

Over the years, the IRS has been repeatedly criticized for placing too much reliance upon tax enforcement measures it has adopted. The critics have charged that front-line personnel have felt pressured by performance measures that were focused on tax enforcement outcomes, such as dollars assessed per FTE or dollars collected per FTE, to take inappropriate enforcement actions in order to achieve perceived enforcement goals. The bulk of this criticism has focused on the impact such tax enforcement measures have had upon field personnel in the examination and collection functions.

For example, in 1955, a report by an advisory group appointed by the Chairman of the Joint Committee on Internal Revenue Taxation (*The Internal Revenue Service: Its Reorganization and Administration*, July 25, 1955, at 6) describes a 1954 initiative by the IRS to "establish specific office standards of production [for examination personnel in regional and district offices], so that both supervisors and employees know what is considered normal." This advisory group reported that imposition of these standards "appears to have caused a worsening of the enforcement picture."

> [U]nder the established production quota system proper standards of individual performance and proper standards of examination are ignored in favor of number of returns examined. The established production quota procedure has too frequently reduced the agent's investigation to a cursory examination of readily available records and a quick look for a few obvious items on which a change can be made so as to close the case and meet the quota set.

In 1957 and again in 1959, questions were raised during hearings before the House Ways and Means Committee regarding IRS production quotas. "Reorganization and Administration of the Internal Revenue Service," Hearings before the Subcommittee on Internal Revenue Taxation of the Committee of Ways and Means, 85th Cong., 1st Sess., at 118–119 (1957); "Income Tax Revision, Panel Discussions before the Committee on Ways and Means, House of Representatives," 86th Cong., 1st Sess. at 805, 808 (1959); "Compendium of Papers on Broadening the Tax Base Submitted to the Committee of Ways and Means," 86th Cong., 1st Sess. at 1527, 1533 (1959).

In November of 1959, the IRS issued a revised policy statement that provided, in part:

> If the duties of the position require the exercise of judgment based on detailed knowledge of laws and regulations or involve material factors of technical or professional judgment, performance must be evaluated in the light of the actual cases or other assignments handled, and no quantitative measurement may be utilized which does not take such differences into account. Dollar production shall not be used as the measurement of any individual's performance.

Policy Statement P–1200–9, approved Nov. 24, 1959

Questions regarding "the rating of revenue agents on the basis of numbers of examinations made and amounts of additional tax recommended" were again raised during the 1961 confirmation hearings held for Commissioner-designate Caplin. Hearings Before the Committee on Finance, United States Senate, 87th Cong., 1st Sess., at 14–15 (1961). Following his confirmation, Commissioner Caplin announced in July of 1961 that the IRS was embarking on a "New Direction," which was designed to counter what he described as the "undue emphasis" placed upon production statistics and the "adverse effect" the perception that production statistics formed the "main basis" for evaluation of offices and individuals had upon examination quality. Under this "New Direction," production goals and statistics would be de-emphasized, statistical data would be given more limited circulation and qualitative measures of performance would be adopted. "New Audit Program Concepts: Views of Commissioner Caplin on Evaluation of Individuals, Programs and Offices in the Audit Activity."

The following year, Commissioner Caplin issued a Special Message to All Audit Personnel, discussing some misunderstandings that had arisen regarding the new audit program. The Commissioner indicated that while supervisors were not allowed to evaluate performance on the basis of statistics or to pressure agents to produce deficiencies at the cost of inadequate audits or inequities to the taxpayer, nothing in the new audit program prohibited supervisors from keeping track of the quality and amount of work produced by agents. Indeed, "this is exactly what the supervisor of a group of agents is expected to do." The Message went on to state "Special Message from the Commissioner," dated September 7, 1962, at 2:

> More serious than these misunderstandings, is the fact that enforcement results have fallen off very substantially. Despite having 1,022 more agents and office auditors in FY 62 than in FY 61, the number of returns

[1] Both the Chief Financial Officers Act of 1990, Pub. L. No. 101-576, 104 Stat. 2838 (1990), and Division E, National Defense Authorization Act for Fiscal Year 1996 (the Clinger-Cohen Act of 1996), Pub. L. No. 104-106, 110 Stat. 186, 679 (1996), also contain requirements that federal agencies establish performance measurement systems.

examined decreased by 13,000, while additional taxes and penalties recommended decreased by $66 million.

> You can readily see how this drop-off endangers our Long Range Plan for gradually increasing our manpower and doing our work more effectively. Under this plan, we have been allowed almost 10,000 additional people over the last three years, and it calls for the addition of about 24,000 more by 1968. Yet, when a substantial increase in staff is followed by this kind of a drop in our enforcement results, the appropriating authorities naturally begin to wonder about the wisdom of financing the rest of our proposed expansion.

Issues regarding the IRS' use of production statistics also came up during Commissioner Alexander's 1973 confirmation hearings before the Senate Finance Committee. When questioned about his opinion toward production quotas, Commissioner Alexander responded that he was completely opposed to their use. Hearings Before the Committee on Finance, United States Senate, 93d Cong., 1st Sess., at 4–5 (1973).

In November of 1973, the IRS adopted the current version of Policy Statement P–1–20, revising its policies regarding the use of records of tax enforcement results and prohibiting absolutely the use of enforcement statistics to evaluate the performance of enforcement personnel; this statement permitted the accumulation and use of enforcement statistics only for "long-range planning, financial planning, allocation of resources, work planning and control, effective functional management, or other related staffing utilization systems and plans." In an accompanying Special Message to all Enforcement Personnel, Commissioner Alexander stated that this prohibition was applicable to all personnel who exercised judgment in determining tax liability or the ability to pay. Commissioner Alexander further declared, "[i]ndividual case or dollar goals–formal, informal, or implied–are not permitted and will not be tolerated."

During 1974, Senate Appropriations Committee hearings again focused on allegations that taxpayers were being mistreated as a result of production quotas (both case closings and dollar amounts). A number of witnesses and the Committee chairman expressed concerns that individual production statistics were being used to evaluate field employees, notwithstanding the existing policy. Testimony during those hearings also indicated that pressure to increase the number of cases closed in Collection directly led to inappropriate seizures. Hearings Before the Subcommittee on the Department of the Treasury, U.S. Postal Service, and General Government Appropriations of the Committee on Appropriations, United States Senate, 93d Cong., 2d Sess., at 2–25, 520, 543–546, 574–584, 586–601, 653–670 (1974); see also, "Taxpayer Assistance and Compliance Programs," Hearings before the Senate Committee on Appropriations, 93d Cong., 1st Sess. at 41–46, 568–569, 642–643, 680–681 (1974).

In 1988, the Senate Appropriations Committee held hearings focusing again on allegations that the IRS' use of enforcement statistics to evaluate programs and personnel had led to inappropriate enforcement actions. Treasury, Postal Service and General Government Appropriations, Fiscal Year 1989, Before the Committee on Appropriations, 100th Cong., 2d Sess. at 588–590 (1988). On November 10, 1988, the Technical and Miscellaneous Revenue Act of 1988, Public Law No. 100–647 (102 Stat. 3734 (1988)) (TBOR 1) was enacted. Section 6231 of that measure prohibits the use of records of tax enforcement results:

> 1) to evaluate employees directly involved in collection activities and their immediate supervisors, or
>
> 2) to impose or suggest production quotas or goals [for such employees and supervisors].

During the appropriation hearings for FY 1989, Commissioner Gibbs testified about the TBOR 1 prohibition (Treasury, Postal Service and General Government Appropriations, Fiscal Year 1989, Before the Senate Committee on Appropriations, 100th Cong., 2d Sess. at 589 (1988)):

> The problem that I have with our policy statement—that policy statement, by the way, being in the taxpayer bill of rights—is that it tells our people what not to do. It says, "Don't use enforcement statistics." ... I don't think that this helps someone on the front line very much to tell them what not to do.
>
> What we have started, within the last 18 months that I have been the Commissioner, is to begin to develop at the working level criteria as to what constitutes a quality collection action, what constitutes a quality examination action. It is an entirely different approach to collection and examination, trying to train the people as to how to approach what they are doing so that if they do it the right way, the numbers will flow. The idea is to get away from simply dollar amounts, comparing one another in terms of how they are doing with respect to collections, or seizures, or anything like that.

The General Accounting Office has expressed a somewhat different view of the appropriate use of enforcement results to measure IRS performance. Its December 10, 1991, report on "IRS' Implementation of the 1988 Taxpayer Bill of Rights" stated (GAO/GGD–92-23 at 14–15):

> In an October 1987 letter to the Chairmen of the House Committee on Ways and Means and the Senate Committee on Finance, we commented on various proposals to prohibit the use of collection statistics in performance evaluations. Our position then and now is that collection statistics should not be the only indicator of performance but, along with other factors, could very well be a useful tool in evaluating employees. We pointed out that relying on a single factor can place more emphasis on that factor than on overall performance. We said that it is not totally inappropriate to generally consider the amount of revenues collected as part of an employee's evaluation if that consideration is only one of several factors under review. We added that setting arbitrary quotas for amounts collected, property seized, or cases closed cannot be justified in evaluating performance, particularly because of the negative impact that trying to achieve those quotas can have on taxpayers.

In its May 11, 1993, report on "Tax Administration: New Delinquent Tax Collection Methods for IRS" (GAO/GGD093–67 at 9), GAO reiterated this view:

> As we have stated in the past, IRS should be able to use collection performance as a criterion in determining compensation and rewards for individual collectors. We believe that information such as taxes collected is a reasonable basis on which to judge the performance of employees whose job it is to collect taxes as long as other criteria, such as fair and courteous treatment of taxpayers, are also evaluated.

In a similar vein, a December 23, 1993, report by the GAO on the offer in compromise program ("Tax Administration: Changes Needed to Cope with Growth in Offer in Compromise Program" (GAO/GGD-94–47 at 24) indicated:

> The Commissioner of Internal Revenue should develop the indicators necessary to evaluate the Offer in Compromise Program as a collection and compliance tool. The indicators should be based on accurate data and include (1) the yield of the program in terms of costs expended and amounts collected, (2) the amount of revenues collected that would not have been collected through other collection means . . . .

In September 1997, the Senate Finance Committee held three days of widely-publicized oversight hearings on the Internal Revenue Service. During these hearings, several IRS employees testified that IRS' performance measurement system was creating an environment in which they felt pressured to achieve certain quantitative goals for tax enforcement results (such as dollars recommended or collected). In his testimony at the conclusion of these hearings, the Acting Commissioner responded to the concerns that had been raised about the negative impact of the IRS performance measurement system by announcing a number of immediate changes in the system. In particular, he announced that IRS would suspend the comparative ranking of its 33 district offices and suspend distribution of any goals related to revenue production to field offices. "Practices and Procedures of the Internal Revenue Service," Hearings before the Committee on Finance, United States Senate, 105th Cong., 1st Sess., at 3, 105–106, 123–128, 153, 155– 156, 162–163, 206–209, 212–213, 303– 304, 310, 317–318, 320–322, 325–326, 330, 333, 351–356.

Following these hearings, the IRS Office of Chief Inspector undertook three management audits to determine how enforcement statistics were then being used as part of the IRS performance measurement system. See, "Review of the Use of Statistics and the Protection of Taxpayer Rights in the Arkansas-Oklahoma District Collection Field Function," Internal Audit Reference Number 380402 (December 5, 1997); "Use of Enforcement Statistics in the Collection Field Function," Internal Audit Reference Number 081904 (January 12, 1998); "Examination Division's Use of Performance Measures and Statistics," Internal Audit Reference Number 084303 (July 7, 1998). These three inquiries generally confirmed that IRS performance measures were focused largely on enforcement goals and productivity as defined by statistics relating to dollars recommended, assessed or collected, or other enforcement actions taken. They found a lack of corresponding emphasis on quality casework, adherence to law, and protection of taxpayer rights.

In order to deal with specific allegations of misconduct made during the September hearings, or discovered in the course of the management audits described above, the IRS Office of Chief Inspector also undertook a number of individual investigations. The Commissioner then established a Special Review Panel of career executives from outside the IRS to review the evidence and to recommend appropriate personnel actions. The Special Review Panel issued a Report to the Commissioner in August 1998. In its Report, the Special Review Panel agreed with earlier conclusions that IRS had responded to external pressures to close the revenue gap through improved productivity by shifting management emphasis to goals and measures that placed a heavy emphasis on use of enforcement statistics. *See also* "IRS Personnel Administration: Use of Enforcement Statistics in Employee Evaluations" (GAO/GGD-99-11, November 39, 1998).

Internal Revenue Service Restructuring and Reform Act of 1998

Sections 1201 and 1204 of the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA) represent the most recent legislative action regarding performance measures used by the IRS. Section 1201 directs the IRS, consistent with its current performance planning procedures, including those established under the GPRA, to establish a performance management system that will establish "goals or objectives for individual, group, or organizational performance." The IRS is directed to use this performance system in the evaluation of employees or groups of employees, in determining salary adjustments and awards, and in other personnel matters. The Conference Report accompanying RRA (H. R. Conf. Rep. No. 105–599, 105th Cong., 2d Sess., at 228 (June 24, 1998) indicates that "in no event would performance measures be used which rank employees or groups of employees based solely on enforcement results, establish dollar goals for assessments or collections, or otherwise undermine fair treatment of taxpayers."

Section 1204 of RRA repealed section 6231 of TBOR 1 and replaced TBOR 1's prohibition on the use of "records of tax enforcement results" to evaluate or to impose or suggest goals for personnel directly involved in collection activity with a prohibition against using such records of tax enforcement results to evaluate, or to impose or suggest production quotas or goals for, any IRS "employee."

Explanation of Provisions

Proposed Effective Date

These regulations are proposed to be effective thirty days after the date of publication in the **Federal Register** of the final regulations.

Balanced Measurement System

These proposed regulations provide guidance and direction for the establishment of a balanced performance measurement system for the Internal Revenue Service. They also provide guidance for implementing the restrictions on the use of "records of tax enforcement results" in evaluating, or imposing or suggesting goals for employees and for establishing "fair and equitable treatment of taxpayers" as one of the standards for evaluating employees.

These proposed regulations establish a new balanced system for measuring the performance of and establishing performance goals for various operational units within the Internal Revenue Service. The three elements of this balanced measurement system are (1) Customer Satisfaction Measures, (2) Employee Satisfaction Measures and (3) Business Results Measures. These measures will, consistent with GPRA, be based on "quantifiable and measurable" data, and will be numerically scored.

The proposed regulations do not provide procedures for certifying whether or not records of tax enforcement results have been used in a manner prohibited by section 1204. Subsequent guidance will provide that information.

a. Customer Satisfaction

To measure customer satisfaction, the IRS will develop data from customer satisfaction surveys it receives from a statistically valid sample of taxpayers with whom it has dealt. Among other things, taxpayers will be asked to provide information regarding whether they were treated courteously and professionally, whether they were informed of their rights and whether they were given an opportunity to voice their concerns and adequate time to respond to IRS requests. Using data derived from these surveys, the IRS will derive quantitative indices of customer satisfaction which will be used to measure progress in achieving customer satisfaction goals.

b. Employee Satisfaction

To measure employee satisfaction, the IRS will utilize an employee survey that permits employees to provide, on an anonymous basis, their assessment of the wide variety of factors that determine whether employees believe that the work environment permits them to perform their duties in a professional manner. Among other items included in the employee survey, the questionnaires should elicit information regarding employees' assessment of the quality of supervision and the adequacy of training and support services. As in the case of the Customer Satisfaction measures, the goals and the accomplishments of units subject to the balanced measurement system will be expressed in quantified form.

c. Business Results

The IRS will employ two parallel avenues to measure business results.

1. Quality Measures

The first of these approaches will focus on the quality of the work done in a sample of cases that were worked on by employees. Such reviews will be conducted of a statistically valid sample of cases worked on by units designated by the Commissioner, such as a collection or examination unit. A staff of personnel specially dedicated to the task will review and numerically score the quality of work done by IRS personnel. These reviews will focus on such factors as whether IRS personnel provided proper and timely service to the taxpayer, properly analyzed the facts, correctly applied the law, protected taxpayer rights by following applicable IRS policies and procedures, devoted an appropriate amount of time to the case, made appropriate judgments regarding liability for tax and ability to pay and provided accurate answers to tax law or account questions posed by callers.

2. Quantity Measures

The quantity measures element of the business results measure will focus exclusively on outcome-neutral production data. Accordingly, as described in the regulation, data concerning the enforcement outcome in cases, such as the dollar amount of audit adjustments, the numbers of liens filed or levies served, and the number of referrals for criminal investigation, would be excluded from the production data used in the quantity measures. On the other hand, outcome-neutral production data, such as cases closed, time per closing or cycle time, which do not reflect the outcome produced by any IRS official's exercise of judgment in determining liability for tax or the collection mechanism to be employed may be used in determining the production element of the business results measures. The IRS has determined, however, that as a matter of policy such outcome-neutral production data may not be used to set goals for or for evaluating any non-supervisory employee with tax enforcement responsibilities.

Further, an organization with enforcement responsibilities may not be given a goal or an evaluation based on enforcement-neutral production data regarding matters calling for the exercise of judgment with respect to tax enforcement results unless that goal or evaluation constitutes only one element in a set of goals or one element in an evaluation based also upon the balanced measurement system.

Special Analyses

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

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any electronic and written (a signed original and eight (8) copies) comments that are submitted timely to the IRS. the IRS and Treasury specifically request comments on the clarity of the proposed regulations and how they may be easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for Thursday, May 13, 1999, beginning at 10 a.m. in room 2615 of the Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the

"FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601 (a) (3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit comments and an outline of the topics to be discussed and the time to be devoted to each topic by Thursday, April 22, 1999. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Julie A. Barry, Office of Assistant Chief Counsel (General Legal Services). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR Chapter I is proposed to be a mended by adding part 801 to Subchapter H to read as follows:

PART 801—BALANCED SYSTEM FOR MEASURING ORGANIZATIONAL AND INDIVIDUAL PERFORMANCE WITHIN THE INTERNAL REVENUE SERVICE

Sec.
801.0–1 Balanced performance measurement system; in general.
801.0–2 Balanced performance measurement system
801.0–3 Customer satisfaction measures
801.0–4 Employee satisfaction measures
801.0–5 Business results measures

Authority: §§ 1201 and 1204, Public Law No. 105–206 (112 Stat. 685, 715–716, 722 (July 22, 1998)).

§801.0–1 Balanced performance measurement system; in general.

(a) *In general.* The regulations in this part 801 implement the provisions of sections 1201 and 1204 of the Internal Revenue Service Restructuring and Reform Act of 1998 and provide rules relating to the establishment by the Internal Revenue Service of a balanced performance measurement system.

(b) *Effective date.* This part 801 is effective thirty days after the date these regulations are published as final regulations in the Federal Register.

§801.0–2 Balanced performance measurement system.

(a) *In general.* Modern management practice and various statutory and regulatory provisions require the IRS to set performance goals for organizational units and to measure the results achieved by those organizations with respect to those goals. To fulfill these requirements, the IRS has established a balanced performance measurement system, composed of three elements: Customer Satisfaction Measures; Employee Satisfaction Measures; and Business Results Measures. The IRS is likewise required to establish a performance evaluation system for individual employees.

(b) *Measuring organizational performance*—(1) *In general.* The performance measures that comprise the balanced measurement system will, to the maximum extent possible, be stated in objective, quantifiable and measurable terms and, subject to the limitation set forth in paragraph 2, will be used to measure the overall performance of various operational units within the IRS. In addition to implementing the requirements of the Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105–206, 112 Stat. 685 (1998), the measures described here will, where appropriate, be used in performance goals and performance evaluations established, *inter alia*, under Division E, National Defense Authorization Act for Fiscal Year 1996 (the Clinger-Cohen Act of 1996), Pub. L. No. 104–106, 110 Stat. 186, 679 (1996); the Government Performance and Results Act of 1993, Pub. L. No. 103–62, 107 Stat. 285 (1993); and the Chief Financial Officers Act of 1990, Pub. L. No. 101–576, 108 Stat. 2838 (1990).

(2) *Limitation—Quantity Measures* (as described in § 801.0–5) will not be used to evaluate the performance of or to impose or suggest production goals for any organizational unit with employees who are responsible for exercising judgment with respect to tax enforcement results (as defined in § 801.0–5) except in conjunction with an evaluation or goals based also upon *Customer Satisfaction Measures*, *Employee Satisfaction Measures*, and *Quality Measures.*

(c) *Measuring individual performance.* All employees of the IRS will be evaluated according to the *critical elements and standards* or other performance criteria established for their positions. In accordance with the requirements of §§ 4312 and 9508 of 5 U.S.C. and §1201 of the Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105–206, 112 Stat. 685 (1998), (as is appropriate to the employee's position), the performance criteria for each position will be composed of elements that support the organizational measures of Customer Satisfaction, Employee Satisfaction and Business Results; however, such organizational measures will not directly determine the evaluation of individual employees.

(1) *Fair and equitable treatment of taxpayers.* In addition to all other criteria required to be used in the evaluation of employee performance, all employees of the IRS will be evaluated on whether they provided fair and equitable treatment to taxpayers.

(2) *Senior Executive Service and special positions.* Employees in the Senior Executive Service will be rated in accordance with the requirements of 5 U.S.C. § 4312 and employees selected to fill positions under 5 U.S.C. § 9503 will be evaluated pursuant to workplans, employment agreements, performance agreements or similar documents entered into between the Internal Revenue Service and the employee.

(3) *General Workforce.* The performance evaluation system for all other employees will:

(i) Establish one or more retention standards for each employee related to the work of the employee and expressed in terms of individual performance; and

(A) require periodic determinations of whether each employee meets or does not meet the employee's established retention standards; and

(B) require that action be taken, in accordance with applicable laws and regulations, with respect to employees whose performance does not meet the established retention standards.

(ii) Establish goals or objectives for individual performance consistent with the IRS's performance planning procedures; and

(A) use such goals and objectives to make performance distinctions among employees or groups of employees; and

(B) use performance assessments as a basis for granting employee awards, adjusting an employee's rate of basic pay, and other appropriate personnel actions, in accordance with applicable laws and regulations.

(4) *Limitations*—(i) No employee of the IRS may use records of tax enforcement results (as defined in § 801.0-5) to evaluate any other employee or to impose or suggest production quotas or goals for any employee.

(A) For purposes of the limitation contained in this paragraph (c)(4), employee has the meaning as defined in 5 U.S.C. § 2105(a).

(B) For purposes of the limitation contained in this paragraph (c)(4), evaluate includes any process used to appraise or measure an employee's performance for purposes of providing the following:

(*1*) Any required or requested performance rating.

(*2*) A recommendation for an award covered by Chapter 45 of Title 5; 5 U.S.C. § 5384; or section 1201(a) of the Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105–206, 112 Stat. 685, 713–716 (1998).

(*3*) An assessment of an employee's qualifications for promotion, reassignment or other change in duties.

(*4*) An assessment of an employee's eligibility for incentives, allowances or bonuses.

(*5*) Ranking of employees for release/recall and reductions in force.

(ii) Employees who are responsible for exercising judgment with respect to tax enforcement results (as defined in § 801.0–5) in cases concerning one or more taxpayers may be evaluated with respect to work done on such cases only on the basis of information derived from a review of the work done on the taxpayer cases handled by such employee.

(iii) Performance measures based in whole or in part on *Quantity Measures* (as described in § 801.0–5) will not be used to evaluate the performance of or to impose or suggest goals for any non-supervisory employee who is responsible for exercising judgment with respect to tax enforcement results (as defined in § 801.0–5).

§ 801.0–3 Customer satisfaction measures.

The customer satisfaction goals and accomplishments of operating units will be determined on the basis of data derived from questionnaires, surveys and other types of information gathering mechanisms. Surveys designed to measure customer satisfaction for a particular work unit will be distributed to a statistically valid sample of the taxpayers served by that operating unit and will be used to measure whether those taxpayers believe that they received courteous, timely and professional treatment by the IRS personnel with whom they dealt. Taxpayers will be permitted to provide information requested for these purposes under conditions that guarantee them anonymity.

§ 801.0–4 Employee satisfaction measures.

The numerical ratings to be given operating units within the IRS for employee satisfaction will be determined on the basis of information derived from a questionnaire which will be distributed to all employees of the operating unit; the employees will be permitted to provide information on an anonymous basis. Data from these surveys will measure, among other factors bearing upon employee satisfaction, the quality of supervision and the adequacy of training and support services.

§ 801.0–5 Business results measures.

(a) *In general.* The business results measures will consist of numerical scores determined under the Quality Measures and the Quantity Measures described below.

(b) *Quality measures.* The quality measure will be determined on the basis of a review by a specially dedicated staff within the IRS of a statistically valid sample of work items handled by certain functions or organizational units determined by the Commissioner or his delegate such as the following:

(1) *Examination and collection units and Automated Collection System units (ACS).* The quality review of the handling of cases involving particular taxpayers will focus on such factors as whether IRS personnel devoted an appropriate amount of time to a matter, properly analyzed the issues presented, developed the facts regarding those issues, correctly applied the law to the facts, and complied with statutory, regulatory and IRS procedures, including timeliness, adequacy of notifications and required contacts with taxpayers.

(2) *Toll-free telephone sites.* The quality review of telephone services will focus on such factors as whether IRS personnel provided accurate tax law and account information.

(3) *Other workunits.* The quality review of other workunits will be determined according to criteria prescribed by the Commissioner or his delegate.

(c) *Quantity measures.* The quantity measures will consist of outcome-neutral production and resource data, such as the number of cases closed, work items completed, hours expended and similar inventory, workload and staffing information, that does not contain information regarding the tax enforcement result reached in any case involving particular taxpayers.

(d) *Definitions*—(1) *Tax enforcement result.* A tax enforcement result is the outcome produced by an IRS employee's exercise of judgment recommending or determining whether or how the IRS should pursue enforcement of the tax law with respect to any assessed or unassessed tax.

(i) *Examples of data containing information regarding tax enforcement results.* The following are examples of data containing information regarding tax enforcement results: number of liens filed; number of levies served; number of seizures executed; dollars assessed; dollars collected; full pay rate; no change rate; and number of fraud referrals.

(ii) *Examples of data that do not contain information regarding tax enforcement results.* The following are examples of data that do not contain information regarding tax enforcement results: number of cases closed; time per case; direct examination time/out of office time; cycle time; number or percentage of overage cases; inventory information; toll-free level of access; talk time; and data derived from a quality review or from a review of an employee's or a workunit's work on a case, such as the number or percentage of cases in which correct examination adjustments were proposed or appropriate lien determinations were made.

(iii) *Records of tax enforcement results. Records of tax enforcement results* are data, statistics, compilations of information or other numerical or quantitative recordations of the tax enforcement results reached in one or more cases, but does not include information, including the tax enforcement result, regarding an individual case to the extent the information is derived from a review of an employee's or a workunit's work on individual cases.

(e) *Permitted Uses of Records of Tax Enforcement Results.* Records of tax enforcement results may be used for purposes such as forecasting, financial planning, resource management, and the formulation of case selection criteria.

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

Example 1. In conducting a performance evaluation, a supervisor may take into consideration information showing that the employee had failed to propose an appropriate adjustment to tax liability in one of the cases the employee examined, provided that information is derived from a review of the work done on the case. All information derived from such a review of individual cases handled by an employee, including time expended, issues raised, and enforcement outcomes reached may be considered in setting goals or evaluating the employee.

Example 2. A supervisor may not establish a goal for proposed adjustments in a future examination, even though the goal was derived from analyses of previously-handled cases, because such enforcement goals are not based upon an analysis of the newly-assigned case.

Example 3. A headquarters unit may use records of tax enforcement results to develop methodologies and algorithms for use in selecting tax returns to audit.

Charles O. Rossotti,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on January 4, 1999, 8:45 a.m., and published in the issue of the Federal Register for January 5, 1999, 64 F.R. 457)

Foundations Status of Certain Organizations

Announcement 99–20

The following organizations have failed to establish or have been unable to maintain their status as public charities or as operating foundations. Accordingly, grantors and contributors may not, after this date, rely on previous rulings or designations in the Cumulative List of Organizations (Publication 78), or on the presumption arising from the filing of notices under section 508(b) of the Code. This listing does *not* indicate that the organizations have lost their status as organizations described in section 501(c)(3), eligible to receive deductible contributions.

Former Public Charities. The following organizations (which have been treated as organizations that are not private foundations described in section 509(a) of the Code) are now classified as private foundations:

Abbas-E-Alamdar, Inc., Houston, TX
The Alliance of Black Churches Inc., Louisa, VA
Alpha House, Inc., Chicago, IL
American to Fellow Miskito, Houston, TX
Amos Agency, Homewood, IL
Animal Shelter Fund Inc., Boca Raton, FL
Animated Education, Inc., Chatsworth, CA
Bad Girls Inc., Bend, OR
Beverly Hills – Acapulco Sister City Committee Incorporated, Beverly Hills, CA
Bergum Group Homes Inc., Costa Mesa, CA
Big Brother – Big Sister of Lapeer County Incorporated, Lapeer, MI
Birthright of La Grande, La Grande, OR
BWICA Educational Fund, Inc., Brooklyn, NY
Bridges of America the Lauderhill Bridge, Inc., Orlando, FL
Brothers in Christ Foundation Ministries, San Antonio, TX
The Campbell Institute, Portland, OR
Camp Council Inc., Jenkintown, PA
Central Commercial Teachers Association, Inc., Madison, WI
Central Erie County Paramedic Association, McKean, PA
Children's Education Fund, Inc., Lincolndale, NY
Church of God Evening Light Mission Trust Inc., McFarland, CA
Circle C Ranch Inc., Stockton, CA
Clergy Care Inc., Joplin, MO
Coachella Public School Transportation Foundation, Coachella, CA
1st Coast Learning Success Skills Center Inc., Jax Beach, FL
Comites of San Francisco, San Francisco, CA
Daystar Ministries, Gladstone, OR
Drs Vinod & Tarlika Thakkar Foundation, Inc., Avon Park, FL
Economic Development & Information Center for Africa, New York, NY
Education Foundation of Millburn – Short Mills, Inc., Short Hills, NJ
Education Through Art a Nonprofit Corporation, Seattle, WA
Educational Music Theatre Inc., Redondo Beach, CA
El Capitain Aquatics Boosters Inc., Lakeside, CA
ESC Foundation of America, Washington, DC
The Eye Tech Foundation, New York, NY
Fairlee Senior Housing Group, Fairlee, VT
Feneta Tutoring Center, Kinston, NC
Filipino American Association of USA Inc., Panorama City, CA
The Fisherman, Inc., Kingston, MA
FISST USA Inc., West Hartford, CT
Focus Re-Direction, New York, NY
Foster Grandparent Foundation, Salem, OR
Foundation for Interventional Cardiology Inc., New York, NY
Glen View Corporation, Shreveport, LA
God Rules Ministry, Baton Rouge, LA
Grant Ministries, Inc., Moore, OK
Gutherie Community Bootstrap Corporation, Gutherie, OK
Harlem Development Corporation, New York, NY
Herbertsville First Aid Squad, Inc., Brick, NJ
Heritage Place of Fayetteville, Inc., Fayetteville, NC
Hope Breeds Citizens Thru Counseling, Arts, Recreation and Education, Oberlin, OH
Iglesia en Marcha, Lubbock, TX
Indiana Civic and Cultural Association, Incorporated, Indiana, PA
Institute for Men and Mens Studies Inc., Greensboro, NC
International Foundation, Broken Arrow, OK
Italian Cultural Society of Northwest Florida Inc., Pensacola, FL
J B C Development Corporation, Duquesne, PA
J Cooper International Academy Tennis Foundation, Houston, TX

J U T E Inc., Orlando, FL
J2M Productions, San Rafael, CA
Jackson County Economic Development Corporation Inc., Black River Falls, WI
Jacksonville Florida Depressive and Manic-Depressive Association Inc., Atlantic Beach, FL
Jacksonville School of Ministry Inc., Jacksonville, FL
Jacobs Blessing, Staten Island, NY
JACPAT Ministries Inc., Cascade, ID
Jaggers Terrace Community Association Inc., Columbia, SC
Jail Chaplaincy Ministry, Houston, TX
Jamaica Mission Inc., Grapevine, TX
Jambalaya Incorporated, Columbia, MD
James D McDonald Charitable Trust Inc., Boynton Beach, FL
James E Clyburn Scholarship and Research Foundation, Columbia, SC
James F Patten Jr Memorial Foundation Inc., Newburyport, MA
Janai Cante Foundation, Tacoma, WA
Jason P Davis Memorial Scholarship Fund Inc., Somerset, KY
Jay Stewart Ministries Inc., Concord, NC
Jaycee Valley Housing Inc., Uhrichsville, OH
Jean Baptiste Pointe Dusable Memorial Statue Committee, Chicago, IL
Jeanette Neill Dance Scholarship Fund, Boston, MA
Jefferson County Tennis Association Inc., Pine Bluff, AR
Jefferson County Youth Football Inc., Charlestown, WV
Jefferson Legacy Foundation, Middlebury, VT
Jefferson Park Youth Scholarship Fund, New York, NY
Jeffrey Grossman 9-1-1 Award Foundation Inc., Winchester, MA
Jenkins Creek Environmental Research Center Inc., Crisfield, MD
Jennifer Ann Hines Memorial Scholarship Foundation Charitable, Tampa, FL
Jennifer Turner Cancer Research Foundation, Tarrytown, NY
Jerry Lisker Scholarship Fund, Massapequa, NY
Jesse Jennette Ministries Inc., Franklin, TN
Jesus Christ Apostolic Church International, Chicago, IL
Jesus Christ King of Kings – Global Ministries Inc., Houston, TX
Jesus Ministries Inc., Oklahoma City, OK
Jesus Streetwise Ministries Incorporated, Excelsior Springs, MO
Jewish Action International Corp., New York, NY
Jewish International Service Corps., Highland Park, IL
Jewish Theater Group of the Berkshires, Lenox, MA
Jewish Womens Center of Pittsburgh, Pittsburgh, PA
Jim Wilson Unity in Christ Crusade Inc., Elizabeth, IN
Jimmy Johnson Foundation for Childrens Charities, Dallas, TX
JMR Funding Inc., Blue Springs, MO
Jobs and Environment Campaign, Inc., Cambridge, MA
Jobs for Teens, San Jose, CA
Jogging for Jesus Inc., Duncanville, TX
John B and Mary Bell Pirtle Endowment Fund, Louisville, KY
John J McMahon Jr Memorial Roller Hockey Club Inc., Deer Park, NY
John W Nixon Cultural Arts Foundation Inc., Birmingham, AL
Johnson County Community Concert Association, Buffalo, WY
Johnsons Island Preservation Society Inc., Marblehead, OH
Joint Education Housing Partnership Program HEHPP Inc., Gulfport, MS
Joplin Area Evangelical Association, Joplin, MO
Joseph Mission Corporation, Dryden, NY
Journey Publications, Lincolnshire, IL
Journey Toward Wholeness Ltd., Kildeer, IL
Joy of Athletics Foundation Inc., Miami Lakes, FL
Juan de Fuca Festival of the Arts, Port Angeles, WA
Juaneno Band of Mission Indians, San Juan Capistrano, CA
Jubilee Agriculture Ministries Inc., Tempe, AZ
Jubilee Center Inc., Concord, MA
Judah Broadcasting Network Inc., Pascagoula, MS
Judah Youth Ministries, Tinton Falls, NJ
Judean Development Project, New York, NY
Julie A Rodick Memorial Foundation Inc., Weymouth, MA
Juneau Pioneers Home Foundation, Juneau, AK
Junior Urban Mentor Programs, Washington, DC
Jus Care, Houston, TX
Justice Works, Newtown, PA
Juvenile Foster Parents Association of Dallas County, Murphy, TX
Juvenile Justice Institute, Baton Rouge, LA
K-12 Educational Foundation, Greenwich, CT
K-12 Foundation, Lafayette, CO
K Edward Popleon Foundation, Baton Rouge, LA
K E E P Incorporation, Chicago, IL
K Hop Institute of Business and Pedology Inc., Kansas City, MO
Kaiserhof, Tomball, TX
Kaleidosart Inc., Hamden, CT
Kandu Corporation, West Chester, PA
Kanine Kandystripers Inc., Brentwood, TN
Kansas Area Transit District 9 Coordinating Council Inc., Louisburg, KS
Kansas City Athletic Advisory Council, Kansas City, MO
Kansas City Jazz International, Kansas City, MO
Kansas City Legends Soccer Club, Leawood, KS
Kansas Intelligence Association, Topeka, KS
Kansas Partners in Progress Inc., Topeka, KS
Kappa Alpha PSI Bklyn-Li Alumni Scholarship Foundation Inc., Elmont, NY
Karate Helping Kids, Canton, OH
Kare, Canton, IL
Karnes County Mental Health Clinic Advisory Board Inc., Karnes City, TX
Kauwahi Anaina Hawaii Hawaiian Civic Club, Orem, UT
Keep America Free Corp., Brooklyn, NY
Keep Graham Beautiful Inc., Graham, TX
Keith Mason Ministries Incorporated, Terry, MS
Kelloway Foundation TR., Reading, MA
Kennedale Youth Association, Kennedale, TX
Kent County Hispanic Resource Center Inc., Grand Rapids, MI
Kern River Valley Health Connection, Inc., Kernville, CA
Kesan, Incorporated, Summersville, WV
Key Inc., Hays, KS
Keys of Hope Inc., Washington, DC
Kezias House Inc., Columbus, OH
Khal Brothers Inc., Lindsey, CA
Kid Mit Ment Foundation, Plymouth, MN

Kidney Research Fund USA, Bryn Mawr, PA
Kids Against Drugs, Shaker Heights, OH
Kids for Kids Theatre Inc., Ballwin, MO
Kids Hope USA, Spring Lake, MI
Kids Kampus Metropolitan Park Inc., Jacksonville, FL
Kids Korner-We Care Latch Key Program of Sumner Iowa, Sumner, IA
Kids Playce Inc., Lexington, VA
Kids Space Inc., Huntsville, AL
Kidsercise Inc., Midvale, UT
Kidspace Child Care Association, Yellow Springs, OH
Kidspeace National Centers for Kids in Crisis of North America, Orefield, PA
Kidwise, Birmingham, AL
Kimberly International Inc., Schoolcraft, MI
Kimbro Kidds, Portland, OR
Kingdom Business Ministries Inc., Paterson, NJ
Kingdom of God Ministries Inc., Nashville, TN
Kings Kids Outreach Ministries, Abilene, TX
Kinzua Bridge Foundation Inc., Mt. Jewett, PA
Kirk Homes Inc., Inkster, MI
Kitsap Youth Services Association, Bremerton, WA
Kiwanis Club of Northeast Wichita Foundation Inc., Wichita, KS
The Kiwanis Club of Parkschester The Bronx Foundation, Inc., Bronx, NY
Kiwanis Club of Tyler-Rose City Foundation Inc., Tyler, TX
Kiwanis Law Enforcement Camp Incorporated, McMinnville, OR
Klaire Research Foundation, Carlsbad, CA
Klingon Language Institute, Flourtown, PA
Knappa Svensen Brownsmead Burnside Youth Program, Astoria, OR
Knoxville Home Child Care Association, Knoxville, TN
Koala Inc., Brevard, NC
Ko-Am World Mission, Torrance, CA
Korean American Liquor Market Association, Huntington Beach, CA
Korean Senior Association of Colorado, Aurora, CO
Korean Senior Citizens Association Inc., Madison, TN
Korean War Veterans Memorial Committee Inc., Louisville, KY
Kroger Community Foundation Inc., Atlanta, GA
KS Nutritional-Neighborhood Services KNS, Houston, TX
Kweisi Mfume Community and Scholarship Fund Inc., Baltimore, MD
Kyoin Educational Foundation, Washington, DC

If an organization listed above submits information that warrants the renewal of its classification as a public charity or as a private operating foundation, the Internal Revenue Service will issue a ruling or determination letter with the revised classification as to foundation status. Grantors and contributors may thereafter rely upon such ruling or determination letter as provided in section 1.509(a)–7 of the Income Tax Regulations. It is not the practice of the Service to announce such revised classification of foundation status in the Internal Revenue Bulletin.

Failure by Certain Charitable Organizations to Meet Certain Qualification Requirements; Taxes on Excess Benefit Transactions; Hearing

Announcement 99–21

ACTION: Notice of public hearing on previously published proposed regulations.

SUMMARY: This document provides notice of a public hearing on proposed regulations relating to the excise taxes on excess benefit transactions under section 4958 of the Internal Revenue Code (Code). In addition, this document announces that persons wishing to testify in the Los Angeles, California, area will be able to make their presentations at an IRS remote videoconference site.

DATES: The public hearing will be held on Tuesday, March 16, 1999, at 1 p.m. (EDT), and will continue Wednesday, March 17, 1999, at 1 p.m., if necessary. Requests to speak and outlines of oral comments must be received by Wednesday, February 24, 1999.

ADDRESSES: The public hearing will be held in the auditorium of the New Carrollton Federal Building (Building A), 5000 Ellin Street, New Carrollton, Maryland. The videoconference site for persons testifying in Los Angeles is room 5003 in the Federal Building, 300 N. Los Angeles Street, Los Angeles, California.

Mail requests to speak and outlines to: CC:DOM:CORP:R (REG–246256–96), room 5226, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Hand deliver outlines Monday through Friday between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (REG–246256–96), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Submit outlines electronically via the Internet by selecting the "Tax Regs"option on the IRS Home Page, or by submitting them directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html.

FOR FURTHER INFORMATION CONTACT: Concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, LaNita Van Dyke, (202) 622-7180 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

The subject of the public hearing is proposed regulations issued under section 4958 of the Code. These regulations (REG–246256–96) appeared in the **Federal Register** (63 F.R. 41486), August 4, 1998, and in the Internal Revenue Bulletin (1998–34 IRB 9), August 24, 1998. No hearing was scheduled at the time of publication of the proposed regulations.

The rules of § 601.601(a)(3) of the "Statement of Procedural Rules" (26 CFR part 601) shall apply with respect to the public hearing, except that persons who did not file written comments within the time prescribed by the notice of proposed rulemaking (*i.e.*, November 2, 1998) will be permitted to make oral comments at the public hearing by submitting their requests to speak and outlines in a timely manner. Any persons who wish to present oral comments at the hearing on the proposed regulations should submit an outline of the oral comments/testimony to be presented at the hearing, as well as the time they wish to devote to each subject (signed original and eight (8) copies). Submissions must be received no later than February 24, 1999.

Each speaker (or group of speakers representing a single entity) will be limited to 10 minutes for an oral presentation, exclusive of the time consumed by the government panel in asking questions of the speaker and answers to those questions.

Because of controlled access restrictions, attendees cannot be admitted beyond the lobby of the Federal Building more than 15 minutes before the hearing starts. Hearing times at the Los Angeles, California, videoconference site will be concurrent with the hearing in New Carrollton, Maryland (*i.e.*, 10 a.m. PDT).

Due to a limited seating capacity at the Los Angeles site, no more than 12 people may be accommodated at any one time in the videoconference room. Seating in the videoconference room will be made available based on the order of presentations. IRS personnel will be available at the Los Angeles videoconference site to assist speakers in using the videoconference equipment.

The IRS will prepare and provide at the hearing, free of charge, an agenda showing the scheduling of speakers. Testimony will begin with the speakers at the Los Angeles videoconference site and conclude with presentations by the speakers in New Carrollton.

Cynthia Grigsby,
Chief, Regulations Unit,
Assistant Chief Counsel (Corporate).

(Filed by the Office of the Federal Register on February 4, 1999, 8:45 a.m., and published in the issue of the Federal Register for February 5, 1999, 64 F.R. 5727)

Section 7428(c) Validation of Certain Contributions Made During Pendency of Declaratory Judgment Proceedings

This announcement serves notice to potential donors that the organization listed below has recently filed a timely declaratory judgment suit under section 7428 of the Code, challenging revocation of its status as an eligible donee under section 170(c)(2).

Protection under section 7428(c) of the Code begins on the date that the notice of revocation is published in the Internal Revenue Bulletin and ends on the date on which a court first determines that an organization is not described in section 170(c)(2), as more particularly set forth in section 7428(c)(1). In the case of individual contributors, the maximum amount of contributions protected during this period is limited to $1,000.00, with a husband and wife being treated as one contributor. This protection is not extended to any individual who was responsible, in whole or in part, for the acts or omissions of the organization that were the basis for the revocation. This protection also applies (but without limitation as to amount) to organizations described in section 170(c)(2) which are exempt from tax under section 501(a). If the organization ultimately prevails in its declaratory judgment suit, deductibility of contributions would be subject to the normal limitations set forth under section 170.

Lenox Institute of Water Technology, Inc.
Lenox, MA

Definition of Terms

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

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

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

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

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

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

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

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

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

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

Abbreviations

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

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