INTERNAL REVENUE BULLETIN

Bulletin No. 2016–36
September 6, 2016

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. 2016–20 page 279.

Federal rates; adjusted federal rates; adjusted federal long-term rate and the long-term exempt rate. For purposes of sections 382, 642, 1274, 1288, 7872, and other sections of the Code, tables set forth the rates for September 2016.

Rev. Proc. 2016–43 page 316.

This revenue procedure provides the national monthly average premium for a bronze-level qualified health plan (NABP) available through Marketplaces in 2016. The NABP is the maximum monthly individual shared responsibility payment under section 5000A for nonexempt individuals who do not have minimum essential coverage for a month.

Rev. Proc. 2016–44 page 316.

This revenue procedure provides safe harbor conditions under which a management contract does not result in private business use of property financed with governmental tax-exempt bonds under section 141(b) of the Internal Revenue Code or cause the modified private business use test for property financed with qualified 501(c)(3) bonds under section 145(a)(2)(B) to be met.

T.D. 9777 page 282.

Section 148 imposes yield restriction and rebate requirements on issuers of tax-exempt bonds and other tax-advantaged bonds. These final regulations under section 148 consolidate and finalize proposed regulations published in 2007 and 2013. The final regulations include numerous, independent, technical amendments to various topics in the regulations under section 148. Generally, the final regulations simplify certain provisions, make certain provisions more administrable, resolve certain technical issues, and address certain market developments. Specific topics addressed in the final regulations include, among other things, working capital financings, qualified hedges, and valuation of investments.

T.D. 9782 page 301.

Section 301 of James Zadroga 9/11 Health and Compensation Act of 2010, Public Law 111–347 (124 Stat. 3623) added section 5000C to the Internal Revenue Code that imposes a 2 percent tax on payments made by the U.S. government to foreign persons pursuant to certain contracts. These final regulations provide guidance to U.S. government acquiring agencies and foreign persons to determine what goods or services are subject to the section 5000C; and how to remit the 2 percent tax by U.S. government acquiring agencies or foreign persons, if the section 5000C tax is applicable.

ESTATE TAX

REG–163113–02 page 329.

These proposed regulations provide additional guidance under section 2704, which contains special rules for valuing interests in corporations and partnerships transferred within the family, for estate, gift and generation-skipping transfer (GST) tax purposes. The proposed regulations add a new section to address restrictions on the liquidation of an individual interest in a family controlled entity and the effect of small interests held by persons who are not members of the family. The effect of these revisions is to disregard restrictions that reduce the value of the interest for tax purposes, but do not reduce the value of the interest to the family-member recipient.

GIFT TAX

REG–163113–02 page 329.

These proposed regulations provide additional guidance under section 2704, which contains special rules for valuing interests in corporations and partnerships transferred within the family, for estate, gift and generation-skipping transfer (GST) tax purposes. The proposed regulations add a new section to address

Finding Lists begin on page ii.

restrictions on the liquidation of an individual interest in a family controlled entity and the effect of small interests held by persons who are not members of the family. The effect of these revisions is to disregard restrictions that reduce the value of the interest for tax purposes, but do not reduce the value of the interest to the family-member recipient.

EXCISE TAX

T.D. 9782 page 301.

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TAX CONVENTIONS

T.D. 9782 page 301.

Section 301 of James Zadroga 9/11 Health and Compensation Act of 2010, Public Law 111–347 (124 Stat. 3623) added section 5000C to the Internal Revenue Code that imposes a 2 percent tax on payments made by the U.S. government to foreign persons pursuant to certain contracts. These final regulations provide guidance to U.S. government acquiring agencies and foreign persons to determine what goods or services are subject to the section 5000C; and how to remit the 2 percent tax by U.S. government acquiring agencies or foreign persons, if the section 5000C tax is applicable.

ADMINISTRATIVE

REG–108792–16 page 320.

This document contains proposed amendments to the regulations that provide user fees for installment agreements. The proposed amendments affect taxpayers who wish to pay their liabilities through installment agreements. This document also provides a notice of public hearing on these proposed amendments to the regulations.

The IRS Mission

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

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly.

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

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

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

The Bulletin is divided into four parts as follows:

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

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

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

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

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

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

Section

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

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

Rev. Rul. 2016–20

This revenue ruling provides various prescribed rates for federal income tax purposes for September 2016 (the current month). Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). The rates in Table 2 have been determined in accordance with § 1.1288–1. See T.D. 9763, 81 FR 24482 (April 26, 2016). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(1) for buildings placed in service during the current month. However, under section 42(b)(2), the applicable percentage for non-federally subsidized new buildings placed in service after July 30, 2008, shall not be less than 9%. Finally, Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520.

REV. RUL. 2016–20 TABLE 1

Applicable Federal Rates (AFR) for September 2016

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
		Short-term		
AFR	.61%	.61%	.61%	.61%
110% AFR	.67%	.67%	.67%	.67%
120% AFR	.73%	.73%	.73%	.73%
130% AFR	.79%	.79%	.79%	.79%
		Mid-term		
AFR	1.22%	1.22%	1.22%	1.22%
110% AFR	1.34%	1.34%	1.34%	1.34%
120% AFR	1.47%	1.46%	1.46%	1.46%
130% AFR	1.60%	1.59%	1.59%	1.58%
150% AFR	1.84%	1.83%	1.83%	1.82%
175% AFR	2.15%	2.14%	2.13%	2.13%
		Long-term		
AFR	1.90%	1.89%	1.89%	1.88%
110% AFR	2.09%	2.08%	2.07%	2.07%
120% AFR	2.28%	2.27%	2.26%	2.26%
130% AFR	2.48%	2.46%	2.45%	2.45%

REV. RUL. 2016–20 TABLE 2

Adjusted AFR for September 2016

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	.45%	.45%	.45%	.45%
Mid-term adjusted AFR	.91%	.91%	.91%	.91%
Long-term adjusted AFR	1.41%	1.41%	1.41%	1.41%

REV. RUL. 2016–20 TABLE 3
Rates Under Section 382 for September 2016

Adjusted federal long-term rate for the current month	1.41%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months.)	2.08%

REV. RUL. 2016–20 TABLE 4
Appropriate Percentages Under Section 42(b)(1) for September 2016

Note: Under section 42(b)(2), the applicable percentage for non-federally subsidized new buildings placed in service after July 30, 2008, shall not be less than 9%.

Appropriate percentage for the 70% present value low-income housing credit	7.36%
Appropriate percentage for the 30% present value low-income housing credit	3.15%

REV. RUL. 2016–20 TABLE 5
Rate Under Section 7520 for September 2016

Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest	1.4%

Section 42.—Low-Income Housing Credit

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 2016. See Rev. Rul. 2016-20, page 279.

Section 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of September 2016. See Rev. Rul. 2016-20, page 279.

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

The adjusted applicable federal long-term rate is set forth for the month of September 2016. See Rev. Rul. 2016-20, page 279.

Section 412.—Minimum Funding Standards

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 2016. See Rev. Rul. 2016-20, page 279.

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

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 2016. See Rev. Rul. 2016-20, page 279.

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

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 2016. See Rev. Rul. 2016-20, page 279.

Section 482.—Allocation of Income and Deductions Among Taxpayers

Federal short-term, mid-term, and long-term rates are set forth for the month of September 2016. See Rev. Rul. 2016-20, page 279.

Section 483.—Interest on Certain Deferred Payments

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 2016. See Rev. Rul. 2016-20, page 279.

Section 642.—Special Rules for Credits and Deductions

Federal short-term, mid-term, and long-term rates are set forth for the month of September 2016. See Rev. Rul. 2016-20, page 279.

Section 807.—Rules for Certain Reserves

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 2016. See Rev. Rul. 2016-20, page 279.

Section 846.—Discounted Unpaid Losses Defined

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 2016. See Rev. Rul. 2016-20, page 279.

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

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 2016. See Rev. Rul. 2016-20, page 279.

Section 7520.—Valuation Tables

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 2016. See Rev. Rul. 2016-20, page 279.

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

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 2016. See Rev. Rul. 2016-20, page 279.

T.D. 9777

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Arbitrage Guidance for Tax-Exempt Bonds

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations on the arbitrage restrictions under section 148 of the Internal Revenue Code (Code) applicable to tax-exempt bonds and other tax-advantaged bonds issued by State and local governments. These final regulations amend existing regulations to address certain market developments, simplify certain provisions, address certain technical issues, and make existing regulations more administrable. These final regulations affect State and local governments that issue tax-exempt and other tax-advantaged bonds.

DATES: *Effective Date*: These final regulations are effective on July 18, 2016.

Applicability Date: For dates of applicability, see §§ 1.141–15, 1.148–11, 1.150–1(a)(2)(iii), and 1.150–2(j).

FOR FURTHER INFORMATION CONTACT: Spence Hanemann, (202) 317-6980 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545-1347. The collection of information in these final regulations is in § 1.148–4(h)(2)(viii), which contains a requirement that the issuer maintain in its records a certificate from the hedge provider. For a hedge to be a qualified hedge, existing regulations require, among other items, that the actual issuer identify the hedge on its books and records. The identification must specify the hedge provider, the terms of the contract, and the hedged bonds. These final regulations require that the identification also include a certificate from the hedge provider specifying certain information regarding the hedge.

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

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

Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) on the arbitrage investment restrictions under section 148 of the Code and related provisions. On June 18, 1993, the Department of the Treasury (the Treasury Department) and the IRS published comprehensive final regulations in the **Federal Register** (TD 8476, 58 FR 33510) on the arbitrage investment restrictions and related provisions for tax-exempt bonds under sections 103, 148, 149, and 150, and, since that time, those final regulations have been amended in certain limited respects (the regulations issued in 1993 and the amendments thereto collectively are referred to as the Existing Regulations).

A notice of proposed rulemaking was published in the **Federal Register** (72 FR 54606; REG–106143–07) on September 26, 2007 (the 2007 Proposed Regulations). The 2007 Proposed Regulations proposed amendments to the Existing Regulations. Comments on the 2007 Proposed Regulations were received and a public hearing was held on January 30, 2008.

Another notice of proposed rulemaking was published in the **Federal Register** (78 FR 56842; REG–148659–07) on September 16, 2013 (the 2013 Proposed Regulations). The 2013 Proposed Regulations proposed additional amendments to the Existing Regulations (the 2007 Proposed Regulations and the 2013 Proposed Regulations collectively are referred to as the Proposed Regulations). Comments on the 2013 Proposed Regulations were received and a public hearing was held on February 5, 2014. The 2013 Proposed Regulations addressed the definition of issue price, among other topics.

A partial withdrawal of notice of proposed rulemaking and notice of proposed rulemaking was published in the **Federal Register** (80 FR 36301; REG–138526–14) on June 24, 2015, re-proposing amendments to the definition of issue price. After consideration of all the comments, the remaining portions of the Proposed Regulations are adopted as amended by this Treasury decision (the Final Regulations).

Summary of Comments and Explanation of Revisions

This section discusses significant aspects of the comments received from the public regarding the Proposed Regulations. It also explains the revisions made in the Final Regulations.

1. *Section 1.148–1 Definitions and Elections*

A. *Working Capital Expenditures and Replacement Proceeds Definition*

i. Introduction

The Existing Regulations impose various restrictions on the use of tax-exempt bond financing for working capital expenditures. One way the Existing Regulations limit working capital financings is through the concept of replacement proceeds, a special category of funds included within the broad definition of gross proceeds to which the arbitrage investment restrictions under section 148 apply. Under the Existing Regulations, replacement proceeds arise if an issuer reasonably expects as of the issue date that: (1) The term of an issue will be longer than reasonably necessary for the governmental purposes of the issue; and (2) there will be available amounts (as defined in the Existing Regulations) for expenditures of the type being financed during the period the issue remains outstanding longer than necessary. The Existing Regulations provide certain safe harbors that prevent the creation of replacement proceeds.

ii. Modified Safe Harbor for Short-Term Working Capital Financings

The 2013 Proposed Regulations proposed to shorten the bond maturity necessary to satisfy the safe harbor for most short-term working capital financings from two years to 13 months to conform with the permitted temporary investment period for working capital expenditures under § 1.148–2(e)(3) and the administrative standard in Rev. Proc. 2002–31, 2002–1 CB 916. One commenter suggested extending this safe harbor to all working capital expenditure financings, rather than just those for restricted working capital expenditures (as defined in the Existing Regulations). This change, which would be implemented by deleting the word "restricted" from the safe harbor, would conform the safe harbor to the proposed extension of the temporary investment period for working capital expenditure financings in the 2013 Proposed Regulations (see section 2 of this preamble). The change also would benefit issuers by expanding the eligible purposes for short-term working capital financings to include extraordinary working capital expenditures. The Final Regulations adopt this comment.

iii. New Safe Harbor for Longer-Term Working Capital Financings

The 2013 Proposed Regulations proposed to add a new safe harbor that would prevent the creation of replacement proceeds for longer-term working capital financings to enhance certainty for issuers experiencing financial distress. This new safe harbor would require an issuer to: (1) Determine the first year in which it expects to have available amounts for working capital expenditures; (2) monitor for actual available amounts in each year beginning with the year it first expects to have such amounts; and (3) apply such available amounts in each year either to redeem or to invest in (or some combination of redeeming and investing in) certain tax-exempt bonds (eligible tax-exempt bonds). The safe harbor would require any amounts invested in eligible tax-exempt bonds to be invested (or reinvested) continuously, so long as the bonds using the safe harbor remain outstanding. In a narrow exception to this requirement, the safe harbor would permit such amounts not to be invested during a period of no more than 30 days per fiscal year in which such amounts are pending reinvestment. These requirements aimed to minimize the burden on the tax-exempt bond market.

The 2013 Proposed Regulations proposed to require an issuer to test for available amounts on the first day of its fiscal year and to apply such amounts to redeem or invest in eligible tax-exempt bonds within 90 days. Commenters sought greater flexibility with respect to the timing of testing the yearly available amounts and the use of such available amounts, based on considerations associated with potential unrepresentative cash positions on particular dates and potential expected short-term cash needs to finance governmental purposes.

To promote administrability and consistency, the Final Regulations retain the first day of the fiscal year as the required annual testing date for available amounts. The Treasury Department and the IRS have concluded that commenters' suggested solutions were complex in application and could produce a result that is unrepresentative of available amounts throughout the rest of the year. By requiring testing on the first day of the fiscal year, the Final Regulations provide an administrable testing date that mirrors the general rule for other replacement proceeds, under which an issuer also must determine its available amounts on the first day of every fiscal year during the period when its bonds are outstanding longer than reasonably necessary. To address commenters' concerns about the need for greater flexibility to address short-term cash flow deficits, the Final Regulations include several other revisions to this safe harbor for longer-term working capital financings. The Final Regulations reduce the total amount the issuer must apply to redeem or invest in eligible tax-exempt bonds to take into account the expenditure of available amounts during the first 90 days of the fiscal year and amounts held in bona fide debt service funds to the extent that those amounts are included in available amounts. Further, the Final Regulations allow an issuer to sell eligible tax-exempt bonds acquired pursuant to the safe harbor, provided that the proceeds of that sale are used within 30 days for a governmental purpose (working capital or otherwise) and the issuer has no other available amounts that it could use for that purpose. Alternatively, an issuer may sell such investments and use those amounts to redeem eligible tax-exempt bonds. Together, these amendments to the Proposed Regulations aim to address issuers' concerns about cash flows in a manner consistent with the existing restrictions on financing working capital expenditures with bonds outstanding longer than reasonably necessary.

Commenters also urged a small, but significant, change to the definition of "available amount" to address situations in which an issuer has proceeds of more than one bond issue that finance working capital expenditures. The definition of available amount in the Existing Regulations specifically excludes proceeds of "the" issue, but not proceeds of other issues. The use of this existing definition for the new safe harbor would have the effect of requiring an issuer to apply proceeds of other issues to redeem or invest in eligible tax-exempt bonds to meet the safe harbor rather than using such proceeds for the intended governmental purpose. The Final Regulations adopt this comment and revise the definition of available amount to exclude proceeds of "any" issue.

Commenters also recommended that the maximum amount required to be applied under the safe harbor to redeem or invest in eligible tax-exempt bonds be reduced from that proposed under the Proposed Regulations, which would set that maximum amount at an amount equal to the outstanding principal of the bonds subject to the safe harbor. The commenters' suggestion would reduce the maximum amount in the Proposed Regulations by the amount of certain other eligible tax-exempt bonds redeemed by the issuer. The Final Regulations do not adopt this recommendation. The Final Regulations retain the measure of the maximum amount required to be applied to redeem or invest in eligible tax-exempt bonds under this safe harbor at the outstanding principal amount of the relevant bonds to ensure that issuers redeem the bonds that are the subject of the safe harbor whenever possible.

The 2013 Proposed Regulations proposed to define eligible tax-exempt bonds for purposes of the new safe harbor to mean those tax-exempt bonds that are not subject to the alternative minimum tax (non-AMT tax-exempt bonds). Commenters requested clarification that eligible tax-exempt bonds for these investments also include certain State and Local Government Series securities (SLGS or, individually, a SLGS security), specifically Demand Deposit SLGS, and certain interests in regulated investment companies that invest in tax-exempt bonds and pass through to their owners income at least 95 percent of which is tax-exempt under section 103. The commenters noted that these two types of investments are included in the existing definition of tax-exempt bonds for purposes of the arbitrage investment restrictions. Commenters noted particularly that Demand Deposit SLGS are much easier to acquire than tax-exempt bonds and also have limited arbitrage potential. The purpose of the requirement to redeem or invest available amounts in certain tax-exempt bonds is to reduce the burden on the tax-exempt bond market of longer-term tax-exempt bonds issued for working capital expenditure financings. Although Demand Deposit SLGS are taxable obligations that do not reduce the burden on the tax-exempt bond market, the Treasury Department and the IRS recognize that including these as eligible tax-exempt bonds provides issuers a simple method of investing with little possibility of earning arbitrage. An interest in a regulated investment company that invests in non-AMT tax-exempt bonds is easier to buy and sell than a bond, and purchasing such an interest reduces the burden on the tax-exempt bond market. Thus, paralleling the existing definition of "tax-exempt bonds" applicable for purposes of the arbitrage investment restrictions, the Final Regulations clarify that eligible tax-exempt bonds include both Demand Deposit SLGS and an interest in a regulated investment company if at least 95% of the income to the holder is from non-AMT tax-exempt bonds.

Commenters also recommended that the Final Regulations expressly address the treatment of refunding bonds issued to refinance working capital expenditures for purposes of the new safe harbor. The Final Regulations provide that this safe harbor applies to refunding bonds in the same way that it applies to other bonds.

iv. Other Technical Changes to Working Capital Rules

The 2013 Proposed Regulations proposed to remove a restriction against financing a working capital reserve, a complex restriction that penalized those State and local governments that previously have maintained the least amount of reserves. Commenters supported this change. The Final Regulations adopt this change as proposed.

The 2013 Proposed Regulations proposed to expand the factors listed in an anti-abuse rule that may justify a bond maturity in excess of those in the safe harbors that prevent the creation of replacement proceeds to include extraordinary working capital items. The Treasury Department and the IRS received no unfavorable comments on this change. The Final Regulations adopt this change as proposed.

Commenters also raised several issues with respect to the working capital rules that the Treasury Department and the IRS have concluded are beyond the scope of this project and, therefore, did not address in the Final Regulations (see section 12 of this preamble).

2. *Section 1.148–2 General Arbitrage Yield Restriction Rules—Temporary Period Spending Exception to Yield Restriction*

The Existing Regulations provide various temporary periods for investment of proceeds of tax-exempt bonds without yield restriction. No express temporary period covers proceeds used for working capital expenditures that are not restricted working capital expenditures, such as extraordinary working capital items. The 2013 Proposed Regulations proposed to broaden the existing 13 month temporary period for restricted working capital expenditures to include all working capital expenditures. One commenter supported and none opposed this proposed change. The Final Regulations adopt this change as proposed.

3. *Section 1.148–3 General Arbitrage Rebate Rules*

A. *Arbitrage Rebate Computation Credit*

The Existing Regulations allow an issuer to take a credit against payment of arbitrage rebate to help offset the cost of computing rebate. The 2007 Proposed Regulations proposed to increase the credit and proposed to add an inflation adjustment to this credit, based on changes in the Consumer Price Index. The Treasury Department and the IRS received no comments on this change. The Final Regulations adopt this change as proposed.

B. *Recovery of Overpayment of Rebate*

Generally, under the Existing Regulations, an issuer computes the amount of arbitrage rebate that it owes under a method that future values payments and receipts on investments using the yield on the bond issue. Under this method, an arbitrage payment made on one computation date is future valued to the next computation date to determine the amount of arbitrage rebate owed on that subsequent computation date. The Existing Regulations provide that an issuer may recover an overpayment of arbitrage rebate with respect to an issue of tax-exempt bonds if the issuer establishes to the satisfaction of the Commissioner that an overpayment occurred. The Existing Regulations further define an overpayment as the excess of "the amount paid" to the United States for an issue under section 148 over the sum of the rebate amount for that issue as of the most recent computation date and all amounts that are otherwise required to be paid under section 148 as of the date the recovery is requested. Thus, even if the future value of the issuer's arbitrage rebate payment on a computation date, computed under the method for determining arbitrage rebate, is greater than the issuer's rebate amount on that date, an issuer is only entitled to a refund to the extent that the amount actually paid exceeds that rebate amount. The Existing Regulations limit the amount of the refund in this manner because the Treasury Department and the IRS were concerned about whether the IRS had statutory authority to pay interest on arbitrage rebate payments. To permit a refund in an amount calculated in whole or in part based upon a future value of the amount actually paid would effectively result in an interest payment on that payment.

An example in the Existing Regulations has caused confusion because it could be interpreted to mean that an issuer can receive a refund of a rebate payment when the future value of such rebate payment exceeds the rebate amount on the next computation date, even though the actual amount of the previous rebate payment does not exceed the rebate amount on that next computation date. The Proposed Regulations proposed to make a technical amendment to this example to conform this example to the intended scope of recovery of an overpayment of arbitrage rebate.

Commenters recommended broadening the scope of recovery of overpayments of arbitrage rebate to permit future valuing of the amount actually paid in computing the amount of the overpayment. Because the Treasury Department and the IRS have concluded that they lack the statutory authority to pay interest on overpayments of arbitrage rebate, the Final Regulations adopt this change as proposed.

4. *Section 1.148–4 Yield on an Issue of Bonds*

A. *Joint Bond Yield Authority*

The 2007 Proposed Regulations proposed to eliminate a provision in the Existing Regulations that permits computation of a single joint bond yield for two or more issues of qualified mortgage bonds or qualified student loan bonds. The 2007 Proposed Regulations solicited public comments on the feasibility of establishing generally applicable, objective standards for joint bond yield computations. Two commenters representing student loan lenders sought to retain this provision and described certain facts on which they believed that the joint computation of yield on student loan bonds might be based. However, in 2010, Congress terminated the Federal Family Education Loan Program (FFELP), effectively eliminating the program for which most student loan bonds were issued yet not affecting State supplemental student loan bond programs. Health Care and Education Reconciliation Act of 2010, Public Law 111–152, section 2201, 124 Stat 1029, 1074 (2010). Given the elimination of the FFELP and the highly factual nature of the requests for joint bond yield computations, the Final Regulations adopt the proposed elimination of the joint bond yield authority provision. In addition, however, in recognition of the administrative challenges for loan yield calculations in these portfolio loan programs, the Final Regulations extend the availability of yield reduction payments to include qualified student loans and qualified mortgage loans generally (see section 5.A. of this preamble).

B. *Modification of Yield Computation for Yield-to-Call Premium Bonds*

The 2007 Proposed Regulations proposed to simplify the yield calculations for certain callable bonds issued with significant amounts of bond premium (sometimes called yield-to-call bonds) to focus on the redemption date that results in the lowest yield on the particular premium bond (rather than the more complex existing focus on the lowest yield on the issue). The Treasury Department and the IRS did not receive any adverse comments regarding this proposed change, received one question that raised issues beyond the scope of this project (see section 12 of this preamble), and received a favorable comment regarding this proposed change. The Final Regulations adopt this change as proposed.

C. *Integration of Hedges*

The Existing Regulations permit issuers to compute the yield on an issue by taking into account payments under "qualified hedges." Generally, under the Existing Regulations, to be a qualified hedge, the hedge must be interest based, the terms of the hedge must correspond closely with the terms of the hedged bonds, the issuer must duly identify the hedge, and the hedge must contain no significant investment element. The Existing Regulations provide two ways in which a qualified hedge may be taken into account in computing yield on the issue, known commonly as "simple integration" and "super integration." In the case of simple integration all net payments and receipts on the qualified hedge and the hedged bonds are taken into account in determining the yield on the bonds, such that generally these hedged bonds are treated as variable yield bonds for arbitrage purposes. In the case of super integration, certain hedged bonds are treated as fixed yield bonds, and the qualified hedge must meet additional eligibility requirements beyond those for simple integration. These additional eligibility requirements focus on assuring that the terms of the hedge and the hedged bonds sufficiently correspond so as to warrant treating the hedged bonds as fixed yield bonds for arbitrage purposes.

i. Cost-of-Funds Hedges

The 2007 Proposed Regulations proposed to clarify that for purposes of applying the definition of periodic payment to determine whether a hedge has a significant investment element, a "specified index" (upon which periodic payments are based) is deemed to include payments under a cost-of-funds swap, thereby eliminating any doubt that cost-of-funds swaps can be qualified hedges. One commenter supported this clarification and none opposed it. One commenter proposed an amendment that is beyond the scope of this project (see section 12 of this preamble). The Final Regulations adopt this clarification as proposed.

ii. Taxable Index Hedges

One of the eligibility requirements for a qualified hedge under the Existing Regulations is that the hedge be interest based. For simple integration, one of the factors used in determining whether a variable-to-fixed interest rate hedge is interest based focuses on whether the variable interest rate on the hedged bonds and the floating interest rate on the hedge are "substantially the same, but not identical to" one another. For super integration purposes, such rates must be "reasonably expected to be substantially the same throughout the term of the hedge." Issuers have raised interpretative questions about how to apply these rules to hedges based on taxable interest rate indices (taxable indices) because interest rates on taxable indices generally do not correspond as closely as interest rates on tax-exempt market indices to actual market interest rates on tax-exempt, variable-rate bonds. These interpretative questions are particularly important for hedges based on taxable indices (taxable index hedges) used with advance refunding bond issues because issuers generally need to use the qualified hedge rules or some other regime to determine with certainty the yield on the tax-exempt advance refunding bonds to comply with the applicable arbitrage yield restrictions on investments in defeasance escrows.

The 2007 Proposed Regulations proposed to clarify that taxable index hedges are eligible for simple integration but also included detailed provisions that prescribed the correlation of interest rates needed for taxable index hedges to qualify for simple integration. Commenters generally criticized the proposed interest rate correlation test for simple integration of taxable index hedges as excessively complex or unworkable in various respects. One commenter urged elimination of this rate correlation test as unnecessary on the grounds that other proposed changes in the 2007 Proposed Regulations, including particularly the provision limiting the size and scope of hedges (described in section 4.C.iii of this preamble), were sufficient to control the parameters of taxable index hedges for purposes of simple integration. The Final Regulations clarify that a taxable index hedge is an interest based contract and adopt the comment to eliminate the interest rate correlation test for taxable index hedges. The Final Regulations also clarify that the difference between the interest rate used on the hedged bonds and that used to compute payments on the hedge will not prevent the hedge from being an interest based contract if the two interest rates are substantially similar.

The 2007 Proposed Regulations proposed to treat taxable index hedges as ineligible for super integration (except in the case of certain anticipatory hedges). Commenters requested an exception to this general prohibition on super integration for instances in which the variable rate on hedged bonds and the variable rate used to determine the hedge provider's payments to the issuer under the hedge are both based on a taxable index and are identical (or nearly so) to one another. The Final Regulations generally adopt the proposed rule that taxable index hedges are ineligible for super integration but, in response to the comments, add an exception for hedges in which the hedge provider's payments are based on an interest rate identical to that on the hedged bonds, because these hedges are perfect hedges that clearly result in a fixed yield. The Treasury Department and the IRS do not adopt commenters' request to permit super integration when the taxable-index-based interest rates for both the hedge and the hedged bonds are nearly identical but not perfectly so. The Treasury Department and the IRS have concluded that such a rule would add unnecessary complexity to the Final Regulations and that commenters' concerns are largely resolved by the extension in the Final Regulations of yield reduction payments to address basis differences between indexes used in hedges and underlying interest rates on hedged bonds in advance refundings (discussed elsewhere in this section of the preamble). The Final Regulations remove references to the particular taxable index called "LIBOR," without inference.

Commenters also sought other specific exceptions to the prohibition on super integration. One commenter noted that taxable index hedges cost less than hedges based on a tax-exempt index and recommended allowing super integration of taxable index hedges with mortgage revenue bonds to facilitate compliance with arbitrage restrictions on the yield of the financed mortgages. The Treasury Department and the IRS have concluded that the Final Regulations adequately address the commenter's concerns by permitting simple integration of taxable index hedges and by allowing yield reduction payments for qualified mortgage loans to facilitate compliance with the arbitrage investment restrictions (see section 5.A. of this preamble).

Other commenters suggested that the proposed prohibition on super integration of taxable index hedges should be prospective. This provision in the Final Regulations applies to bonds sold on or after the date that is 90 days after publication of the Final Regulations in the **Federal Register,** and does not apply to bonds sold prior to that date or to hedges on those bonds, regardless of when the issuer enters into such a hedge, unless the issuer avails itself of permissive application under § 1.148–11(l)(1) of these Final Regulations.

The 2007 Proposed Regulations also proposed to modify the yield reduction payment rules to permit issuers to make yield reduction payments on certain hedged advance refunding issues. This proposed provision effectively would allow yield reduction payments to cover the basis differences between the hedge and the hedged bonds in certain circumstances in which super integration was unavailable to address those basis differences, such as when taxable index swaps hedge the interest rate on advance refunding bonds. Commenters requested clarification of which bonds in the issue must be hedged for the issuer to be eligible to make yield reduction payments under the proposed provision. The Final Regulations eliminate the term "hedged bond issue" to clarify that the yield reduction payment is narrowly targeted to the portion of the issue that funds the defeasance escrow and otherwise adopt this change as proposed.

iii. Size and Scope of a Qualified Hedge

The 2007 Proposed Regulations proposed to add an express requirement that limits the size and scope of a qualified hedge to a level that is reasonably necessary to hedge the issuer's risk with respect to interest rate changes on the hedged bonds. Generally, the purpose of this proposed limitation is to clarify that certain leveraged hedges are not qualified hedges.

The 2007 Proposed Regulations proposed an example of a hedge of the appropriate size and scope, based on the principal amount and the reasonably expected interest requirements of the hedged bonds. One commenter suggested clarifying this size and scope limitation to provide more flexibility for anticipatory hedges that are entered into before the issuance of the hedged bonds. The Final Regulations adopt the size and scope limitation as proposed and clarify that this limitation applies to anticipatory hedges based on the reasonably expected terms of the hedged bonds to be issued.

iv. Correspondence of Payments for Simple Integration

The Existing Regulations require that, for a hedge to be a qualified hedge, the payments received by the issuer from the hedge provider under the contract correspond closely in time to either the specific payments being hedged on the hedged bonds or specific payments required to be made pursuant to the bond documents, regardless of the hedge, to a sinking fund, debt service fund, or similar fund maintained for the issue of which the hedged bond is a part. The 2007 Proposed Regulations proposed to treat payments as corresponding closely in time for this purpose if the payments were made within 60 calendar days of each other.

One commenter recommended increasing the permitted period for corresponding payments from 60 days to 90 days to accommodate a range of conventions used in the swap market. The Final Regulations adopt this comment.

v. Identification of Qualified Hedges

The 2007 Proposed Regulations proposed to extend the time for an issuer to identify a qualified hedge from three days to 15 days and to clarify that these are calendar days. The 2013 Proposed Regulations proposed to add a requirement that the identification of a qualified hedge include a certificate from the hedge provider containing certain information. Under the 2013 Proposed Regulations, one element required to be certified by the hedge provider is that the rate being paid by the bonds' issuer on the hedge is comparable to the rate that would be paid by a similarly situated issuer of taxable debt.

Several commenters recommended clarifying the date on which the 15-day period for identification of a hedge commences. The Final Regulations clarify that the date on which the 15-day period begins is the date on which the parties enter into a binding agreement to enter into the hedge (as distinguished from the closing date of the hedge or start date for payments on the hedge, if different).

Several commenters suggested permitting a party other than the issuer to identify the hedge on its books and records, but such changes are beyond the scope of this project (see section 12 of this preamble).

One commenter supported the requirement of a hedge provider's certificate. Two other commenters recommended eliminating this requirement as both unnecessary and burdensome in that it exceeds the requirements for other financial contracts related to tax-exempt bond yield. These commenters recommended that, if the pricing of the hedge is a concern, the regulations should provide other methods for establishing fair pricing. These commenters, however, acknowledged that many issuers already use some form of hedge provider's certificate and that the provisions in the Proposed Regulations reflect to some degree the standard provisions of such certificates. In the alternative, these commenters recommended that the hedge provider's certificate should focus on factual aspects of establishing a qualified hedge, rather than on legal conclusions, and offered specific suggestions to that effect. For example, these commenters suggested that issuers also should be required to demonstrate their efforts to establish that the hedge pricing does not include compensation for underwriting or other services, rather than to obtain a certification to that effect. These commenters further suggested that the representation in the Proposed Regulations that the terms of the hedge were agreed to between a willing buyer and a willing seller in a bona fide, arm's length transaction was unnecessary and required a legal conclusion outside the hedge provider's knowledge. Further, the commenters noted that comparable hedges on taxable debt with counterparties similar to State and local government issuers may be rare and recommended that issuers be required to establish that the rate on the hedge is comparable to the rate that the hedge provider would charge for a similar hedge with a counterparty similar to the issuer, but without a reference to debt obligations other than tax-exempt bonds.

The Final Regulations retain the requirement for a hedge provider's certificate because the hedge provider is uniquely positioned to validate pricing information needed to determine whether a hedge meets the requirements for being a qualified hedge. The Final Regulations retain the certification regarding an arm's length transaction between a willing buyer and a willing seller as one primarily based on fact and commonly obtained by issuers under current practices. In response to public comments, the Final Regulations amend the other required certifications to focus on factual aspects of the hedging transaction. In light of the evolving regulatory environment for swaps, however, the Final Regulations omit the certification that the issuer's rate on the hedge is comparable to the rate that would be paid by a similarly situated issuer of taxable debt. The Final Regulations reserve the authority for the Commissioner to add additional certifications in guidance published in the Internal Revenue Bulletin. In developing any future guidance, the Treasury Department and the IRS may look to the market for swaps on taxable debt and consider the availability of appropriate comparable rates.

vi. Accounting for Modifications and Terminations

a. Modifications and Terminations of Qualified Hedges

The Existing Regulations provide that a termination of a qualified hedge includes any sale or other disposition of the hedge by the issuer or the acquisition by the issuer of an offsetting hedge. The Existing Regulations further provide that a deemed termination of a qualified hedge occurs when the hedged bonds are redeemed, when the hedge ceases to be a qualified hedge, or when the modification or assignment of the hedge results in a deemed exchange under section 1001. The issuer takes termination payments resulting from a deemed or actual termination of an integrated hedge into account in computing yield on the bonds.

The 2013 Proposed Regulations proposed guidance on the treatment of modifications and terminations of qualified hedges. The 2013 Proposed Regulations also proposed to eliminate the ambiguous existing standard that triggered terminations for offsetting hedges. The 2013 Proposed Regulations proposed that a modification, including an actual modification, an acquisition of another hedge, or an assignment, results in a deemed termination of a hedge if the modification is material and results in a deemed disposition under section 1001.

The 2013 Proposed Regulations proposed to simplify the treatment of deemed terminations to provide that a material modification of a qualified hedge (that otherwise would result in a deemed termination) does not result in such a termination if the modified hedge is a qualified hedge. For this purpose, the 2013 Proposed Regulations proposed to require re-testing of the modified hedge for compliance with the requirements for a qualified hedge at the time of the modification, with adjustments. In doing this re-testing, the 2013 Proposed Regulations proposed to disregard any off-market value of the existing hedge at the time of modification. In addition, the 2013 Proposed Regulations proposed to measure the time period for identification of the modified hedge from the date of the modification. Finally, the 2013 Proposed Regulations proposed to omit the requirement for a hedge provider's certificate for the modified hedge. Commenters supported these changes. The Final Regulations adopt these proposed changes with one modification: Assignment of a hedge is no longer given as an example of a modification. The Final Regulations remove this example not because an assignment is not a modification, but because under the regulations under section 1001 an assignment generally does not result in a deemed exchange.

Commenters sought confirmation that the proposed rules for modifications of qualified hedges in the 2013 Proposed Regulations would replace an existing rule regarding such modifications that is set forth in the first sentence of section 5.1 of Notice 2008–41, 2008–1 CB 742. That sentence generally provides that a modification of a qualified hedge does not result in a deemed termination if the issuer does not expect the modification to change the yield on the hedged bonds over their remaining term by more than 0.25% and the modified hedge is integrated with the bonds. The Final Regulations provide comprehensive rules for determining when a modification of a qualified hedge results in a termination and, therefore, supersede the first sentence of section 5.1 of Notice 2008–41. The Final Regulations have no effect on the remainder of Notice 2008–41. See the section in this preamble entitled "Effect on Other Documents."

b. Continuations of Qualified Hedges in Refundings

The 2013 Proposed Regulations similarly proposed to simplify the treatment of a qualified hedge upon a refunding of the hedged bonds when no actual termination of the associated hedge occurs. If the hedge meets the requirements for a qualified hedge of the refunding bonds as of the issue date of the refunding bonds, with certain exceptions, the 2013 Proposed Regulations proposed to treat the hedge as continuing as a qualified hedge of the refunding bonds instead of being terminated. The Treasury Department and the IRS received favorable comments regarding this proposed change and one comment beyond the scope of this project (see section 12 of this preamble). The Final Regulations adopt this change as proposed.

The Existing Regulations provide special rules for terminations of super-integrated qualified hedges. A termination is disregarded and these special rules do not apply if, based on the facts and circumstances, the yield will not change. The 2013 Proposed Regulations proposed to apply these special rules to a modified super-integrated qualified hedge that is eligible for continued simple integration. Commenters sought clarification of the effect of this rule on super integration treatment. The purpose of this rule is to determine whether a modified super-integrated qualified hedge that continues to qualify for simple integration also would continue to qualify for super integration. The Final Regulations clarify that the applicable test is the test under the Existing Regulations for determining when to disregard terminations of super-integrated qualified hedges.

c. Terminations of Hedges at Fair Market Value

The Proposed Regulations proposed to modify the amounts taken into account for a deemed termination or actual termination of a qualified hedge. For an actual termination of a qualified hedge, the 2013 Proposed Regulations proposed to limit the amount of the hedge termination payment treated as made or received on the hedged bonds to an amount that is (i) no greater than the fair market value of the qualified hedge if paid by the issuer, and (ii) no less than the fair market value of the qualified hedge if received by the issuer. For a deemed termination of a qualified hedge, the 2013 Proposed Regulations proposed that the amount of the deemed termination payment is equal to the fair market value of the qualified hedge on the termination date.

Commenters recommended that, for an actual termination, the amount actually paid or received by the issuer in connection with the termination should be considered the fair market value of the qualified hedge. The commenters further recommended that, for a deemed termination, the issuer should be able to rely on bid-side quotations from the hedge provider and other providers for purposes of determining the fair market value of the qualified hedge on the termination date. The commenters indicated that, in all cases, the termination amounts, whether actual or deemed, reflect the "bid side" of the hedge market. Because of concerns about the pricing of a hedge in determining the amount to be paid as a termination payment, the Final Regulations retain the rule that the amount of a termination payment that may be taken into account for arbitrage purposes is the fair market value of the qualified hedge on the termination date. The Final Regulations simplify the Proposed Regulations by providing a uniform fair market value standard for both actual and deemed terminations. Although the Treasury Department and the IRS have concluded that bona fide market quotations may be used to support fair market value determinations, the Treasury Department and the IRS have concerns about further specification of particular types of market quotations for purposes of proper reflection of fair market value in various circumstances. Accordingly, the Final Regulations provide that the fair market value of a qualified hedge upon termination is based on all of the facts and circumstances.

5. *Section 1.148–5 Yield and Valuation of Investments*

A. *Yield Reduction Payment Rules*

For certain limited situations, the Existing Regulations permit payment of yield reduction payments to the United States to satisfy yield restriction requirements on certain investments. The 2007 Proposed Regulations proposed to expand these situations to permit issuers to make yield reduction payments to cover nonpurpose investments that an issuer purchases on a date when the issuer is unable to purchase SLGS because the Treasury Department has suspended sales of SLGS.

Three commenters favored the proposed expansion of the availability of yield reduction payments when SLGS are unavailable. One commenter expressed concern that the proposed provision may not address the circumstance in which a SLGS sale suspension is in effect when an issuer commits to purchase investments, but SLGS sales resume before settlement on that purchase. The Final Regulations clarify that an issuer is permitted to make yield reduction payments if it enters into an agreement to purchase investments on a date when SLGS sales are suspended.

The commenter also recommended extending the availability of yield reduction payments to cover the circumstance in which an issuer is uncertain whether the Treasury Department may suspend SLGS sales in the future after an issuer has subscribed to purchase SLGS and before the issuance of those SLGS. Although the Treasury Department reserves full discretion to manage its borrowings, including SLGS, it has been the Treasury Department's practice to honor all outstanding SLGS subscriptions received before it suspends SLGS sales. Accordingly, the Treasury Department and the IRS have concluded that yield reduction payments are not needed in this circumstance, and the Final Regulations do not adopt this comment.

In addition, in comments regarding the proposed elimination of the Commissioner's authority to compute a joint yield for two or more issues of qualified mortgage bonds or qualified student loan bonds, one commenter requested that issuers of qualified student loan bonds be permitted to make yield reduction payments for all qualified student loans, not just those under the FFELP. The Treasury Department and the IRS recognize that the ability to make yield reduction payments for qualified student loans and qualified mortgage loans would provide issuers an administrable alternative to the rarely used authority to compute a joint bond yield on issues of such bonds. The Treasury Department and the IRS also recognize that these portfolio loan programs have particular administrative challenges with loan yield compliance due to the large number of loans. Accordingly, in connection with the elimination of that joint bond yield authority under the Final Regulations, the Treasury Department and the IRS adopt this comment and expand the availability of yield reduction payments to include qualified student loans and qualified mortgage loans generally.

Commenters requested permission to make yield reduction payments in several other situations not provided in the Proposed Regulations. The Treasury Department and the IRS have concluded these amendments are beyond the scope of this project and, therefore, did not address them in the Final Regulations (see section 12 of this preamble).

B. *Valuation of Investments*

The Existing Regulations provide guidance on how to value investments allocated to an issue but leave some ambiguity about when the present value and the fair market value methods of valuation are permitted or required. The 2013 Proposed Regulations proposed to clarify that the fair market value method of valuation generally is required for any investment on the date the investment is first allocated to an issue or first ceases to be allocated to an issue as a consequence of a deemed acquisition or a deemed disposition.

The 2013 Proposed Regulations did not propose to distinguish between purpose investments and nonpurpose investments. One commenter urged clarification that purpose investments must be valued at present value at all times. This commenter further suggested that the rules clearly distinguish between purpose and nonpurpose investments. The Treasury Department and the IRS recognize that purpose investments are special investments that are intended to pass on the benefits of the lower borrowing costs of tax-exempt bond financings to eligible beneficiaries of the particular authorized tax-exempt bond program (for example, eligible first-time low and moderate income homebuyers who receive qualified mortgage loans financed with qualified mortgage bonds). Accordingly, the Final Regulations adopt these comments.

The Existing Regulations include an exception to the mandatory fair market value rule for reallocations of investments between tax-exempt bond issues as a result of the transferred proceeds rule under § 1.148–9(b) or the universal cap rule under § 1.148–6(b)(2). To remove a disincentive against retiring tax-exempt bonds with taxable bonds when the fair market value of the investments allocable to the tax-exempt bonds would cause investment yield to exceed the tax-exempt bond yield, the 2013 Proposed Regulations proposed to change this exception to the fair market value rule to require that only the issue from which the investment is allocated consist of tax-exempt bonds.

Commenters generally viewed this change favorably. One commenter suggested clarifying an ambiguity in the Existing Regulations regarding when a reallocation from one issue to another occurs "as a result of" the universal cap rule. The Final Regulations clarify that the exception to fair market valuation for investments reallocated as a result of the universal cap rule applies narrowly to circumstances in which investments are deallocated from an issue as a result of the universal cap rule and are reallocated to another issue without further action as a result of an existing pledge of the investment to the other issue (for example, a pledge of investments to multiple bond issues secured by common security under a master indenture). In these circumstances, the issuer has not structured the transaction to benefit from the market valuation of the nonpurpose investments.

This commenter also suggested providing a safe harbor for when an issuer may liquidate escrow investments after a taxable refunding without concern that the Commissioner would exercise his anti-abuse authority to value the investment at fair market value. This comment is beyond the scope of this project (see section 12 of this preamble).

Commenters also recommended broad interpretations or expansions of the exception to fair market valuation for investments reallocated as a result of the universal cap rule to cover various types of transactions involving investments that secure a tax-exempt bond issue and that are liquidated at a profit so long as the investment proceeds of the liquidated investments are used to retire tax-exempt bonds early. In one representative scenario, an issuer using funds other than tax-exempt bond proceeds created a yield-restricted escrow fund to defease tax-exempt bonds for which it retained the call rights. If the fair market value of investments in the escrow appreciated, the issuer would issue taxable bonds and use a portion of the proceeds of the taxable bonds to redeem the tax-exempt bonds. Applying universal cap principles, the investments would cease to be allocated to the tax-exempt bonds when the tax-exempt bonds were redeemed and the investments would be allocated to the taxable refunding bonds not as a result of a pre-existing pledge but as replacement proceeds. If the investments were valued at fair market value, the yield on the escrow would exceed the yield on the tax-exempt bonds resulting in arbitrage bonds. The bonds would not be arbitrage bonds if the regulations permitted these escrow investments to be valued at present value at the time of the refunding. Another scenario for which the commenters requested using the present value of investments rather than fair market value involves liquidating the appreciated investments in a defeasance escrow to redeem the tax-exempt issue rather than issuing taxable refunding bonds.

The Treasury Department and the IRS have concerns about potential unintended consequences and circumvention of arbitrage investment restrictions in these and other similar transactions. In the first scenario, the issuer has structured the transaction specifically to benefit from an appreciation of the escrow investments in a manner inconsistent with the arbitrage restrictions. In the second scenario, the use of present value would allow the issuer to realize the investment return in contravention of the statutory requirements to take into account any gain or loss on the disposition of a nonpurpose investment. Accordingly, except for the technical clarification of the limited application of universal cap deallocations under this rule, the Final Regulations adopt as proposed the revised exception to fair market valuation for investments reallocated as a result of the transferred proceeds rule or the universal cap rule.

C. *Fair Market Value of Treasury Obligations*

The Existing Regulations provide a general rule that the fair market value of an investment is the price at which a willing buyer would purchase the investment from a willing seller in a bona fide, arm's length transaction. For United States Treasury obligations that are traded on the open market, trading values at the time of trades are used to establish fair market values. The Existing Regulations further provide a special rule, aimed primarily at non-transferrable, non-tradable SLGS, that the fair market value of a United States Treasury obligation that is purchased directly from the United States Treasury is its purchase price. This special rule properly indicates that the fair market value of a United States Treasury obligation that is purchased directly from the United States is its purchase price on the original purchase date, but this provision is ambiguous regarding how to determine the fair market value of such an obligation on dates after the original purchase date.

The 2013 Proposed Regulations proposed to clarify that, on the original purchase date only, the fair market value of such an obligation, including a SLGS security, is its purchase price. The 2013 Proposed Regulations further proposed that, on any date other than the original purchase date, the fair market value of a SLGS security is its redemption price. One commenter objected to the valuation of a SLGS security at other than its purchase price upon a deemed acquisition or deemed disposition. United States Treasury obligations other than SLGS may be purchased and sold on the open market. SLGS, however, are nontransferable obligations that may be purchased or redeemed only from the United States Treasury. For this reason, the 2013 Proposed Regulations proposed that the fair market value of a SLGS security on any date other than its purchase date is the redemption price determined by the United States Treasury under applicable regulations for the SLGS program. The Final Regulations adopt this change as proposed.

D. *Modified Fair Market Value Safe Harbor for Guaranteed Investment Contracts*

The Existing Regulations provide a safe harbor for establishing the fair market value of a guaranteed investment contract. This safe harbor generally relies on a prescribed bidding procedure, including requirements that all bidders be given an equal opportunity to bid with no opportunity to review other bids before providing a bid (that is, the "no last look" rule) and that the bid specifications be provided to prospective bidders "in writing." The 2007 Proposed Regulations proposed to amend this safe harbor to accommodate electronic bidding procedures by: (1) Permitting bid specifications to be sent electronically over the Internet or by fax; and (2) providing that no impermissible last look occurs if in effect all bidders have an equal opportunity for a last look. One commenter noted an ambiguity in this proposed change. In response to this comment, the Final Regulations clarify that bids must be in writing and timely disseminated and that a writing may be in electronic form and may be disseminated by fax, email, an Internet-based Web site, or other electronic medium that is similar to an Internet-based Web site and regularly used to post bid specifications. The Final Regulations otherwise adopt this change as proposed.

E. *External Commingled Investment Funds*

The Existing Regulations provide certain preferential rules for the treatment of administrative costs of certain widely held external commingled funds. Under the Existing Regulations, a fund is treated as widely held if the fund, on average, has more than 15 unrelated investors and each investor maintains a prescribed minimum average investment in the fund. The 2007 Proposed Regulations proposed to allow additional smaller investors to invest in an external commingled fund without disqualifying the fund so long as at least 16 unrelated investors each maintain the required minimum average investment in the fund.

One commenter suggested that the regulations should require that a specified percentage of the unrelated investors hold a specified percentage of the daily average value of the fund's assets. The Final Regulations do not adopt this comment, because it is inconsistent with the purpose of the proposed change to enable a fund to become even more widely held by accommodating an unlimited number of small investors without restriction so long as at least 16 unrelated investors each maintain the required minimum average investment in the fund. The commenter also suggested other amendments beyond the scope of this project (see section 12 of this preamble). The Final Regulations adopt this change as proposed.

6. *Section 1.148–8 Small Issuer Exception to Rebate Requirement—Pooled Bonds*

The 2007 Proposed Regulations proposed to amend the Existing Regulations to conform to changes made to section 148(f)(4)(D) by section 508 of the Tax Increase Prevention and Reconciliation Act of 2005, Public Law 109–222, 120 Stat. 345, which eliminated a rule that permitted a pool bond issuer to ignore its pool bond issue in computing whether it had exceeded its $5 million limit for purposes of the small issuer rebate exception. The Treasury Department and the IRS received no comments regarding this proposed change. The Final Regulations adopt this change as proposed.

7. *Section 1.148–10 Anti-Abuse Rules and Authority of Commissioner*

The 2013 Proposed Regulations proposed to amend the Commissioner's authority to depart from the arbitrage regulations when an issuer enters into a transaction for a principal purpose of obtaining a material financial advantage based on the difference between tax-exempt and taxable interest rates in a manner inconsistent with the purposes of section 148, from that "necessary to clearly reflect the economic substance of the transaction" to that "necessary to prevent such financial advantage." The 2013 Proposed Regulations proposed to remove the references to "economic substance" to prevent confusion of the Commissioner's authority under this arbitrage anti-abuse rule with the economic substance doctrine under general federal tax principles. No substantive change was intended.

Commenters suggested that this proposed change would give unduly broad discretion to the Commissioner and would reduce certainty of the applicability of published guidance. These commenters recommended limiting the Commissioner's authority to that necessary "to reflect the economics of the transaction to prevent such financial advantage." The Final Regulations adopt this comment.

8. *Section 1.148–11 Transition Provision for Certain Guarantee Funds*

The Existing Regulations include a transition rule that allows certain State perpetual trust funds (for example, certain State permanent school funds) to pledge funds to guarantee tax-exempt bonds without resulting in arbitrage-restricted replacement proceeds. The 2013 Proposed Regulations proposed to include changes proposed in Notice 2010–5, 2010–2 IRB 256, to increase the amount of tax-exempt bonds that such funds could guarantee under this special rule. Further, in response to comments received on Notice 2010–5, the 2013 Proposed Regulations proposed to extend this special rule to cover certain tax-exempt bonds issued to finance public charter schools, which may be 501(c)(3) organizations. The Treasury Department and the IRS received no comments on these proposed changes. The Final Regulations adopt these changes as proposed.

9. *Section 1.150–1 Definitions*

A. *Definition of Tax-Advantaged Bonds*

The 2013 Proposed Regulations proposed a new definition of tax-advantaged bonds. The Treasury Department and the IRS received no comments regarding this new definition. The Final Regulations substitute "tax benefit" for "subsidy" in describing tax-advantaged bonds but otherwise adopt the definition as proposed.

B. *Definition of Issue*

The Existing Regulations provide that tax-exempt bonds and taxable bonds are not part of the same issue. The 2013 Proposed Regulations proposed to clarify that taxable tax-advantaged bonds and other taxable bonds are part of different issues and that different types of tax-advantaged bonds are parts of different issues. The Treasury Department and IRS received one comment supporting this proposed change and no opposing comments. The Final Regulations adopt this change as proposed.

C. *Definition and Treatment of Grants*

The 2013 Proposed Regulations proposed that the existing definition of grant for arbitrage purposes applies for purposes of other tax-exempt bond provisions. The 2013 Proposed Regulations also proposed to clarify that the character and nature of a grantee's use of proceeds generally is taken into account in determining whether arbitrage and other applicable requirements of the issue are met.

Commenters requested confirmation that the proposed rule preserves the existing rule that an issuer spends proceeds used for grants for purposes of the arbitrage investment restrictions when the issuer makes the grant to an unrelated third-party. Thus, for example, if the grantee uses the grant to reimburse its expenditures, the reimbursement allocation rules do not apply. The 2013 Proposed Regulations expressly proposed the special grant expenditure rule for arbitrage purposes as an example of a specific exception to the proposed general rule. Commenters also suggested other amendments to the rules for grants that are beyond the scope of this project (see section 12 of this preamble). The Final Regulations adopt these changes as proposed.

10. *Section 1.141–15 Effective Dates*

The Final Regulations include certain technical amendments to final regulations (TD 9741) that were published in the **Federal Register** on Tuesday, October 27, 2015 (80 FR 65637). Those final regulations provide guidance on allocation and accounting rules and certain remedial actions for purposes of the private activity bond restrictions under section 141 of the Internal Revenue Code that apply to tax-exempt bonds issued by State and local governments.

The technical amendments amend the applicability dates to include a transition rule for refunding bonds, provided that the weighted average maturity of the refunding bonds is no longer than that of the refunded bonds or, in the case of certain short-term obligations, no longer than 120 percent of the weighted average reasonably expected economic life of the facilities financed. The technical amendments also clarify permissive application of certain provisions to outstanding bonds.

11. *Revenue Procedure 97–15*

Revenue Procedure 97–15, 1997–1 CB 635, provides a program under which an issuer of tax-exempt bonds may request a closing agreement with respect to outstanding bonds to prevent the interest on those bonds from being includible in gross income of the bondholders or being treated as an item of tax preference for purposes of the alternative minimum tax as a result of an action subsequent to the issue date of the bonds that causes the bonds to fail to meet certain requirements relating to the use of proceeds. Notice 2008–31, 2008–1 CB 592, also provides a voluntary closing agreement program for tax-exempt bonds and tax credit bonds. The scope of the violations that can be remedied under Notice 2008–31 is broader than that under Rev. Proc. 97–15. As a result, this Treasury Decision obsoletes Rev. Proc. 97–15.

12. *Comments Beyond the Scope of the Proposed and Final Regulations*

Commenters submitted additional suggestions for revisions to the Existing Regulations. These suggestions include: (1) Adding a new safe harbor to prevent the creation of replacement proceeds specifically for grants and extraordinary working capital financings (and redefining "extraordinary working capital"); (2) adding new rules for using proceeds to fund working capital reserves; (3) providing how an issuer should allocate certain expenses related to yield-to-call premium bonds for computing yield on the issue; (4) revising the rules for determining if an interest rate cap contains a significant investment element; (5) permitting a conduit borrower to identify a qualified hedge on its books and records; (6) providing a safe harbor for when an issuer may liquidate escrow investments for purposes of valuation of investments; (7) revising the proceeds-spent-last expenditure rule to permit financing of certain payments on hedges; (8) permitting yield reduction payments on investments purchased to defease zero-coupon bonds; (9) providing yield reduction payments for a basis difference under circumstances other than those in the Proposed Regulations; (10) exempting external comingled funds that are operated by a government on a not-for-profit basis from the requirements for administrative costs of such funds to be included in qualified administrative costs of investments; (11) establishing an economic life for grants based on the benefit of the grant to the grantor; (12) providing rules for grant repayments; and (13) explaining how certain rules in the Proposed Regulations would apply to very specific facts. These comments identify issues that are beyond the scope of the Proposed Regulations and thus are not addressed in the Final Regulations.

Applicability Dates

The Final Regulations generally apply to bonds that are sold on or after October 17, 2016. Certain provisions related to hedges on bonds apply to hedges that are entered into or modified on or after October 17, 2016. The Final Regulations also permit issuers to apply certain of the amended provisions to bonds sold before October 17, 2016. For specific dates of applicability, see §§ 1.141–15, 1.148–11, 1.150–1, and 1.150–2.

In addition, the amendments to § 1.148–3(j) in the Final Regulations apply to bonds subject to § 1.148–3(i). For this purpose, a bond is considered to be subject to § 1.148–3(i) if the issue of which the bond is a part is subject to the version of § 1.148–3(i) published in TD 8476 (58 FR 33510) or any subsequent version.

Effect on Other Documents

As of October 17, 2016, Revenue Procedures 95–47 and 97–15 are obsoleted and Notice 2008–41 is modified.

Special Analyses

Certain IRS regulations, including this one, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory impact assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that the collection of information in these regulations is required for hedging transactions entered into primarily between larger State and local governments and large counterparties. It is also based on the fact that the estimated recordkeeping burden for all issuers and counterparties is relatively small and the reasonable costs of that burden do not constitute a significant economic impact. Accordingly, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, the proposed regulations preceding these final regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business. No comments were received.

Drafting Information

The principal authors of these regulations are Johanna Som de Cerff, Spence Hanemann, and Lewis Bell of the Office of Associate Chief Counsel (Financial Institutions and Products), IRS. However, other personnel from the Treasury Department and the IRS participated in their development.

Availability of IRS Documents

IRS revenue procedures and notices cited in these final regulations are made available by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entry for § 1.148–6 to read in part as follows:

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

Par. 2. Section 1.141–0 is amended by:

1. Revising the entry for § 1.141–15(l)(2).

2. Adding an entry for § 1.141–15(l)(3).

3. Adding an entry for § 1.141–15(n).

The additions and revisions read as follows:

§ 1.141–0 Table of contents.

* * * * *

§ 1.141–15 Effective/applicability dates.

* * * * *

(l) * * *

(2) Refunding bonds.

(3) Permissive application.

* * * * *

(n) Effective/applicability dates for certain regulations relating to certain definitions.

* * * * *

Par. 3. Section 1.141–1 is amended by revising paragraph (a) to read as follows:

§ 1.141–1 Definitions and rules of general application.

(a) *In general*. For purposes of §§ 1.141–0 through 1.141–16, the following definitions and rules apply: the definitions in this section, the definitions in § 1.150–1, the definition of placed in service in § 1.150–2(c), the definition of reasonably required reserve or replacement fund in § 1.148–2(f), and the definitions in § 1.148–1 of bond year, commingled fund, fixed yield issue, higher yielding investments, investment, investment proceeds, issue price, issuer, nonpurpose investment, purpose investment, qualified guarantee, qualified hedge, reasonable expectations or reasonableness, rebate amount, replacement proceeds, sale proceeds, variable yield issue and yield.

* * * * *

Par. 4. Section 1.141–15 is amended by:

1. Redesignating paragraph (l)(2) as (l)(3).

2. Adding new paragraph (l)(2).

3. Amending the first sentence of redesignated paragraph (l)(3) by adding "Except as otherwise provided in this section," at the beginning of the sentence and removing the word "Issuers" and adding the word "issuers" in its place.

4. Adding paragraph (n).

The additions and revisions read as follows:

§ 1.141–15 Effective/applicability dates.

* * * * *

(l) * * *

(2) *Refunding bonds*. Except as otherwise provided in this section, §§ 1.141–1(e), 1.141–3(g)(2)(v), 1.141–6, and 1.145–2(b)(4), (5), and (c)(2) do not apply to any bonds sold on or after January 25, 2016, to refund a bond to which these sections do not apply, provided that the weighted average maturity of the refunding bonds is no longer than—

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

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

* * * * *

(n) *Effective/applicability dates for certain regulations relating to certain definitions*. § 1.141–1(a) applies to bonds that are sold on or after October 17, 2016.

Par. 5. Section 1.148–0(c) is amended by:

1. Revising the entry for § 1.148–2(e)(3).

2. Adding an entry for § 1.148–3(d)(4).

3. Revising the entry for § 1.148–5(d)(2).

4. Revising the entry for § 1.148–8(d).

5. Removing the entries for § 1.148–8(d)(1) and (2).

6. Revising the entry for § 1.148–10(e).

7. Adding entries for § 1.148–11(k).

8. Revising the entries for § 1.148–11(l).

The revisions and additions read as follows:

§ 1.148–0 Scope and table of contents.

* * * * *

(c) * * *

§ 1.148–2 General arbitrage yield restriction rules.

* * * * *

(e) * * *

(3) Temporary period for working capital expenditures.

* * * * *

§ 1.148–3 General arbitrage rebate rules.

* * * * *

(d) * * *

(4) Cost-of-living adjustment.

* * * * *

§ 1.148–5 Yield and valuation of investments.

* * * * *

(d) * * *

(2) Mandatory valuation of certain yield restricted investments at present value.

* * * * *

§ 1.148–8 Small issuer exception to rebate requirement.

* * * * *

(d) Pooled financings—treatment of conduit borrowers.

* * * * *

§ 1.148–10 Anti-abuse rules and authority of Commissioner.

* * * * *

(e) Authority of the Commissioner to prevent transactions that are inconsistent with the purpose of the arbitrage investment restrictions.

* * * * *

§ 1.148–11 Effective/applicability dates.

* * * * *

(k) Certain arbitrage guidance updates.

(1) In general.

(2) Valuation of investments in refunding transactions.

(3) Rebate overpayment recovery.

(4) Hedge identification.

(5) Hedge modifications and termination.

(6) Small issuer exception to rebate requirement for conduit borrowers of pooled financings.

(l) Permissive application of certain arbitrage updates.

(1) In general.

(2) Computation credit.

(3) Yield reduction payments.

(4) External commingled funds.

Par. 6. Section 1.148–1 is amended by:

1. Revising paragraph (c)(4)(i)(B)(*1*).

2. Removing the "or" at the end of paragraph (c)(4)(i)(B)(*2*).

3. Removing the period at the end of paragraph (c)(4)(i)(B)(*3*) and adding in its place a semicolon and the word "or".

4. Adding paragraph (c)(4)(i)(B)(*4*).

5. Revising paragraph (c)(4)(ii).

The revisions and additions read as follows:

§ 1.148–1 Definitions and elections.

* * * * *

(c) * * *

(4) * * *

(i) * * *

(B) * * *

(*1*) For the portion of an issue that is to be used to finance working capital expenditures, if that portion is not outstanding longer than the temporary period under § 1.148–2(e)(3) for which the proceeds qualify;

* * * * *

(*4*) For the portion of an issue (including a refunding issue) that is to be used to finance working capital expenditures, if that portion satisfies paragraph (c)(4)(ii) of this section.

(ii) *Safe harbor for longer-term working capital financings*. A portion of an issue used to finance working capital expenditures satisfies this paragraph (c)(4)(ii) if the issuer meets the requirements of paragraphs (c)(4)(ii)(A) through (E) of this section.

(A) *Determine first testing year*. On the issue date, the issuer must determine the first fiscal year following the applicable temporary period under § 1.148–2(e) in which it reasonably expects to have available amounts (first testing year), but in no event can the first day of the first testing year be later than five years after the issue date.

(B) *Application of available amount to reduce burden on tax-exempt bond market*. Beginning with the first testing year and for each subsequent fiscal year for which the portion of the issue that is the subject of this safe harbor remains outstanding, the issuer must determine the available amount as of the first day of each fiscal year. Then, except as provided in paragraph (c)(4)(ii)(D) of this section, within the first 90 days of that fiscal year, the issuer must apply that amount (or if less, the available amount on the date of the required redemption or investment) to redeem or to invest in eligible tax-exempt bonds (as defined in paragraph (c)(4)(ii)(E) of this section). For this purpose, available amounts in a bona fide debt service fund are not treated as available amounts.

(C) *Continuous investment requirement*. Except as provided in this paragraph (c)(4)(ii)(C), any amounts invested in eligible tax-exempt bonds under paragraph (c)(4)(ii)(B) of this section must be invested continuously in such tax-exempt bonds to the extent provided in paragraph (c)(4)(ii)(D) of this section.

(*1*) *Exception for reinvestment period*. Amounts previously invested in eligible tax-exempt bonds under paragraph (c)(4)(ii)(B) of this section that are held for not more than 30 days in a fiscal year pending reinvestment in eligible tax-exempt bonds are treated as invested in eligible tax-exempt bonds.

(*2*) *Limited use of invested amounts*. An issuer may spend amounts previously invested in eligible tax-exempt bonds under paragraph (c)(4)(ii)(B) of this section within 30 days of the date on which they cease to be so invested to make expenditures for a governmental purpose on any date on which the issuer has no other available amounts for such purpose, or to redeem eligible tax-exempt bonds.

(D) *Cap on applied or invested amounts*. The maximum amount that an issuer is required to apply under paragraph (c)(4)(ii)(B) of this section or to invest continuously under paragraph (c)(4)(ii)(C) of this section with respect to the portion of an issue that is the subject of this safe harbor is the outstanding principal amount of such portion. For purposes of this cap, an issuer receives credit towards its requirement to invest available amounts in eligible tax-exempt bonds for amounts previously invested under paragraph (c)(4)(ii)(B) of this section that remain continuously invested under paragraph (c)(4)(ii)(C) of this section.

(E) *Definition of eligible tax-exempt bonds*. For purposes of paragraph (c)(4)(ii) of this section, *eligible tax-exempt bonds* means any of the following:

(*1*) A bond the interest on which is excludable from gross income under section 103 and that is not a specified private activity bond (as defined in section 57(a)(5)(C)) subject to the alternative minimum tax;

(*2*) An interest in a regulated investment company to the extent that at least 95 percent of the income to the holder of the interest is interest on a bond that is excludable from gross income under section 103 and that is not interest on a specified private activity bond (as defined in section 57(a)(5)(C)) subject to the alternative minimum tax; or

(*3*) A certificate of indebtedness issued by the United States Treasury pursuant to the Demand Deposit State and Local Government Series program described in 31 CFR part 344.

* * * * *

Par. 7. Section 1.148–2 is amended by revising the heading of paragraph (e)(3) and revising paragraph (e)(3)(i) to read as follows:

§ 1.148–2 General arbitrage yield restriction rules.

* * * * *

(e) * * *

(3) *Temporary period for working capital expenditures*—(i) *General rule*. The proceeds of an issue that are reasonably expected to be allocated to working capital expenditures within 13 months after the issue date qualify for a temporary pe-

riod of 13 months beginning on the issue date. Paragraph (e)(2) of this section contains additional temporary period rules for certain working capital expenditures that are treated as part of a capital project.

* * * * *

Par. 8. Section 1.148–3 is amended by:

1. Revising paragraph (d)(1)(iv).

2. Adding paragraph (d)(4).

3. Revising *Example 2(iii)(D)* of paragraph (j).

The revisions and addition read as follows:

§ 1.148–3 General arbitrage rebate rules.

* * * * *

(d) * * *

(1) * * *

(iv) On the last day of each bond year during which there are amounts allocated to gross proceeds of an issue that are subject to the rebate requirement, and on the final maturity date, a computation credit of $1,400 for any bond year ending in 2007 and, for bond years ending after 2007, a computation credit in the amount determined under paragraph (d)(4) of this section; and

* * * * *

(4) *Cost-of-living adjustment*. For any calendar year after 2007, the $1,400 computation credit set forth in paragraph (d)(1)(iv) of this section shall be increased by an amount equal to such dollar amount multiplied by the cost-of-living adjustment determined under section 1(f)(3) for such year, as modified by this paragraph (d)(4). In applying section 1(f)(3) to determine this cost-of-living adjustment, the reference to "calendar year 1992" in section 1(f)(3)(B) shall be changed to "calendar year 2006." If any such increase determined under this paragraph (d)(4) is not a multiple of $10, such increase shall be rounded to the nearest multiple thereof.

* * * * *

(j) * * *

Example 2. * * *

(iii) * * *

(D) If the yield during the second computation period were, instead, 7.0000 percent, the rebate amount computed as of July 1, 2004, would be $1,320,891. The future value of the payment made on July 1, 1999, would be $1,471,007. Although the future value of the payment made on July 1, 1999 ($1,471,007), exceeds the rebate amount computed as of July 1, 2004 ($1,320,891), § 1.148–3(i) limits the amount recoverable as a defined overpayment of rebate under section 148 to the excess of the total "amount paid" over the sum of the amount determined under the future value method to be the "rebate amount" as of the most recent computation date and all other amounts that are otherwise required to be paid under section 148 as of the date the recovery is requested. Because the total amount that the issuer paid on July 1, 1999 ($1,042,824.60), does not exceed the rebate amount as of July 1, 2004 ($1,320,891), the issuer would not be entitled to recover any overpayment of rebate in this case.

* * * * *

Par. 9. Section 1.148–4 is amended by:

1. Revising paragraph (a).

2. Revising paragraph (b)(3)(i).

3. Adding two sentences at the end of paragraph (h)(2)(ii)(A).

4. Revising the heading and introductory text of paragraph (h)(2)(v).

5. Revising the last sentence of paragraph (h)(2)(v)(B).

6. Adding a sentence at the end of paragraph (h)(2)(vi).

7. Revising paragraph (h)(2)(viii).

8. Revising paragraph (h)(3)(iv)(A).

9. Redesignating paragraphs (h)(3)(iv)(B) through (E) as paragraphs (h)(3)(iv)(E) through (H) respectively.

10. Adding new paragraphs (h)(3)(iv)(B), (C), and (D).

11. Revising newly redesignated paragraph (h)(3)(iv)(E).

12. Revising the first sentence in newly redesignated paragraph (h)(3)(iv)(F).

13. Revising newly redesignated paragraph (h)(3)(iv)(G).

14. Revising the first sentence in newly redesignated paragraph (h)(3)(iv)(H).

15. Adding a sentence at the end of paragraph (h)(4)(i)(C).

16. Adding paragraphs (h)(4)(i)(C)(*1*) and (*2*).

17. Adding paragraph (h)(4)(iv).

The revisions and additions read as follows:

§ 1.148–4 Yield on an issue of bonds.

(a) *In general*. The yield on an issue of bonds is used to apply investment yield restrictions under section 148(a) and to compute rebate liability under section 148(f). Yield is computed under the economic accrual method using any consistently applied compounding interval of not more than one year. A short first compounding interval and a short last compounding interval may be used. Yield is expressed as an annual percentage rate that is calculated to at least four decimal places (for example, 5.2525 percent). Other reasonable, standard financial conventions, such as the 30 days per month/360 days per year convention, may be used in computing yield but must be consistently applied. The yield on an issue that would be a purpose investment (absent section 148(b)(3)(A)) is equal to the yield on the conduit financing issue that financed that purpose investment.

(b) * * *

(3) *Yield on certain fixed yield bonds subject to optional early redemption*—(i) *In general*. If a fixed yield bond is subject to optional early redemption and is described in paragraph (b)(3)(ii) of this section, the yield on the issue containing the bond is computed by treating the bond as redeemed at its stated redemption price on the optional redemption date that would produce the lowest yield on that bond.

* * * * *

(h) * * *

(2) * * *

(ii) * * *

(A) * * * Solely for purposes of determining if a hedge is a qualified hedge under this section, payments that an issuer receives pursuant to the terms of a hedge that are equal to the issuer's cost of funds are treated as periodic payments under § 1.446–3 without regard to whether the payments are calculated by reference to a "specified index" described in § 1.446–3(c)(2). Accordingly, a hedge does not have a significant investment element under this paragraph (h)(2)(ii)(A) solely because an issuer receives payments pursuant to the terms of a hedge that are computed to be equal to the issuer's cost of funds, such as the issuer's actual market-based tax-exempt variable interest rate on its bonds.

* * * * *

(v) *Interest-based contract and size and scope of hedge*. The contract is primarily interest-based (for example, a hedge based on a debt index, including a tax-exempt debt index or a taxable debt index, rather than an equity index). In addition, the size and scope of the hedge under the contract is limited to that which is reasonably necessary to hedge the issuer's risk with respect to interest rate changes on the hedged bonds. For example, a contract is limited to hedging an issuer's risk with respect to interest rate changes on the hedged bonds if the hedge is based on the principal amount and the reasonably expected interest payments of the hedged bonds. For anticipatory hedges under paragraph (h)(5) of this section, the size and scope limitation applies based on the reasonably expected terms of the hedged bonds to be issued. A contract is not primarily interest based unless—

* * * * *

(B) * * * For this purpose, differences that would not prevent the resulting bond from being substantially similar to another type of bond include: a difference between the interest rate used to compute payments on the hedged bond and the interest rate used to compute payments on the hedge where one interest rate is substantially similar to the other; the difference resulting from the payment of a fixed premium for a cap (for example, payments for a cap that are made in other than level installments); and the difference resulting from the allocation of a termination payment where the termination was not expected as of the date the contract was entered into.

(vi) * * * For this purpose, such payments will be treated as corresponding closely in time under this paragraph (h)(2)(vi) if they are made within 90 calendar days of each other.

* * * * *

(viii) *Identification*—(A) *In general*. The actual issuer must identify the contract on its books and records maintained for the hedged bonds not later than 15 calendar days after the date on which there is a binding agreement to enter into a hedge contract (for example, the date of a hedge pricing confirmation, as distinguished from the closing date for the hedge or start date for payments on the hedge, if different). The identification must specify the name of the hedge provider, the terms of the contract, the hedged bonds, and include a hedge provider's certification as described in paragraph (h)(2)(viii)(B) of this section. The identification must contain sufficient detail to establish that the requirements of this paragraph (h)(2) and, if applicable, paragraph (h)(4) of this section are satisfied. In addition, the existence of the hedge must be noted on the first form relating to the issue of which the hedged bonds are a part that is filed with the Internal Revenue Service on or after the date on which the contract is identified pursuant to this paragraph (h)(2)(viii).

(B) *Hedge provider's certification*. The hedge provider's certification must—

(*1*) Provide that the terms of the hedge were agreed to between a willing buyer and willing seller in a bona fide, arm's-length transaction;

(*2*) Provide that the hedge provider has not made, and does not expect to make, any payment to any third party for the benefit of the issuer in connection with the hedge, except for any such third-party payment that the hedge provider expressly identifies in the documents for the hedge;

(*3*) Provide that the amounts payable to the hedge provider pursuant to the hedge do not include any payments for underwriting or other services unrelated to the hedge provider's obligations under the hedge, except for any such payment that the hedge provider expressly identifies in the documents for the hedge; and

(*4*) Contain any other statements that the Commissioner may provide in guidance published in the Internal Revenue Bulletin. See § 601.601(d)(2)(ii) of this chapter.

(3) * * *

(iv) *Accounting for modifications and terminations*—(A) *Modification defined*. A modification of a qualified hedge includes, without limitation, a change in the terms of the hedge or an issuer's acquisition of another hedge with terms that have the effect of modifying an issuer's risk of interest rate changes or other terms of an existing qualified hedge. For example, if the issuer enters into a qualified hedge that is an interest rate swap under which it receives payments based on the Securities Industry and Financial Market Association (SIFMA) Municipal Swap Index and subsequently enters a second hedge (with the same or different provider) that limits the issuer's exposure under the existing qualified hedge to variations in the SIFMA Municipal Swap Index, the new hedge modifies the qualified hedge.

(B) *Termination defined*. A termination means either an actual termination or a deemed termination of a qualified hedge. Except as otherwise provided, an actual termination of a qualified hedge occurs to the extent that the issuer sells, disposes of, or otherwise actually terminates all or a portion of the hedge. A deemed termination of a qualified hedge occurs if the hedge ceases to meet the requirements for a qualified hedge; the issuer makes a modification (as defined in paragraph (h)(3)(iv)(A) of this section) that is material either in kind or in extent and, therefore, results in a deemed exchange of the hedge and a realization event to the issuer under section 1001; or the issuer redeems all or a portion of the hedged bonds.

(C) *Special rules for certain modifications when the hedge remains qualified*. A modification of a qualified hedge that otherwise would result in a deemed termination under paragraph (h)(3)(iv)(B) of this section does not result in such a termination if the modified hedge is re-tested for qualification as a qualified hedge as of the date of the modification, the modified hedge meets the requirements for a qualified hedge as of such date, and the modified hedge is treated as a qualified hedge prospectively in determining the yield on the hedged bonds. For purposes of this paragraph (h)(3)(iv)(C), when determining whether the modified hedge is qualified, the fact that the existing qualified hedge is off-market as of the date of the modification is disregarded and the identification requirement in paragraph (h)(2)(viii) of this section applies by measuring the time period for identification from the date of the modification and without regard to the requirement for a hedge provider's certification.

(D) *Continuations of certain qualified hedges in refundings*. If hedged bonds are redeemed using proceeds of a refunding issue, the qualified hedge for the refunded bonds is not actually terminated, and the hedge meets the requirements for a qualified hedge for the refunding bonds as of the issue date of the refunding bonds, then no termination of the hedge occurs and the hedge instead is treated as a qualified hedge for the refunding bonds. For purposes of this paragraph (h)(3)(iv)(D), when determining whether the hedge is a qualified hedge for the refunding bonds, the fact that the hedge is off-market with respect to the refunding bonds as of the issue date of the refunding bonds is disregarded and the identification requirement in paragraph (h)(2)(viii) of this section applies by measuring the time period for identification from the issue date of the refunding bonds and without regard to the requirement for a hedge provider's certification.

(E) *General allocation rules for hedge termination payments*. Except as otherwise provided in paragraphs (h)(3)(iv)(F), (G), and (H) of this section, a payment made or received by an issuer to terminate a qualified hedge, or a payment deemed made or received for a deemed termination, is treated as a payment made or received, as appropriate, on the hedged bonds. Upon an actual termination or a deemed termination of a qualified hedge, the amount that an issuer may treat as a termination payment made or received on the hedged bonds is the fair market value of the qualified hedge on its termination date, based on all of the facts and circumstances. Except as otherwise provided, a termination payment is reasonably allocated to the remaining periods originally covered by the terminated hedge in a manner that reflects the economic substance of the hedge.

(F) *Special rule for terminations when bonds are redeemed*. Except as otherwise provided in this paragraph (h)(3)(iv)(F) and in paragraph (h)(3)(iv)(G) of this section, when a qualified hedge is deemed terminated because the hedged bonds are redeemed, the termination payment as determined under paragraph (h)(3)(iv)(E) of this section is treated as made or received on that date. * * *

(G) *Special rules for refundings*. When there is a termination of a qualified hedge because there is a refunding of the hedged bonds, to the extent that the hedged bonds are redeemed using the proceeds of a refunding issue, the termination payment is accounted for under paragraph (h)(3)(iv)(E) of this section by treating it as a payment on the refunding issue, rather than the hedged bonds. In addition, to the extent that the refunding issue is redeemed during the period to which the termination payment has been allocated to that issue, paragraph (h)(3)(iv)(F) of this section applies to the termination payment by treating it as a payment on the redeemed refunding issue.

(H) *Safe harbor for allocation of certain termination payments*. A payment to terminate a qualified hedge does not result in that hedge failing to satisfy the applicable provisions of paragraph (h)(3)(iv)(E) of this section if that payment is allocated in accordance with this paragraph (h)(3)(iv)(H). * * *

(4) * * *

(i) * * *

(C) * * * A hedge based on a taxable interest rate or taxable interest index cannot meet the requirements of this paragraph (h)(4)(i)(C) unless either—

(*1*) The hedge is an anticipatory hedge that is terminated or otherwise closed substantially contemporaneously with the issuance of the hedged bond in accordance with paragraph (h)(5)(ii) or (iii) of this section; or

(*2*) The issuer's payments on the hedged bonds and the hedge provider's payments on the hedge are based on identical interest rates.

* * * * *

(iv) *Consequences of certain modifications*. The special rules under paragraph (h)(4)(iii) of this section regarding the effects of termination of a qualified hedge of fixed yield hedged bonds apply to a modification described in paragraph (h)(3)(iv)(C) of this section. Thus, such a modification is treated as a termination for purposes of paragraph (h)(4)(iii) of this section unless the rule in paragraph (h)(4)(iii)(C) applies.

* * * * *

Par. 10. Section 1.148–5 is amended by:

1. Revising paragraph (c)(3).

2. Revising paragraphs (d)(2) and (3).

3. Revising the last sentence in paragraph (d)(6)(i) and adding a sentence at the end of the paragraph.

4. Revising paragraphs (d)(6)(iii)(A)(*1*) and (*6*).

5. Revising the second sentence of paragraph (e)(2)(ii)(B).

The revisions and additions read as follows:

§ 1.148–5 Yield and valuation of investments.

* * * * *

(c) * * *

(3) *Applicability of special yield reduction rule*. Paragraph (c) applies only to investments that are described in at least one of paragraphs (c)(3)(i) through (ix) of this section and, except as otherwise expressly provided in paragraphs (c)(3)(i) through (ix) of this section, that are allocated to proceeds of an issue other than gross proceeds of an advance refunding issue.

(i) *Nonpurpose investments allocated to proceeds of an issue that qualified for certain temporary periods*. Nonpurpose investments allocable to proceeds of an issue that qualified for one of the temporary periods available for capital projects, working capital expenditures, pooled financings, or investment proceeds under § 1.148–2(e)(2), (3), (4), or (6), respectively.

(ii) *Investments allocable to certain variable yield issues*. Investments allocable to a variable yield issue during any computation period in which at least 5 percent of the value of the issue is represented by variable yield bonds, unless the issue is an issue of hedge bonds (as defined in section 149(g)(3)(A)).

(iii) *Nonpurpose investments allocable to certain transferred proceeds*. Nonpurpose investments allocable to transferred proceeds of—

(A) A current refunding issue to the extent necessary to reduce the yield on those investments to satisfy yield restrictions under section 148(a); or

(B) An advance refunding issue to the extent that investment of the refunding escrows allocable to the proceeds, other than transferred proceeds, of the refunding issue in zero-yielding nonpurpose investments is insufficient to satisfy yield restrictions under section 148(a).

(iv) *Purpose investments allocable to qualified student loans and qualified mortgage loans*. Purpose investments allocable to qualified student loans and qualified mortgage loans.

(v) *Nonpurpose investments allocable to gross proceeds in certain reserve funds*. Nonpurpose investments allocable to gross proceeds of an issue in a reasonably required reserve or replacement fund or a fund that, except for its failure to satisfy the size limitation in § 1.148–2(f)(2)(ii), would qualify as a reasonably required reserve or replacement fund, but only to the extent the requirements in paragraphs (c)(3)(v)(A) or (B) of this section are met. This paragraph (c)(3)(v) includes nonpurpose investments described in this paragraph that are allocable to transferred proceeds of an advance refunding issue, but only to the extent necessary to satisfy yield restriction under section 148(a) on those proceeds treating all investments allocable to those proceeds as a separate class.

(A) The value of the nonpurpose investments in the fund is not greater than 15 percent of the stated principal amount of the issue, as computed under § 1.148–2(f)(2)(ii).

(B) The amounts in the fund (other than investment earnings) are not reasonably expected to be used to pay debt service on the issue other than in connection with reductions in the amount required to be in that fund (for example, a reserve fund for a revolving fund loan program).

(vi) *Nonpurpose investments allocable to certain replacement proceeds of refunded issues*. Nonpurpose investments allocated to replacement proceeds of a refunded issue, including a refunded issue that is an advance refunding issue, as a result of the application of the universal cap to amounts in a refunding escrow.

(vii) *Investments allocable to replacement proceeds under a certain transition rule*. Investments described in § 1.148–11(f).

(viii) *Nonpurpose investments allocable to proceeds when State and Local Government Series Securities are unavailable*. Nonpurpose investments allocable to proceeds of an issue, including an advance refunding issue, that an issuer purchases if, on the date the issuer enters into the agreement to purchase such investments, the issuer is unable to subscribe for State and Local Government Series Securities because the U.S. Department of the Treasury, Bureau of the Fiscal Service, has suspended sales of those securities.

(ix) *Nonpurpose investments allocable to proceeds of certain variable yield advance refunding issues*. Nonpurpose investments allocable to proceeds of the portion of a variable yield issue used for advance refunding purposes that are deposited in a yield restricted defeasance escrow if—

(A) The issuer has entered into a qualified hedge under § 1.148–4(h)(2) with respect to all of the variable yield bonds of the issue allocable to the yield restricted defeasance escrow and that hedge is in the form of a variable-to-fixed interest rate swap under which the issuer pays the hedge provider a fixed interest rate and receives from the hedge provider a floating interest rate;

(B) Such qualified hedge covers a period beginning on the issue date of the hedged bonds and ending on or after the date on which the final payment is to be made from the yield restricted defeasance escrow; and

(C) The issuer restricts the yield on the yield restricted defeasance escrow to a yield that is not greater than the yield on the issue, determined by taking into account the issuer's fixed payments to be made under the hedge and by assuming that the issuer's variable yield payments to be paid on the hedged bonds are equal to the floating payments to be received by the issuer under the qualified hedge and are paid on the same dates (that is, such yield reduction payments can only be made to address basis risk differences between the variable yield payments on the hedged bonds and the floating payments received on the hedge).

* * * * *

(d) * * *

(2) *Mandatory valuation of certain yield restricted investments at present value*. A purpose investment must be valued at present value, and except as otherwise provided in paragraphs (b)(3) and (d)(3) of this section, a yield restricted nonpurpose investment must be valued at present value.

(3) *Mandatory valuation of certain investments at fair market value*—(i) *In general*. Except as otherwise provided in paragraphs (d)(3)(ii) and (d)(4) of this section, a nonpurpose investment must be valued at fair market value on the date that it is first allocated to an issue or first ceases to be allocated to an issue as a consequence of a deemed acquisition or deemed disposition. For example, if an issuer deposits existing nonpurpose investments into a sinking fund for an issue, those investments must be valued at fair market value as of the date first deposited into the fund.

(ii) *Exception to fair market value requirement for transferred proceeds allocations, certain universal cap allocations, and commingled funds*. Paragraph (d)(3)(i) of this section does not apply if the investment is allocated from one issue to another as a result of the transferred proceeds allocation rule under § 1.148–9(b) or is deallocated from one issue as a result of the universal cap rule under § 1.148–6(b)(2) and reallocated to another issue as a result of a preexisting pledge of the investment to secure that other issue, provided that, in either circumstance (that is, transferred proceeds allocations or universal cap deallocations), the issue from which the investment is allocated (that is, the first issue in an allocation from one issue to another issue) consists of tax-exempt bonds. In addition, paragraph (d)(3)(i) of this section does not apply to investments in a commingled fund (other than a bona fide debt service fund) unless it is an investment being initially deposited in or withdrawn from a commingled fund described in § 1.148–6(e)(5)(iii).

* * * * *

(6) * * *

(i) * * * On the purchase date, the fair market value of a United States Treasury obligation that is purchased directly from the United States Treasury, including a State and Local Government Series Security, is its purchase price. The fair market value of a State and Local Government Series Security on any date other than the purchase date is the redemption price for redemption on that date.

* * * * *

(iii) * * *

(A) * * *

(*1*) The bid specifications are in writing and are timely disseminated to potential providers. For purposes of this paragraph (d)(6)(iii)(A)(*1*), a writing may be in electronic form and may be disseminated by fax, email, an internet-based Web site, or other electronic medium that is similar to an internet-based Web site and regularly used to post bid specifications.

* * * * *

(*6*) All potential providers have an equal opportunity to bid. If the bidding process affords any opportunity for a potential provider to review other bids before providing a bid, then providers have an equal opportunity to bid only if all potential providers have an equal opportunity to review other bids. Thus, no potential provider may be given an opportunity to review other bids that is not equally given to all potential providers (that is, no exclusive "last look").

* * * * *

(e) * * *

(2) * * *

(ii) * * *

(B) * * * For purposes of this paragraph (e)(2)(ii)(B), a fund is treated as widely held only if, during the immediately preceding fixed, semiannual period chosen by the fund (for example, semiannual periods ending June 30 and December 31), the fund had a daily average of more than 15 investors that were not related parties, and at least 16 of the unrelated investors each maintained a daily average amount invested in the fund that was not less than the lesser of $500,000 and one percent (1%) of the daily average of the total amount invested in the fund (with it being understood that additional smaller investors will not disqualify the fund). * * *

* * * * *

Par. 11. Section 1.148–6 is amended by:

1. Revising the second sentence of paragraph (d)(3)(iii)(A).

2. Removing paragraph (d)(4)(iii).

The revision reads as follows:

§ 1.148–6 General allocation and accounting rules.

* * * * *

(d) * * *

(3) * * *

(iii) * * *

(A) * * * Except as otherwise provided, available amount excludes proceeds of any issue but includes cash, investments, and other amounts held in accounts or otherwise by the issuer or a related party if those amounts may be used by the issuer for working capital expenditures of the type being financed by an issue without legislative or judicial action and without a legislative, judicial, or contractual requirement that those amounts be reimbursed.

* * * * *

Par. 12. Section 1.148–7 is revised by:

1. Revising paragraph (c)(3)(v).

2. Revising paragraph (i)(6)(ii).

The revisions read as follows:

§ 1.148–7 Spending exceptions to the rebate requirement.

* * * * *

(c) * * *

(3) * * *

(v) Representing repayments of grants (as defined in § 1.150–1(f)) financed by the issue.

* * * * *

(i) * * *

(6) * * *

(ii) Repayments of grants (as defined in § 1.150–1(f)) financed by the issue.

* * * * *

Par. 13. Section 1.148–8(d) is revised to read as follows:

§ 1.148–8 Small issuer exception to rebate requirement.

* * * * *

(d) *Pooled financings—treatment of conduit borrowers*. A loan to a conduit borrower in a pooled financing qualifies for the small issuer exception, regardless of the size of either the pooled financing or of any loan to other conduit borrowers, only if—

(1) The bonds of the pooled financing are not private activity bonds;

(2) None of the loans to conduit borrowers are private activity bonds; and

(3) The loan to the conduit borrower meets all the requirements of the small issuer exception.

* * * * *

Par. 14. Section 1.148–10 is amended by:

1. Revising the last sentence of paragraph (a)(4).

2. Revising the heading and first sentence of paragraph (e).

The revisions read as follows:

§ 1.148–10 Anti-abuse rules and authority of Commissioner.

(a) * * *

(4) * * * These factors may be outweighed by other factors, such as bona fide cost underruns, an issuer's bona fide need to finance extraordinary working capital items, or an issuer's long-term financial distress.

* * * * *

(e) *Authority of the Commissioner to prevent transactions that are inconsistent with the purpose of the arbitrage investment restrictions*. If an issuer enters into a transaction for a principal purpose of obtaining a material financial advantage based on the difference between tax-exempt and taxable interest rates in a manner that is inconsistent with the purposes of section 148, the Commissioner may exercise the Commissioner's discretion to depart from the rules of § 1.148–1 through § 1.148–11 as necessary to reflect the economics of the transaction to prevent such financial advantage. * * *

* * * * *

Par. 15. Section 1.148–11 is amended by:

1. Redesignating paragraphs (d)(1)(i), (ii), (iii), (iv), (v), and (vi) as paragraphs (d)(1)(i)(A), (B), (C), (D), (E), and (F), respectively.

2. Revising the heading of paragraph (d)(1) and adding introductory text to paragraph (d)(1)(i).

3. Revising newly redesignated paragraphs (d)(1)(i)(B), (D), and (F).

4. Adding new paragraph (d)(1)(ii).

5. Adding paragraph (k).

6. Revising paragraph (l).

The revisions and additions read as follows:

§ 1.148–11 Effective/applicability dates.

* * * * *

(d) * * *

(1) *Certain perpetual trust funds*—(i) A guarantee by a fund created and controlled by a State and established pursuant to its constitution does not cause the amounts in the fund to be pledged funds treated as replacement proceeds if—

* * * * *

(B) The corpus of the guarantee fund may be invaded only to support specifically designated essential governmental functions (designated functions) carried on by political subdivisions with general taxing powers or public elementary and public secondary schools;

* * * * *

(D) The issue guaranteed consists of obligations that are not private activity bonds (other than qualified 501(c)(3) bonds) substantially all of the proceeds of which are to be used for designated functions;

* * * * *

(F) As of the sale date of the bonds to be guaranteed, the amount of the bonds to be guaranteed by the fund plus the then-outstanding amount of bonds previously guaranteed by the fund does not exceed a total amount equal to 500 percent of the total costs of the assets held by the fund as of December 16, 2009.

(ii) The Commissioner may, by published guidance, set forth additional circumstances under which guarantees by certain perpetual trust funds will not cause amounts in the fund to be treated as replacement proceeds.

* * * * *

(k) *Certain arbitrage guidance updates*—(1) *In general*. Sections 1.148–1(c)(4)(i)(B)(1); 1.148–1(c)(4)(i)(B)(4); 1.148–1(c)(4)(ii); 1.148–2(e)(3)(i); 1.148–3(d)(1)(iv); 1.148–3(d)(4); 1.148–4(a); 1.148–4(b)(3)(i); 1.148–4(h)(2)(ii)(A); 1.148–4(h)(2)(v); 1.148–4(h)(2)(vi); 1.148(h)(4)(i)(C); 1.148–5(c)(3); 1.148–5(d)(2); 1.148–5(d)(3); 1.148–5(d)(6)(i); 1.148–5(d)(6)(iii)(A); 1.148–5(e)(2)(ii)(B); 1.148–6(d)(4); 1.148–7(c)(3)(v); 1.148–7(i)(6)(ii); 1.148–10(a)(4); 1.148–10(e); 1.148–11(d)(1)(i)(B); 1.148–11(d)(1)(i)(D); 1.148–11(d)(1)(i)(F); and 1.148–11(d)(1)(ii) apply to bonds sold on or after October 17, 2016.

(2) *Valuation of investments in refunding transactions*. Section 1.148–5(d)(3) also applies to bonds refunded by bonds sold on or after October17, 2016.

(3) *Rebate overpayment recovery*. (i) Section 1.148–3(i)(3)(i) applies to claims arising from an issue of bonds to which § 1.148–3(i) applies and for which the final computation date is after June 24, 2008. For purposes of this paragraph (k)(3)(i), issues for which the actual final computation date is on or before June 24, 2008, are deemed to have a final computation date of July 1, 2008, for purposes of applying § 1.148–3(i)(3)(i).

(ii) Section 1.148–3(i)(3)(ii) and (iii) apply to claims arising from an issue of bonds to which § 1.148–3(i) applies and for which the final computation date is after September 16, 2013.

(iii) Section 1.148–3(j) applies to bonds subject to § 1.148–3(i).

(4) *Hedge identification*. Section 1.148–4(h)(2)(viii) applies to hedges that are entered into on or after October 17, 2016.

(5) *Hedge modifications and termination*. Section 1.148–4(h)(3)(iv)(A) through (H) and (h)(4)(iv) apply to—

(i) Hedges that are entered into on or after October 17, 2016;

(ii) Qualified hedges that are modified on or after October 17, 2016, with respect to modifications on or after such date; and

(iii) Qualified hedges on bonds that are refunded on or after October 17, 2016, with respect to the refunding on or after such date.

(6) *Small issuer exception to rebate requirement for conduit borrowers of pooled financings*. Section 1.148–8(d) applies to bonds issued after May 17, 2006.

(l) *Permissive application of certain arbitrage updates*—(1) *In general*. Except as otherwise provided in this paragraph (l), issuers may apply the provisions described in paragraph (k)(1), (2), and (5) in whole, but not in part, to bonds sold before October 17, 2016.

(2) *Computation credit*. Issuers may apply § 1.148–3(d)(1)(iv) and (d)(4) for bond years ending on or after July 18, 2016.

(3) *Yield reduction payments*. Issuers may apply § 1.148–5(c)(3) for investments purchased on or after July 18, 2016.

(4) *External commingled funds*. Issuers may apply § 1.148–5(e)(2)(ii)(B) with respect to costs incurred on or after July 18, 2016.

Par. 16. Section 1.150–1 is amended by:

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

2. Adding a definition for "tax-advantaged bond" in alphabetical order to paragraph (b).

3. Revising paragraph (c)(2).

4. Adding paragraph (f).

The revisions and additions read as follows:

§ 1.150–1 Definitions.

(a) * * *

(2) * * *

(iii) *Special effective date for definitions of tax-advantaged bond, issue, and grant*. The definition of tax-advantaged bond in paragraph (b) of this section, the revisions to the definition of issue in paragraph (c)(2) of this section, and the definition and rules regarding the treatment of grants in paragraph (f) of this section apply to bonds that are sold on or after October 17, 2016.

* * * * *

(b) * * *

Tax-advantaged bond means a tax-exempt bond, a taxable bond that provides a federal tax credit to the investor with respect to the issuer's borrowing costs, a taxable bond that provides a refundable federal tax credit payable directly to the issuer of the bond for its borrowing costs under section 6431, or any future similar bond that provides a federal tax benefit that reduces an issuer's borrowing costs. Examples of tax-advantaged bonds include qualified tax credit bonds under section 54A(d)(1) and build America bonds under section 54AA.

* * * * *

(c) * * *

(2) *Exceptions for different types of tax-advantaged bonds and taxable bonds*. Each type of tax-advantaged bond that has a different structure for delivery of the tax benefit that reduces the issuer's borrowing costs or different program eligibility requirements is treated as part of a different issue under this paragraph (c). Further, tax-advantaged bonds and bonds that are not tax-advantaged bonds are treated as part of different issues under this paragraph (c). The issuance of tax-advantaged bonds in a transaction with other bonds that are not tax-advantaged bonds must be tested under the arbitrage anti-abuse rules under § 1.148–10(a) and other applicable anti-abuse rules (for example, limitations against window maturity structures or unreasonable allocations of bonds).

* * * * *

(f) *Definition and treatment of grants*—(1) *Definition*. Grant means a transfer for a governmental purpose of money or property to a transferee that is not a related party to or an agent of the transferor. The transfer must not impose any obligation or condition to directly or indirectly repay any amount to the transferor or a related party. Obligations or conditions intended solely to assure expenditure of the transferred moneys in accordance with the governmental purpose of the transfer do not prevent a transfer from being a grant.

(2) *Treatment*. Except as otherwise provided (for example, § 1.148–6(d)(4), which treats proceeds used for grants as spent for arbitrage purposes when the grant is made), the character and nature of a grantee's use of proceeds are taken into account in determining which rules are applicable to the bond issue and whether the applicable requirements for the bond issue are met. For example, a grantee's use of proceeds generally determines whether the proceeds are used for capital projects or working capital expenditures under section 148 and whether the qualified purposes for the specific type of bond issue are met.

Par. 17. Section 1.150–2(d)(3) is amended by:

1. Amending paragraph (a) by adding an entry for § 1.150–2(j)(3).

2. Revising paragraphs (d)(3) and (j)(1).

3. Adding paragraph (j)(3).

The revisions and additions read as follows:

§ 1.150–2 Proceeds of bonds used for reimbursement.

(a) * * *

(j) * * *

(3) Nature of expenditure.

* * * * *

(d) * * *

(3) *Nature of expenditure*. The original expenditure is a capital expenditure, a cost of issuance for a bond, an expenditure described in § 1.148–6(d)(3)(ii)(B) (relating to certain extraordinary working capital items), a grant (as defined in § 1.150–1(f)), a qualified student loan, a qualified mortgage loan, or a qualified veterans' mortgage loan.

* * * * *

(j) * * *

(1) *In general*. Except as otherwise provided, the provisions of this section apply to all allocations of proceeds of reimbursement bonds issued after June 30, 1993.

* * * * *

(3) *Nature of expenditure*. Paragraph (d)(3) of this section applies to bonds that are sold on or after October 17, 2016.

John Dalrymple,
Deputy Commissioner for Services and Enforcement.

Approved: June 28, 2016

Mark J. Mazur,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on July 15, 2016, 8:45 a.m., and published in the issue of the Federal Register for July 15, 2016, 81 F.R. 46582)

T.D. 9782

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1, 301, and 602

Tax on Certain Foreign Procurement

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations under section 5000C of the Internal Revenue Code relating to the 2 percent tax on payments made by the U.S. government to foreign persons pursuant to certain contracts. The regulations affect U.S. government acquiring agencies and foreign persons providing certain goods or services to the U.S. government pursuant to a contract. This document also contains final regulations under section 6114, with respect to foreign persons claiming an exemption from the 2 percent tax under an income tax treaty.

DATES: *Effective Date*: These regulations are effective on August 17, 2016.

Applicability Date: For dates of applicability, see § 1.5000C–7 and § 301.6114–1(e)(2).

FOR FURTHER INFORMATION CONTACT: Kate Hwa at (202) 317-6934, and for questions related to tax treaties and the regulations under section 6114, Rosy Lor at (202) 317- 6933, (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

On January 2, 2011, section 301 of the James Zadroga 9/11 Health and Compensation Act of 2010, Public Law 111–347 (the Act), 124 Stat. 3623, added section 5000C to the Internal Revenue Code (Code). Section 5000C(a) imposes on any foreign person that receives a specified Federal procurement payment a tax equal to 2 percent of the amount such payment. Section 5000C(b) defines the term *specified Federal procurement payment* as any payment made pursuant to a contract with the Government of the United States (U.S. government) for goods or services if the goods are manufactured or produced or the services are provided in any country that is not a party to an international procurement agreement with the United States. Section 301(a)(3) of the Act provides that section 5000C applies to payments received pursuant to contracts entered into on and after January 2, 2011. Additionally, section 301(b)(1)(c) of the Act states that this section must be applied in a manner consistent with U.S. obligations under international agreements. Section 5000C(d)(1) provides that the amount deducted and withheld under chapter 3 shall be increased by the amount of tax imposed under section 5000C.

On April 22, 2015, the Department of Treasury (Treasury Department) and the Internal Revenue Service (IRS) published in the *Federal Register* (80 FR 22449) a notice of proposed rulemaking (REG–103281–11) (NPRM) under sections 5000C and 6114 (the proposed regulations). The regulations set forth a number of exemptions from the tax and provided procedures for collecting the tax. Notice 2015–35, 2015–18 I.R.B. 943, issued contemporaneously with the proposed regulations, provided a list of income tax treaties in effect that prevented the imposition of the tax. No public hearing was requested or held. Written comments on the proposed regulations were received and are available at *www.regulations.gov* or upon request. After consideration of the comments, the proposed regulations are adopted as amended by this Treasury decision. The revisions are discussed below.

Explanation and Summary of Comments

1. Payments by Contracting Parties to Subcontractors

A commenter asked for clarification that the proposed regulations apply only to payments made by the U.S. government to direct (prime) contractors with the U.S. government, and not to payments made by prime contractors pursuant to subcontracts. Consistent with the proposed regulations, the final regulations provide section 5000C imposes the tax on any foreign contracting party, which means a foreign person that is a party to a contract with the U.S. government that was entered into on or after January 2, 2011. Therefore, the final regulations do not generally impose the tax on a subcontractor that is not party to a contract with the U.S. government. For example, if an acquiring agency contracts with a domestic corporation (prime contractor) for goods or services, and the prime contractor separately contracts with a foreign subcontractor for goods and services to be provided under the contract, section 5000C will not ordinarily apply to payments by the prime contractor to its foreign subcontractor that relate to those goods or services.

However, the activities of a subcontractor are taken into account when determining the country in which goods are manufactured or produced or in which services are provided under § 1.5000C–1(e). Furthermore, the final regulations retain the rules in the proposed regulations that payments received by a nominee or agent on behalf of a contracting party are considered to be received by that contracting party. For the definition of a contracting party, see § 1.5000C–1(c)(4). The final regulations also retain the anti-abuse rule in § 1.5000C–5 that in certain circumstances may treat a subcontractor that is a foreign person as being liable for tax under section 5000C.

2. Exemption for Certain Foreign Humanitarian Assistance Contracts

The United States Agency for International Development (USAID) regularly enters into contracts with foreign persons for goods and services for purposes of implementing USAID's development projects and programs in a host country. The proposed regulations do not provide relief from the tax under section 5000C for payments made pursuant to some of these contracts. The Treasury Department and the IRS have concluded that it is appropriate to exempt from the tax payments made to foreign contracting parties that USAID engages to execute its development projects and programs in a host country. In this context, the U.S. government is not procuring goods and services for its own benefit, but rather to provide humanitarian assistance for the benefit of the host countries. As a result, the final regulations add an exemption under which section 5000C does not apply to a contract for the purpose of obtaining goods or services described in or authorized under certain specified statutes that are for the purpose of providing foreign humanitarian assistance when the acquiring agency determines that the payment is for the purpose of providing foreign humanitarian assistance. This exemption generally applies to a contract entered into by an acquiring agency with a foreign contracting party to obtain goods or services for purposes of implementing an agreement between the United States and a foreign country or a group of countries to provide foreign humanitarian assistance as authorized under the Food for Peace Act (7 U.S.C. 1691, *et seq.*) and the Foreign Assistance Act of 1961 (22 U.S.C. 2151, *et seq.*).

Similarly, this exemption also generally applies to contacts providing foreign humanitarian assistance under the Migration and Refugee Assistance Act of 1962 (22 U.S.C. 2601 *et seq.*), the Freedom Support Act of 1992 (22 U.S.C. 5801 *et seq.*), and the SEED Act of 1989 (22 U.S.C. 5401 *et seq.*), and to transportation of humanitarian relief supplies to foreign countries described in 10 U.S.C. 402, foreign disaster assistance described in 10 U.S.C. 404, humanitarian demining assistance described in 10 U.S.C. 407, excess non-lethal supplies for humanitarian relief purposes described in 10 U.S.C. 2557, and transportation of humanitarian relief and for other humanitarian purposes described in 10 U.S.C. 2561. *See* § 1.5000C–1(d)(4). A corresponding change is made to the withholding rules to take into account this exemption. *See* § 1.5000C–2(b)(6).

3. Procurement Not Pursuant to the Federal Acquisition Regulations

A commenter noted that it was unclear whether payments by acquiring agencies under contracts that are not entered into pursuant to the Federal Acquisition Regulations (FAR) are subject to tax under section 5000C. The FAR is the body of rules that generally governs acquisitions and contracting procedures for federal agencies. *See* 48 CFR Chapter 1. Although the final regulations utilize certain concepts and definitions contained in the FAR, neither the Act nor the final regulations are limited to contracts executed pursuant to the FAR. Thus, while the term "contract" in the proposed and final regulations uses the FAR definition of the term "contract", it can nevertheless include a contract that is not executed under the FAR. A sentence was added to the definition of contract in the final regulations to clarify this point.

4. Definition of International Procurement Agreement and Least Developed Countries

The General Explanation of Tax Legislation prepared by the Staff of the Joint Committee on Taxation accompanying section 5000C explains that parties engaged in cross-border transactions are required to comply with relevant trade agreements of the jurisdictions in which they operate. *See* Staff of the Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 111th Congress (JCS-2-11), at 694, March 16, 2011 (Joint Committee Explanation). In describing these obligations, the Joint Committee Explanation listed the Government Procurement Agreement (GPA) that is an annex to the World Trade Organization agreement, as well as the government procurement obligations of U.S. free trade agreements. *Id.* Accordingly, the proposed regulations defined the term *international procurement agreement* as the World Trade Organization GPA (WTO GPA) within the meaning of 48 CFR 25.400(a)(1) and any free trade agreement to which the United States is a party that includes government procurement obligations that provide appropriate competitive government procurement opportunities to U.S. goods, services, and suppliers.

One commenter noted that the FAR provides that eligible products from WTO GPA and free trade agreement countries are entitled to certain nondiscriminatory treatment, and that 48 CFR 25.404 expands this nondiscriminatory treatment to include least developed countries described in 48 CFR 25.400(a)(3). The commenter requested that the final regulations also expand the definition of international procurement agreement to include goods manufactured or produced or services provided in a least developed country.

The final regulations do not adopt this comment for two reasons. First, the proposed regulations referred to 48 CFR 25.400(a)(1) in order to utilize a term that was widely understood in the context of government procurement but was not intended to incorporate any related provisions of the FAR. Second, the Joint Committee Explanation indicates that Congress intended the exemption under section 5000C(b) related to international procurement agreements to be limited to signatories of free trade agreements with government procurement obligations or procurement agreements.

5. Definition of International Agreements

Section 301(c) of the Act requires that section 5000C be applied in a manner consistent with the United States' obligations under international agreements. A commenter indicated that the proposed regulations limit international agreements that may affect the application of section 5000C to income tax treaties and requested that final regulations include other international agreements that may impact taxation. In particular, the commenter indicated that the Vienna Convention on Consular Relations and bilateral framework agreements negotiated and administered by USAID contain tax provisions.

The final regulations do not adopt this request. The specific international agreements to which the commenter referred prohibit host country taxation of expenditures of a U.S. consulate or amounts provided through USAID programs but do not limit the United States' taxing rights. Consequently, these international agreements do not provide relief from the tax imposed under section 5000C. Furthermore, in identifying the income tax treaties that provide relief from the tax under section 5000C, the regulations do not preclude a foreign contracting party from claiming relief from the tax under any other applicable international agreement.

6. Simplified Acquisition Threshold

The proposed regulations provide that that the tax imposed under section 5000C will not apply to payments for purchases under the simplified acquisition procedures described in the FAR that do not exceed the simplified acquisition threshold in 48 CFR 2.101. One commenter recommended that the determination of the $150,000 simplified acquisition threshold should be computed on an annual basis rather than on a contract-by-contract basis. The final regulations do not adopt this suggestion because the Treasury Department and the IRS have determined that it is generally more administrable to make a determination of the threshold amount when entering into a particular contract. However, as described in *7. Personal Service Contacts* of this preamble, this suggestion has been adopted in the limited context of personal service contracts.

7. Personal Service Contracts

A commenter requested a new exemption from the tax for service contracts entered into with individuals (personal service contracts). The commenter further stated that some acquiring agencies do not use the FAR to procure personal services from individuals. As such, the commenter stated that these personal service contracts do not fall within the simplified acquisition procedures of the FAR but typically are for an amount less than $150,000 per contract. The commenter also suggested that the threshold amount of personal service contracts with individuals would be more appropriately determined on an annual (rather than a per contract) basis.

Section 5000C applies to contracts for the provision of services, so the final regulations do not provide an exemption for all personal service contracts. However, the Treasury Department and the IRS have decided that it is appropriate to extend the simplified acquisition exemption to personal service contracts, whether or not they are not executed pursuant to the FAR. Further, the Treasury Department and the IRS agree with the comment that when applying this exemption, the amount paid for personal services under the contracts should be determined on an annual basis. Accordingly, the final regulations provide an exemption in § 1.5000C–1(d)(3) for payments for services provided by, and under contracts with, a single individual in which the payments do not exceed on an annual basis the simplified acquisition threshold as described in 48 CFR 2.101 for all years of the contract. A corresponding change is made to the withholding rules to take into account this exemption. *See* § 1.5000C–2(b)(5).

8. Definition of Emergency Acquisition

Proposed § 1.5000C–1(d)(2) exempts payments pursuant to contracts awarded for certain emergency acquisitions. One commenter suggested that this exemption be broadened to include contracts that involve other agency acquisitions of importance to the government, such as contracts for acquisitions determined to be in the national interest by the acquiring agency. The final regulations do not adopt this comment for two reasons. First, the Treasury Department and the IRS have concluded that the more limited exemption in the proposed regulations appropriately balances compliance with section 5000C with the government's need to procure goods and services in certain emergency situations. Second, the commenter's suggestion would introduce a subjective, potentially overbroad exemption from the tax imposed by section 5000C.

9. Credit Card Payments

One commenter requested a new exemption from the section 5000C tax for payments made with a credit card. The commenter indicated that applying the section 5000C tax to payments made with a credit card would be difficult to administer because of the volume of these transactions.

The final regulations do not adopt this suggestion for several reasons. First, in most cases, payments made with a credit card will be in an amount that will fall within the exemption for payments for simplified acquisitions, which applies to purchases under the simplified acquisition procedures described in the FAR that do not exceed the simplified acquisition threshold as described in 48 CFR 2.101. *See* § 1.5000C–1(d)(1). Second, in cases in which payments made with a credit card do not meet the exemption for simplified acquisitions, adopting this comment would allow foreign contracting parties to avoid the tax by receiving payment with a credit card for large amounts that should be subject to the tax.

10. Payments Only in Part for Goods or Services

A commenter indicated that, in some circumstances, a contract may be for goods or services but also include payments that are not for goods or services, giving as an example payments to reimburse taxes incurred by the contracting party. In response to the comment, the withholding steps in the final regulations clarify that acquiring agencies should not withhold to the extent that a payment is for something other than goods or services. *See* § 1.5000C–2(b)(1). However, this clarification should not be read to mean that payments to reimburse taxes incurred by the contracting party in providing goods or services are anything other than payments for those goods or services

11. Form W–14, "Certificate of Foreign Contracting Party Receiving Federal Procurement Payments"

The proposed regulations provided that a foreign contracting party must submit a "Section 5000C Certificate" that provides all of the information required by the proposed regulations to claim an exemption from section 5000C. The proposed regulations also contained a model Section 5000C Certificate. Simultaneous with the publication of the final regulations, the IRS is publishing Form W–14, "Certificate of Foreign Contracting Party Receiving Federal Procurement Payments," which may be used as the Section 5000C Certificate. Accordingly, the final regulations do not contain a model Section 5000C Certificate but rather provide that a foreign person may use Form W–14 as its Section 5000C Certificate provided that it includes all the necessary information. *See* §§ 1.5000C–1(c)(14) and 1.5000C–2(d)(7).

Notice 2015–35 listed the countries that had entered into qualified income tax treaties with the United States as of the date of its publication. The instructions to Form W–14, issued contemporaneously with the publication of these final regulations, identify income tax treaties in force, as of the date of the issuance of the form, that are qualified income tax treaties. When new income tax treaties come into force, foreign persons and acquiring agencies should review IRS Forms, Instructions, Publications or other media (including www.irs.gov) for an updated list of qualified income tax treaties, rather than Notice 2015–35.

12. Change in Circumstances

Section 1.5000C–2(d)(6) provides that a foreign contracting party must submit a revised Section 5000C Certificate within 30 days of a change in circumstances that causes the information in a Section 5000C Certificate held by the acquiring agency to be incorrect with respect to the acquiring agency's determination of whether to withhold or the amount of withholding under Section 5000C. One commenter suggested that an example would be helpful to illustrate this rule. In response to this comment, an example was added to illustrate the withholding obligation of an acquiring agency when it receives a revised Section 5000C Certificate due to a change in circumstances. *See* § 1.5000C–6, *Example 6*.

13. Effective Date of Section 5000C and the Final Regulations

Comments recommended that the final regulations delay the applicability of the tax imposed by section 5000C to contracts entered into on or after the date of the publication of the final regulations. Alternatively, one commenter recommended that the final regulations delay the applicability of the tax until the issuance of final amendments to the FAR as promulgated by the Department of Defense (DoD), General Services Administration (GSA), and National Aeronautics and Space Administration (NASA), if any, that may take into account these final regulations. This commenter reasoned that a delay in the application of the final regulations would allow the necessary time needed to amend the FAR in order to take into account the rules provided in the final regulations. While the DoD, GSA, and NASA have amended some sections of the FAR to reflect the enactment of section 5000C (see 48 CFR 31.205–41(b), 52.229–3(b)(2), 52.229–4(b)(2), 52.229–6(c)(2), and 52.229–7(b)(2)), commenters stated that other sections of the FAR (such as CFR 52.229–3) will also need to be amended.

Section 301(a)(3) of the Act specifically provides that the tax imposed by section 5000C applies to payments received pursuant to contracts entered into on and after January 2, 2011, indicating a clear Congressional intent as to the effective date. Further, the Act does not require Treasury regulations or FAR amendments to be applicable before the requirements of the statute take effect. Thus, the final regulations do not adopt this comment and confirm the statutory effective date.

Consistent with the proposed regulations, the final regulations apply on and after the date that is 90 days after the date they are published as final regulations in the *Federal Register* (applicability date). However, contracting parties and acquiring agencies may rely upon the rules in the final regulations before the applicability date.

Under the Act, while acquiring agencies have an obligation to withhold, the foreign contracting parties remain liable for the tax if withholding does not fully satisfy the foreign person's tax liability.

The Treasury Department and the IRS are aware that some foreign persons subject to statutory obligations under section 5000C may have deferred compliance actions pending the applicability of the final regulations. The Treasury Department and the IRS have concluded that 90 days is sufficient for these foreign persons to satisfy their tax and filing obligations with respect to section 5000C for prior periods. Accordingly, § 1.5000C–7 provides that if a foreign contracting party fully satisfies its tax and filing obligations under section 5000C with respect to any payments received in tax years ending before the applicability date of the regulations on or before the later of the applicability date of the final regulations or the due date for the foreign person's income tax return for the year in which the payment was received in a manner consistent with the final regulations, penalties will not be asserted on the foreign contracting parties with respect to those payments or returns. For example, assume a foreign corporation received a single specified Federal procurement payment during its tax year ending on December 31, 2013 that is not described in any of the exemptions in these final regulations, and the payment was not withheld upon. If the corporation files Form 1120–F, "U.S. Income Tax Return of a Foreign Corporation," for 2013 and pays the tax imposed under section 5000C in the manner described in § 1.5000C–4(d) before the applicability date of the final regulations, penalties will not be asserted with respect to that payment or return. However, the final regulations do not relieve a foreign person of any applicable rules relating to interest under Subtitle F.

Additionally, for purposes of section 6114 and the regulations thereunder, if a foreign contracting party has received a payment exempt from tax under a qualified income tax treaty before the effective date of the final regulations under section 5000C, reporting is waived if the foreign contracting party has properly relied on Notice 2015–35. *See* § 301.6114–1(e)(2).

Special Analyses

Certain IRS regulations, including these, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. It has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to this regulation. It is hereby certified that the collection of information contained in this regulation will not have a significant economic impact on a substantial number of small entities. Accordingly, a regulatory flexibility analysis is not required. The collection of information requirement in the regulations will not have a significant economic impact on a substantial number of small entities because a limited number of foreign contracting parties that are small entities will be subject to the tax, in part because the final regulations provide exemptions for simplified acquisitions and for certain personal service contracts. Because section 5000C(a) applies to foreign persons regardless of the size of the entity, a limited number of small foreign entities that received specified Federal procurement payments are affected by the regulation. Pursuant to section 7805(f) of the Internal Revenue Code, the NPRM preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal authors of these regulations are Kate Hwa and Rosy Lor, Office of Associate Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1, 301, and 602 are amended as follows:

PART I—INCOME TAXES

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

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

Section 1.5000C–1 is also issued under 26 U.S.C. 5000C

Section 1.5000C–2 is also issued under 26 U.S.C. 5000C

Section 1.5000C–3 is also issued under 26 U.S.C. 5000C

Section 1.5000C–4 is also issued under 26 U.S.C. 5000C

Section 1.5000C–5 is also issued under 26 U.S.C. 5000C

Section 1.5000C–6 is also issued under 26 U.S.C. 5000C

Par. 2. An undesignated center heading is added following § 1.5000A–5 to read as follows:

Tax on Certain Foreign Procurement

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§ 1.5000C–0 Outline of regulation provisions for section 5000C.

*****

§ 1.5000C–1 Tax on specified Federal procurement payments.

(a) Overview.
(b) Imposition of tax.
(c) Definitions.
(d) Exemptions.
(1) Simplified acquisitions.
(2) Emergency acquisitions.
(3) Certain personal service contracts.
(4) Certain foreign humanitarian assistance contracts.
(5) Certain international agreements.
(6) Goods manufactured or produced or services provided in the United States.
(7) Goods manufactured or produced or services provided in a country that is a party to an international procurement agreement.
(e) Country in which goods are manufactured or produced or services provided.
(1) Goods manufactured or produced.
(2) Provision of services.
(3) Allocation of total contract price to determine the nonexempt amount.
(4) Reduction or elimination of withholding by an acquiring agency.

§ 1.5000C–2 Withholding on specified Federal procurement payments.

(a) In general.
(b) Steps in determining the obligation to withhold under section 5000C.
(1) Determine whether the payment is pursuant to a contract for goods or services.

(2) Determine whether the payment is made pursuant to a contract with a U.S. person.

(3) Determine whether the payment is for purchases under the simplified acquisition procedures.

(4) Determine whether the payment is for emergency acquisitions.

(5) Determine whether the payment is for personal services under the simplified acquisition threshold.

(6) Determine whether the payment is pursuant to a foreign humanitarian assistance contract.

(7) Determine whether the foreign contracting party is entitled to relief pursuant to an international agreement.

(8) Determine whether the contract is for goods manufactured or produced or services provided in the United States or in a foreign country that is a party to an international procurement agreement.

(9) Compute amounts to withhold.

(10) Deposit and report amounts withheld.

(c) Determining whether the contracting party is a U.S. person.

(1) In general.

(2) Determination based on Taxpayer Identification Number (TIN).

(3) Determination based on the Form W–9.

(4) Contracting party treated as a foreign contracting party.

(d) Withholding when a foreign contracting party submits a Section 5000C Certificate.

(1) In general.

(2) Exemption for a foreign contracting party entitled to the benefit of relief pursuant to certain international agreements.

(3) Exemption when goods are manufactured or produced or services provided in the United States, or in a foreign country that is a party to an international procurement agreement.

(4) Information required for Section 5000C Certificate.

(5) Validity period of Section 5000C Certificate.

(6) Change in circumstances.

(7) Form W–14.

(8) Time for submitting Section 5000C Certificate.

(e) Offset for underwithholding or overwithholding.

(1) In general.

(2) Underwithholding.

(3) Overwithholding.

§ 1.5000C–3 Payment and returns of tax withheld by the acquiring agency.

(a) In general.

(b) Deposit rules.

(1) Acquiring agency with a chapter 3 deposit requirement treats amounts withheld as under chapter 3.

(2) Acquiring agency with no chapter 3 filing obligation deposits withheld amounts monthly.

(c) Return requirements.

(1) In general.

(2) Classified or confidential contracts.

(d) Special arrangement for certain contracts.

§ 1.5000C–4 Requirement for the foreign contracting party to file a return and pay tax, and procedures for the contracting party to seek a refund.

(a) In general.

(b) Tax obligation of foreign contracting party independent of withholding.

(c) Return of tax by the foreign contracting party.

(d) Time and manner of paying tax.

(e) Refund requests when amount withheld exceeds tax liability.

§ 1.5000C–5 Anti-abuse rule.

§ 1.5000C–6 Examples.

§ 1.5000C–7 Effective/applicability date.

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Par. 3. Sections 1.5000C–1 through 1.5000C–7 are added to read as follows:

§ 1.5000C–1 Tax on specified Federal procurement payments.

(a) *Overview*. This section provides definitions and general rules relating to the imposition of, and exemption from, the tax on specified Federal procurement payments under section 5000C. Section 1.5000C–2 provides rules concerning withholding under section 5000C(d)(1), including the steps that must be taken to determine the obligation to withhold and whether an exemption from withholding applies. Section 1.5000C–3 provides the time and manner for depositing the amounts withheld under section 5000C and the related reporting requirements. Section 1.5000C–4 contains the rules that apply to a foreign contracting party that must pay and report the tax under section 5000C when the tax obligation under section 5000C is not fully satisfied by withholding, as well as procedures by which a contracting party may seek a refund when the amount withheld exceeds its tax liability under section 5000C. Section 1.5000C–5 contains an anti-abuse rule. Section 1.5000C–6 contains examples illustrating the principles of §§ 1.5000C–1 through 1.5000C–4. Finally, § 1.5000C–7 contains the effective/applicability date for §§ 1.5000C–1 through 1.5000C–7.

(b) *Imposition of tax*. Except as otherwise provided, section 5000C imposes on any foreign contracting party a tax equal to 2 percent of the amount of a specified Federal procurement payment. In general, the tax imposed under section 5000C applies to specified Federal procurement payments received pursuant to contracts entered into on and after January 2, 2011. Specified Federal procurement payments received by a nominee or agent on behalf of a contracting party are considered to be received by that contracting party. The tax imposed under section 5000C is to be applied in a manner consistent with U.S. obligations under international agreements. Payments for the purchase or lease of land or an interest in land are not subject to the tax imposed under section 5000C.

(c) *Definitions*. Solely for purposes of section 5000C and §§ 1.5000C–1 through 1.5000C–7, the following definitions apply:

(1) The term *acquiring agency* means the U.S. government department, agency, independent establishment, or corporation described in paragraph (c)(7) of this section that is a party to the contract. To the extent that a U.S. government department or agency, other than the acquiring agency, is making the payments pursuant to the contract, that department or agency is also considered to be the acquiring agency.

(2) The term *contract* has the same meaning as provided in 48 CFR 2.101,

and thus does not include a grant agreement or a cooperative agreement within the meaning of 31 U.S.C. 6304 and 6305, respectively. A contract may include an agreement that is not executed under the Federal Acquisition Regulations (FAR), 48 CFR Chapter 1.

(3) The term *contract ratio* refers to the nonexempt amount over the total contract price.

(4) The term *contracting party* means any person that is a party to a contract with the U.S. government that is entered into on or after January 2, 2011. See § 1.5000C–1(b) for situations involving a nominee or agent.

(5) The term *foreign contracting party* means a contracting party that is a foreign person.

(6) The term *foreign person* means any person other than a United States person (as defined in section 7701(a)(30)).

(7) The term *Government of the United States* or *U.S. government* means the executive departments specified in 5 U.S.C. 101, the military departments specified in 5 U.S.C. 102, the independent establishments specified in 5 U.S.C. 104(1), and wholly owned government corporations specified in 31 U.S.C. 9101(3). Unless otherwise specified in 5 U.S.C. 101, 102, or 104(1), or 31 U.S.C. 9101(3), the term Government of the United States or U.S. government does not include any quasi-governmental entities or instrumentalities of the U.S. government.

(8) The term *international procurement agreement* means the World Trade Organization Government Procurement Agreement within the meaning of 48 CFR 25.400(a)(1) and any free trade agreement to which the United States is a party that includes government procurement obligations that provide appropriate competitive government procurement opportunities to U.S. goods, services, and suppliers. A party to an international procurement agreement is a signatory to the agreement and does not include a country that is merely an observer with respect to the agreement.

(9) The term *nonexempt amount* means the portion of the contract price allocated to nonexempt goods and nonexempt services.

(10) The term *nonexempt goods* means goods manufactured or produced in a foreign country that is not a party to an international procurement agreement with the United States.

(11) The term *nonexempt services* means services provided in a foreign country that is not a party to an international procurement agreement with the United States.

(12) The term *outlying areas* has the same meaning as set forth in 48 CFR 2.101(b), which includes Puerto Rico, the Northern Mariana Islands, American Samoa, Guam, the Virgin Islands, Baker Island, Howland Island, Jarvis Island, Johnston Atoll, Kingman Reef, Midway Islands, Navassa Island, Palmyra Atoll, and Wake Atoll.

(13) The term *qualified income tax treaty* means a U.S. income tax treaty in force that contains a nondiscrimination provision that applies to the tax imposed under section 5000C and prohibits taxation that is more burdensome on a foreign national than a U.S. national (or in the case of certain income tax treaties, taxation that is more burdensome on a foreign citizen than a U.S. citizen), regardless of its residence.

(14) The term *Section 5000C Certificate* means a written statement that includes the information described in § 1.5000C–2(d) that the foreign contracting party submits to an acquiring agency for the purposes of demonstrating that the foreign contracting party is eligible for certain exemptions from withholding (in whole or in part) under section 5000C with respect to a contract. The term may also include any form that the Internal Revenue Service may prescribe as a substitute for the Section 5000C Certificate, such as Form W–14, "Certificate of Foreign Contracting Party Receiving Federal Procurement Payments."

(15) The term *specified Federal procurement payment* means any payment made pursuant to a contract with a foreign contracting party that is for goods manufactured or produced or services provided in a foreign country that is not a party to an international procurement agreement with the United States. For purposes of the prior sentence, a foreign country does not include an outlying area.

(16) The term *Taxpayer Identification Number* or *TIN* means the identifying number assigned to a person under section 6109, as defined in section 7701(a)(41).

(17) The term *total contract price* means the total cost to the U.S. Government of the goods and services procured under a contract and paid to the contracting party.

(d) *Exemptions*. The tax imposed under paragraph (b) of this section does not apply to the payments made in the following situations. For the exemptions in paragraphs (d)(5), (6) and (7) of this section, see § 1.5000C–2(d) for the procedures to eliminate withholding by an acquiring agency.

(1) *Simplified acquisitions*. Payments for purchases under the simplified acquisition procedures that do not exceed the simplified acquisition threshold as described in 48 CFR 2.101.

(2) *Emergency acquisitions*. Payments made pursuant to a contract if the contract is—

(i) Awarded under the "unusual and compelling urgency" authority of 48 CFR 6.302–2, or

(ii) Entered into under the emergency acquisition flexibilities as defined in 48 CFR part 18.

(3) *Certain personal service contracts*. Payments for services provided by, and under contracts with, a single individual in which the payments do not (and will not) exceed on an annual calendar year basis the simplified acquisition threshold as described in 48 CFR 2.101 for all years of the contract. Payments that satisfy this exemption remain exempt if the contract is later renegotiated so that future payments under the contract do not meet this exemption.

(4) *Certain foreign humanitarian assistance contracts*. Payments made by the U.S. government pursuant to a contract with a foreign contracting party to obtain goods or services described in or authorized under 7 U.S.C. 1691, *et seq.*, 22 U.S.C. 2151, *et seq.*, 22 U.S.C 2601 *et seq.*, 22 U.S.C. 5801 *et seq.*, 22 U.S.C. 5401 *et seq.*, 10 U.S.C. 402, 10 U.S.C. 404, 10 U.S.C. 407, 10 U.S.C. 2557, and 10 U.S.C. 2561, if the acquiring agency determines that the payment is for the purpose of providing foreign humanitarian assistance.

(5) *Certain international agreements*. Payments made by the U.S. government

pursuant to a contract with a foreign contracting party when the payments are entitled to relief from the tax imposed under section 5000C pursuant to an international agreement with the United States, including relief pursuant to a nondiscrimination provision of a qualified income tax treaty, because the foreign contracting party is entitled to the benefit of that provision.

(6) *Goods manufactured or produced or services provided in the United States*. A payment made pursuant to a contract to the extent that the payment is for goods manufactured or produced or services provided in the United States.

(7) *Goods manufactured or produced or services provided in a country that is a party to an international procurement agreement*. A payment made pursuant to a contract to the extent the payment is for goods manufactured or produced or services provided in a country that is a party to an international procurement agreement, as defined in paragraph (c)(8) of this section.

(e) *Country in which goods are manufactured or produced or services provided*—(1) *Goods manufactured or produced*. Solely for purposes of section 5000C, goods are manufactured or produced in the country (or countries)—

(i) Where property has been substantially transformed into the goods that are procured pursuant to a contract; or

(ii) Where there has been assembly or conversion of component parts (involving activities that are substantial in nature and generally considered to constitute the manufacture or production of property) into the final product that constitutes the goods procured pursuant to a contract.

(2) *Provision of services*. Solely for purposes of section 5000C, services are considered to be provided in the country where the individuals performing the services are physically located when they perform their duties pursuant to the contract.

(3) *Allocation of total contract price to determine the nonexempt amount*. If, pursuant to a contract, goods are manufactured or produced, or services are provided, in multiple countries and only a portion of the goods manufactured or produced, or the services provided, pursuant to the contract are nonexempt goods or nonexempt services, a foreign contracting party may use a reasonable allocation method to determine the nonexempt amount. A reasonable allocation method would include taking into account the proportionate costs (including the cost of labor and raw materials) incurred to manufacture or produce the goods in each country, or taking into account the proportionate costs incurred to provide the services in each country.

(4) *Reduction or elimination of withholding by an acquiring agency*. For procedures to reduce or eliminate withholding by an acquiring agency based on where goods are manufactured or produced or where services are provided, including as a result of an allocation under this paragraph (e), see § 1.5000C–2(d).

§ 1.5000C–2 Withholding on specified Federal procurement payments.

(a) *In general*. Except as otherwise provided in this section, every acquiring agency making a specified Federal procurement payment on which tax is imposed under section 5000C and §§ 1.5000C–1 through 1.5000C–7 must deduct and withhold an amount equal to 2 percent of the payment. For rules relating to the liability of a foreign contracting party with respect to specified Federal procurement payments not fully withheld upon at source, see § 1.5000C–4. An acquiring agency may rely upon any information furnished by a contracting party under this section unless the acquiring agency has reason to know that the information is incorrect or unreliable. An acquiring agency has reason to know that the information is incorrect or unreliable if it has knowledge of relevant facts or statements contained in the submitted information such that a reasonably prudent person in the position of the acquiring agency would know that the information provided is incorrect or unreliable.

(b) *Steps in determining the obligation to withhold under section 5000C*. An acquiring agency generally determines its obligation to withhold under section 5000C according to the steps described in this paragraph (b). See, however, paragraph (e) of this section for situations in which withholding may be increased in the case of underwithholding, or may be decreased in the case of overwithholding.

(1) *Determine whether the payment is pursuant to a contract for goods or services*. The acquiring agency determines whether it is making a payment pursuant to a contract for goods or services. To the extent that the acquiring agency is making a payment for any other purpose, it does not have an obligation to withhold under section 5000C on the payment.

(2) *Determine whether the payment is made pursuant to a contract with a U.S. person*. The acquiring agency determines whether the payment is made pursuant to a contract with a person considered to be a United States person (U.S. person) in accordance with paragraph (c) of this section. If the other contracting party is a U.S. person, the acquiring agency does not have an obligation to withhold under section 5000C on the payment.

(3) *Determine whether the payment is for purchases under the simplified acquisition procedures*. The acquiring agency determines whether the payment is for purchases under the simplified acquisitions procedures that do not exceed the simplified acquisition threshold as described in 48 CFR 2.101. If it is, the acquiring agency does not have an obligation to withhold under section 5000C on the payment.

(4) *Determine whether the payment is for emergency acquisitions*. The acquiring agency determines whether the payment is made for certain emergency acquisitions within the meaning of § 1.5000C–1(d)(2). If it is, the acquiring agency does not have an obligation to withhold under section 5000C on the payment.

(5) *Determine whether the payment is for personal services under the simplified acquisition threshold*. The acquiring agency determines whether payments for services under contracts with a single individual do not exceed the simplified acquisition threshold as described in 48 CFR 2.101 on an annual basis for all years of the contract. If that is the case, the acquiring agency does not have an obligation to withhold under section 5000C on the payment.

(6) *Determine whether the payment is pursuant to a foreign humanitarian assistance contract*. The acquiring agency determines whether the payment is made pursuant to a foreign humanitarian assistance contract described in § 1.5000C–

1(d)(4). If it is, the acquiring agency does not have an obligation to withhold under section 5000C on the payment.

(7) *Determine whether the foreign contracting party is entitled to relief pursuant to an international agreement*. If the foreign contracting party submits a Section 5000C Certificate in accordance with paragraph (d) of this section representing that the foreign contracting party is entitled to relief from the tax imposed under section 5000C pursuant to an international agreement with the United States (such as relief pursuant to the nondiscrimination provision of a qualified income tax treaty), the acquiring agency does not have an obligation to withhold under section 5000C on the payment.

(8) *Determine whether the contract is for goods manufactured or produced or services provided in the United States or in a foreign country that is a party to an international procurement agreement*. If the foreign contracting party submits a Section 5000C Certificate in accordance with paragraph (d) of this section that represents that the contract is for goods manufactured or produced or services provided in the United States, or in a foreign country that is a party to an international procurement agreement, the acquiring agency does not have an obligation to withhold. If the Section 5000C Certificate provides that payments under the contract are only partially exempt from withholding under section 5000C, the acquiring agency must withhold to the extent described in paragraph (b)(8) of this section.

(9) *Compute amounts to withhold*. If, after evaluating each step described in this paragraph (b), the acquiring agency determines that it has an obligation to withhold, the acquiring agency computes the amount of withholding by multiplying the amount of the payment by 2 percent, unless the foreign contracting party has provided a Section 5000C Certificate or the payment is only in part for goods or services. In cases in which the Section 5000C Certificate demonstrates that the exemption in Step 8 applies, the acquiring agency generally computes the amount of withholding by multiplying the amount of the payment by the contract ratio provided on the most recent Section 5000C Certificate, the product of which is multiplied by 2 percent. However, in cases in which the exemption in Step 8 applies and the requirements of paragraph (d)(4)(iii)(B)(*2*) of this section are met, the acquiring agency computes the amount of withholding based on the payment for the specifically identified items, which may be identified by the contract line item number, or CLIN. In the case in which the payment is only in part for goods or services, the acquiring agency reduces the amount of the payment subject to the tax to the extent it is for something other than goods or services. The acquiring agency withholds the computed amount from the payment.

(10) *Deposit and report amounts withheld*. The acquiring agency deposits and reports the amounts determined in the prior step in accordance with § 1.5000C–3.

(c) *Determining whether the contracting party is a U.S. person*—(1) *In general*. An acquiring agency must rely on the provisions of this paragraph (c) to determine the status of the contracting party as a U.S. person for purposes of withholding under section 5000C.

(2) *Determination based on Taxpayer Identification Number (TIN)*. An acquiring agency must treat a contracting party as a U.S. person if the U.S. government information system (such as the System for Award Management (SAM)) indicates that the contracting party is a corporation (for example, because the name listed in SAM contains the term "Corporation," "Inc.," or "Corp.") and that it has a TIN that begins with two digits other than "98" (a limited liability company or LLC is not treated as a corporation for purposes of this paragraph (c)(2)). Further, an acquiring agency must treat a contracting party as a U.S. person if the acquiring agency has access to a U.S. government information system that indicates that the contracting party is an individual with a TIN that begins with a digit other than "9".

(3) *Determination based on the Form W–9*. An acquiring agency must treat a contracting party as a U.S. person if the person has submitted to it a valid Form W–9, "Request for Taxpayer Identification Number (TIN) and Certificate" (or valid substitute form described in § 31.3406(h)–3(c)(2) of this chapter), signed under penalties of perjury.

(4) *Contracting party treated as a foreign contracting party*. If an acquiring agency cannot determine that a contracting party is a U.S. person based on application of paragraph (c)(2) or (3) of this section, then the contracting party is treated as a foreign contracting party for purposes of this section.

(d) *Withholding when a foreign contracting party submits a Section 5000C Certificate*—(1) *In general*. Unless the acquiring agency has reason to know that the information is incorrect or unreliable, the acquiring agency may rely on a claim that a foreign contracting party is entitled to an exemption (in whole or in part) from withholding on payments pursuant to a contract if the foreign contracting party provides a Section 5000C Certificate to the acquiring agency as prescribed in this paragraph (d). When a Section 5000C Certificate is furnished, the acquiring agency does not withhold, or must reduce the amount of withholding, on payments made to a foreign person if the certificate establishes that the foreign person is wholly or partially exempt from withholding. An acquiring agency may establish a system for a foreign contracting party to electronically furnish a Section 5000C Certificate.

(2) *Exemption for a foreign contracting party entitled to the benefit of relief pursuant to certain international agreements*. An acquiring agency does not withhold on payments pursuant to a contract with a foreign contracting party when the payment is entitled to relief from the tax imposed under section 5000C pursuant to an international agreement, including relief pursuant to a nondiscrimination provision of a qualified income tax treaty, because the foreign contracting party is entitled to the benefit of that agreement and the foreign contracting party has submitted a Section 5000C Certificate that includes all of the information described in paragraphs (d)(4)(i) and (ii) of this section.

(3) *Exemption when goods are manufactured or produced or services provided in the United States, or in a foreign country that is a party to an international procurement agreement*. An acquiring agency does not withhold on payments pursuant to a contract with a foreign contracting party to the extent that the pay-

ments are for goods manufactured or produced or services provided in the United States or in a foreign country that is a party to an international procurement agreement with the United States, provided that the foreign contracting party has submitted a Section 5000C Certificate that includes all of the information described in paragraphs (d)(4)(i) and (iii) of this section. If the Section 5000C Certificate provides that the payment is only partially exempt from withholding under section 5000C, the acquiring agency must withhold to the extent that the payment is not exempt.

(4) *Information required for Section 5000C Certificate*—(i) *In general*. The Section 5000C Certificate must be signed under penalties of perjury by the foreign contracting party and contain—

(A) The name of the foreign contracting party, country of organization (if applicable), and permanent residence address of the foreign contracting party;

(B) The mailing address of the foreign contracting party (if different than the permanent residence address);

(C) The TIN assigned to the foreign contracting party (if any);

(D) The identifying or reference number on the contract (if known);

(E) The name and address of the acquiring agency;

(F) A statement that the person signing the Section 5000C Certificate is the foreign contracting party listed in paragraph (d)(4)(i)(A) of this section (or is authorized to sign on behalf of the foreign contracting party);

(G) A statement that the foreign contracting party is not acting as an agent or nominee for another foreign person with respect to the goods manufactured or produced or services provided under the contract;

(H) A statement that the foreign contracting party agrees to pay an amount equal to any tax (including any applicable penalties and interest) due under section 5000C that the acquiring agency does not withhold under section 5000C;

(I) A statement that the foreign contracting party acknowledges and understands the rules in § 1.5000C–4 relating to procedural obligations related to section 5000C; and

(J) A statement that the foreign contracting party has not engaged in a transaction (or series of transactions) with a principal purpose of avoiding the tax imposed under section 5000C as defined in § 1.5000C–5.

(ii) *Additional information required for claiming an exemption based on certain international agreements with the United States*. In addition to the information required by paragraph (d)(4)(i) of this section, a foreign contracting party claiming an exemption from withholding in reliance on a provision of an international agreement with the United States, including a qualified income tax treaty, must provide—

(A) The name of the international agreement under which the foreign contracting party is claiming benefits;

(B) The specific provision of the international agreement relied upon (for example, the nondiscrimination article of a qualified income tax treaty); and

(C) The basis on which it is entitled to the benefits of that provision (for example, because the foreign contracting party is a corporation organized in a foreign country that has in force a qualified income tax treaty with the United States that covers all nationals, regardless of their residence).

(iii) *Additional required information for claiming exemption based on country where goods are manufactured or services provided*. (A) *In general*. In addition to the information required by paragraph (d)(4)(i) of this section, a foreign contracting party claiming an exemption from withholding (in whole or in part) because payments will be pursuant to a contract for goods manufactured or produced or services provided in the United States, or a foreign country that is party to an international procurement agreement, must describe on the Section 5000C Certificate the relevant goods or services and the country (or countries) in which they are manufactured or produced, or are provided, and must include the name of the international procurement agreement or agreements (if relevant).

(B) *Information on allocation to exempt and nonexempt amounts*. (*1*) *In general*. In situations in which a foreign contracting party claims the exemption in paragraph (d)(3) of this section with respect to only a portion of the payments received under the contract, the Section 5000C Certificate must include an explanation of the method used by the foreign contracting party to allocate the total contract price among the countries, as described in § 1.5000C–1(e)(3), if applicable. In general, the Section 5000C Certificate also must include the total contract price and the nonexempt amount; however, when necessary, an estimate of the total contract price or the nonexempt amount may be used. For example, total contract price may be estimated when a Section 5000C Certificate is being completed with respect to payments to be made pursuant to a cost-reimbursement contract that is paid on the basis of actual incurred costs and the total amount of such costs is not known at the time the certificate is provided.

(*2*) *Specific identification of exempt items*. If agreed to by the acquiring agency, the Section 5000C Certificate may identify specific exempt and nonexempt amounts. For example, specific contract line items (such as a contract line item number or CLIN) identified in the contract may be listed on the Section 5000C Certificate as exempt and nonexempt amounts (in whole or in part), as applicable. When this paragraph applies, and whether or not the contract identifies exempt and nonexempt amounts, a foreign contracting party must provide the information required by paragraphs (d)(4)(iii)(A) and (d)(4)(iii)(B)(*1*) of this section, on the Section 5000C Certificate to explain why the contract line items are eligible for an exemption; however, the foreign contracting party is not required to include information about the total contract price under this paragraph. In these circumstances, only one Section 5000C Certificate is required to be provided identifying the exempt and nonexempt contract line items that relate to the contract (for example, a spreadsheet may be attached to the Section 5000C Certificate that identifies the contract line items with an explanation for the treatment as exempt or nonexempt).

(5) *Validity period of Section 5000C Certificate*. Except as otherwise provided in paragraph (d)(6) of this section, the Section 5000C Certificate is valid for the term of the contract.

(6) *Change in circumstances*. A foreign contracting party must submit a revised Section 5000C Certificate within 30 days of a change in circumstances that causes the information in a Section 5000C Certificate held by the acquiring agency to be incorrect with respect to the acquiring agency's determination of whether to withhold or the amount of withholding under Section 5000C. An acquiring agency must request a new Section 5000C Certificate from a contracting party in circumstances in which it knows (or has reason to know) that a previously submitted Section 5000C Certificate becomes incorrect or unreliable. An acquiring agency may request an updated Section 5000C Certificate at any time, including when other documentation is required under the contract, such as the annual representations and certifications required in 48 CFR 4.1201. *See* § 1.5000C–6, *Example 6*, for an illustration of this paragraph (6).

(7) *Form W–14*. A foreign contracting party may choose to use Form W–14, "Certificate of Foreign Contracting Party Receiving Federal Procurement Payments" (or other form that the IRS may prescribe), as its Section 5000C Certificate, provided that it includes all the necessary information required by this paragraph (d).

(8) *Time for submitting Section 5000C Certificate*. A contracting party must submit the Section 5000C Certificate (such as Form W–14 or Form W–9) as early as practicable (for example, when the offer for the contract is submitted to the U.S. government). In all cases, however, the Section 5000C Certificate must be submitted to the acquiring agency no later than the date of execution of the contract.

(e) *Offset for underwithholding or overwithholding*—(1) *In general*. If the foreign contracting party discovers that amounts withheld on prior payments either were insufficient or in excess of the amount required to satisfy its tax liability under section 5000C, the foreign contracting party may request the acquiring agency to increase or decrease the amount of withholding on future payments for which withholding is required under section 5000C. The request must be in writing, signed under penalties of perjury, contain the amount by which the foreign contracting party requests to increase or decrease future amounts withheld under section 5000C, and explain the reason for the request. The request may be submitted in conjunction with an original or updated Section 5000C Certificate.

(2) *Underwithholding*. Upon receipt of a request described in paragraph (e)(1) of this section, acquiring agencies may increase the amount of withholding under this paragraph to correct underwithholding only if the payment for which the increase is applied is otherwise subject to withholding under section 5000C and made before the date that Form 1042, "Annual Withholding Tax Return for U.S. Source Income of Foreign Persons," is required to be filed (not including extensions) with respect to the payment for which the underwithholding occurred. Amounts withheld under this paragraph must be deposited and reported in the time and manner as prescribed by § 1.5000C–3. *See* § 1.5000C–4 for procedures for a foreign contracting party that must pay tax due when its tax liability under section 5000C was not fully satisfied by withholding by an acquiring agency.

(3) *Overwithholding*. Upon receipt of a request described in paragraph (e)(1) of this section, acquiring agencies may decrease the amount of withholding on subsequent payments made to the foreign contracting party that are otherwise subject to withholding under section 5000C provided that the payment for which the decrease is applied is made on or before the date on which Form 1042, "Annual Withholding Tax Return for U.S. Source Income of Foreign Persons," is required to be filed (not including extensions) with respect to the payment for which the overwithholding occurred. *See* § 1.5000C–4(e) for procedures for foreign contracting parties to file a claim for refund for the overwithheld amount under section 5000C.

§ 1.5000C–3 Payment and returns of tax withheld by the acquiring agency.

(a) *In general*. This section provides administrative procedures that acquiring agencies must follow to satisfy their obligations to deposit and report amounts withheld under § 1.5000C–2. An acquiring agency with a section 5000C withholding obligation must increase the amount it deducts and withholds under chapter 3 for fixed or determinable annual or periodical income (FDAP income) by the amount it must withhold under § 1.5000C–2. Accordingly, this section generally applies the administrative provisions of chapter 3 for FDAP income relating to the deposit, payment, and reporting for amounts withheld under § 1.5000C–2, and contains some variation from those provisions to take into account the nature of the tax imposed under section 5000C.

(b) *Deposit rules*—(1) *Acquiring agency with a chapter 3 deposit requirement treats amounts withheld as under chapter 3*. If an acquiring agency has a chapter 3 deposit obligation for a period, it must treat any amount withheld under § 1.5000C–2 as an additional amount of tax withheld under chapter 3 for purposes of the deposit rules of § 1.6302–2. Thus, depending on the combined amount withheld under chapter 3 and § 1.5000C–2, an acquiring agency subject to this paragraph (b)(1) must make monthly deposits, quarter-monthly deposits, or annual deposits under the rules in § 1.6302–2. To the extent provided in forms, instructions, or publications prescribed by the Internal Revenue Service (IRS), acquiring agencies must deposit all withheld amounts by *electronic funds transfer*, as that term is defined in § 31.6302–1(h)(4)(i) of this chapter.

(2) *Acquiring agency with no chapter 3 filing obligation deposits withheld amounts monthly*. If an acquiring agency has no chapter 3 deposit obligation to which the deposit rules of § 1.6302–2 apply for a calendar month, it must make monthly deposits of the amounts withheld under the rules in this paragraph (b)(2). Thus, an acquiring agency with no chapter 3 deposit obligations and that has withheld any amount under § 1.5000C–2 during any calendar month must deposit that amount by the 15th day of the month following the payment. To the extent provided in forms, instructions, or publications prescribed by the Internal Revenue Service (IRS), acquiring agencies must deposit all withheld amounts by *electronic funds transfer*, as that term is defined in § 31.6302–1(h)(4)(i) of this chapter.

(c) *Return requirements*—(1) *In general*. Except as provided in paragraph (c)(2) of this section, an acquiring agency that withholds an amount pursuant to section 5000C generally must file Form 1042–S, "Foreign Person's U.S. Source Income Subject to Withholding," and Form 1042, "Annual Withholding Tax Return for U.S. Source Income of Foreign Persons," each year, or other such forms as the IRS may prescribe, to report information related to amounts withheld under section 5000C. The acquiring agency must prepare a Form 1042–S for each contracting party reporting the amount withheld under section 5000C for the preceding calendar year. The Form 1042 must show the aggregate amounts withheld under section 5000C that were required to be reported on Forms 1042–S (including those amounts withheld under section 5000C for which a Form 1042–S is not required to be filed pursuant to paragraph (c)(2) of this section). The Form 1042 must also include the information required by the form and accompanying instructions. Further, any forms required under this paragraph (c) are due at the same time, at the same place, and eligible for the same extended due dates and may be amended in the same manner as Form 1042 and Form 1042–S (or such other forms as the IRS may prescribe related to chapter 3). The acquiring agency must furnish a copy of the Form 1042–S (or such other form as the IRS may prescribe for the same purpose) to the contracting party for whom the form is prepared on or before March 15 of the calendar year following the year in which the amount subject to reporting under section 5000C was paid. It must be filed with a transmittal form as provided in the instructions for Form 1042–S and to the transmittal form. Section 5000C Certificates or other statements or information as prescribed by § 1.5000C–2 that are provided to the acquiring agency are not required to be attached to the Form 1042 filed with the IRS. However, an acquiring agency that is required to file Form 1042 must retain a copy of Form 1042, Form 1042–S, the Section 5000C Certificates, or other statements or information prescribed by § 1.5000C–2 for at least three years from the original due date of Form 1042 or the date it was filed, whichever is later. An acquiring agency that is not required to file Form 1042 must retain any Section 5000C Certificates or other statements or information as prescribed by § 1.5000C–2 for at least three years from the date the Form 1042 would have been due had the acquiring agency had an obligation to file.

(2) *Classified or confidential contracts*. An acquiring agency is not required to report information otherwise required by this section on Form 1042–S for payments made pursuant to classified or confidential contracts (as described in section 6050M(e)(3)), unless the acquiring agency determines that the information reported on the Form 1042–S does not compromise the safeguarding of classified information or national security.

(d) *Special arrangement for certain contracts*. In limited circumstances, the IRS may authorize the amount otherwise required to be withheld under section 5000C to be deposited in the time and manner mutually agreed upon by the acquiring agency and the foreign contracting party. In these circumstances, the IRS may in its sole discretion also modify any reporting or return requirements of the acquiring agency or the foreign contracting party.

§ 1.5000C–4 Requirement for the foreign contracting party to file a return and pay tax, and procedures for the contracting party to seek a refund.

(a) *In general*. For purposes of subtitle F of the Internal Revenue Code ("Procedure and Administration"), the tax imposed under section 5000C on foreign persons is treated as a tax imposed under subtitle A. Except as provided elsewhere in the regulations under section 5000C, forms, or accompanying instructions, the tax imposed on foreign contracting parties under section 5000C is administered in a manner similar to gross basis income taxes. This section provides procedures that a foreign contracting party must follow to satisfy its obligations to report and deposit tax due under § 1.5000C–1 as well as procedures for contracting parties to seek a refund of amounts overwithheld.

(b) *Tax obligation of foreign contracting party independent of withholding*. A foreign contracting party subject to tax under section 5000C and §§ 1.5000C–1 through 1.5000C–7 remains liable for the tax unless its tax obligation was fully satisfied by withholding by an acquiring agency in accordance with §§ 1.5000C–2 and 1.5000C–3.

(c) *Return of tax by the foreign contracting party*. If the tax liability under § 1.5000C–1 relating to a payment is not fully satisfied by withholding in accordance with §§ 1.5000C–2 and 1.5000C–3 (including as a result of the use of an estimated nonexempt amount or estimated total contract price in computing the contract ratio), a foreign contracting party subject to tax under § 1.5000C–1 during a calendar year must make a return of tax on, for example, Form 1120–F, "U.S. Income Tax Return of a Foreign Corporation," or such other form as the Internal Revenue Service (IRS) may prescribe to report the amount of tax due under section 5000C (required return). A foreign contracting party with no other U.S. tax filing obligation other than with respect to its liability for the tax imposed under section 5000C must file its required return on or before the fifteenth day of the sixth month following the close of its taxable year. The required return must include the information required by the form and accompanying instructions. The required return must be filed at the place and time (including any extension of time to file) provided by the form and accompanying instructions. Penalties for failure to file contained in Subtitle F can apply to foreign contracting parties who fail to file the required return. A foreign contracting party must attach copies of all Forms 1042–S, "Foreign Person's U.S. Source Income Subject to Withholding," received from acquiring agencies (if any) to the required return.

(d) *Time and manner of paying tax*. A foreign contracting party must pay the tax imposed under section 5000C in the manner provided and in the time prescribed in the required return and accompanying instructions. In general, the foreign contracting party must pay the tax at the time that the required return is due, excluding extensions. To the extent provided in forms, instructions, or publications prescribed by the IRS, each foreign contracting party must deposit tax due under section 5000C by *electronic funds transfer*, as that term is defined in § 31.6302–1(h)(4)(i) of this chapter. A foreign contracting party that fails to pay tax in the time and manner prescribed in this section (or under forms, instructions, or publications prescribed by the IRS under this section) may be subject to penalties and interest under Subtitle F.

(e) *Refund requests when amount withheld exceeds tax liability*. After taking into account any offsets pursuant to § 1.5000C–2(e)(3), if the acquiring agency has overwithheld amounts under section 5000C and has made a deposit of the amounts under § 1.5000C–3(b), the contracting party may claim a refund of the amount overwithheld pursuant to the procedures described in chapter 65. The contracting party's claim for refund must meet the requirements of section 6402 and the regulations thereunder, as applicable, and must be filed before the expiration of the period of limitations on refund in section 6511 and the regulations thereunder. In general, the contracting party making a refund claim must file the required return to claim a refund, stating the grounds upon which the claim is based. A Section 5000C Certificate and a copy of the Form 1042–S received from the acquiring agency must be attached to the required return. For purposes of this section, an amount is overwithheld if the amount withheld from the payment pursuant to section 5000C and §§ 1.5000C–1 through 1.5000C–7 exceeds the contracting party's tax liability under § 1.5000C–1, regardless of whether the overwithholding was in error or appeared correct when it occurred. A U.S. person may seek a refund under this paragraph (e) even if it was treated as a foreign person under the rules in § 1.5000C–2 (for example, because it neither had a taxpayer identification number on file in the System for Award Management nor submitted Form W–9, "Request for Taxpayer Identification Number (TIN) and Certification," to the acquiring agency).

§ 1.5000C–5 Anti-abuse rule.

If a foreign person engages in a transaction (or series of transactions) with a principal purpose of avoiding the tax imposed under section 5000C, the transaction (or series of transactions) may be disregarded or the arrangement may be recharacterized (including disregarding an intermediate entity), in accordance with its substance. If this section applies, the foreign person remains liable for any tax (including any tax obligation unsatisfied as a result of underwithholding) and the Internal Revenue Service retains all other rights and remedies under any applicable law available to collect any tax imposed on the foreign contracting party by section 5000C.

§ 1.5000C–6 Examples.

The rules of §§ 1.5000C–1 through 1.5000C–4 are illustrated by the following examples. For purposes of the examples: All contracts are executed with acquiring agencies on or after January 2, 2011, and are for the provision of either goods or services; none of the exemptions described in § 1.5000C–1(d) apply, unless otherwise explicitly stated; the acquiring agencies have no other withholding obligations under chapter 3 of the Code and have no other contracts subject to section 5000C; the foreign contracting parties do not have any U.S. source income or a U.S. tax return filing obligation other than a tax return filing obligation that arises based on the facts described in the particular example; and none of the contracts are classified or confidential contracts as described in section 6050M(e)(3).

Example 1. U.S. person not subject to tax; no withholding. (i) *Facts*. Company A Inc., a domestic corporation and the contracting party, enters into a contract with Agency L, the acquiring agency. Before making its first payment under the contract (for example, on the date of execution of the contract), pursuant to the first step in § 1.5000C–2(b), Agency L determines that the contract will be for services. Under the second step, Agency L reviews Company A Inc.'s record in the System for Award Management (SAM) and determines that Company A is a corporation and is considered to be a U.S. person because Agency L's records demonstrate that Company A Inc. is a business entity treated as a corporation for tax purposes that has a TIN that does not begin with "98."

(ii) *Analysis*. Company A Inc. is a U.S. person and thus is not subject to the tax under section 5000C. Moreover, because Company A Inc. is a corporation for tax purposes that has a TIN that does not begin with "98," Agency L is able to determine that it has no obligation to withhold any amounts under section 5000C on the payment made to Company A Inc. For purposes of section 5000C, Company A Inc. could also establish that it is a U.S. person by providing a Form W–9, "Request for Taxpayer Identification Number (TIN) and Certification," to Agency L. Company A Inc. does not need to file a Section 5000C Certificate to demonstrate its eligibility for an exemption from withholding.

Example 2. Foreign national entitled to the benefit of a nondiscrimination provision of a treaty; no withholding. (i) *Facts*. Company B, a foreign contracting party and a national of Country T, provides goods to Agency M, the acquiring agency. Company B determines that it is exempt from tax under section 5000C because it is entitled to the benefit of the nondiscrimination article of a qualified income tax treaty between the United States and Country T. Company B submits a Section 5000C Certificate to Agency M when the contract is executed. Company B uses Form W–14, "Certificate of Foreign Contracting Party Receiving Federal Procurement Payments," and properly fills the relevant sections stating the name of the treaty, the specific article relied upon, and the basis on which it is entitled to the benefits of that article. Following the steps in § 1.5000C–2, Agency M determines that the nondiscrimination provision of the Country T-United States income tax treaty applies to exempt Company B from the tax imposed under section 5000C. Agency M makes one lump sum payment of $50 million to Company B pursuant to the contract.

(ii) *Analysis*. Company B has no liability for tax under section 5000C because it is entitled to the benefit of a nondiscrimination article of a qualified income tax treaty. Because Company B submitted a Section 5000C Certificate meeting the requirements in § 1.5000C–2 and Agency M does not have reason to know that the submitted information is incorrect or unreliable, Agency M is not required to withhold under section 5000C. Agency M must retain the Section 5000C Certificate for at least three years pursuant to § 1.5000C–3(c)(1) from the due date for the Form 1042 (if it were required).

Example 3. Foreign treaty beneficiary does not submit Section 5000C Certificate; withholding required. (i) *Facts*. The facts are the same as in *Example 2*, except that Company B does not submit a Section 5000C Certificate to Agency M before Agency M makes the $50 million payment.

(ii) *Analysis*. Company B is not subject to tax under section 5000C, but Agency M must nevertheless withhold on the payment made to Company B because Agency M did not receive a Section 5000C Certificate from Company B in the time and manner required pursuant to § 1.5000C–2(d). Agency M must withhold $1 million (2 percent of $50 million) on the payment, and deposit that amount under the rules in § 1.5000C–3 no later than the 15th day of the month following the month in which the payment was made. Agency M must also complete Forms 1042, "Annual Withholding Tax Return for U.S. Source Income of Foreign Persons," and 1042–S, "Foreign Person's U.S. Source Income Subject to Withholding," on or before the date specified on those forms and the accompanying instructions. Agency M must furnish copies of Form 1042–S to Company B. Agency M must retain a copy of the Form 1042 and the Form 1042–S for 3 years from the due date for the Form 1042 pursuant to § 1.5000C–3(c)(1). As Company B is not liable for the tax, it may later file a claim for refund pursuant to the procedures described in chapter 65.

Example 4. Foreign contracting party partially exempt from tax under section 5000C when goods *are manufactured in different countries*. (i) *Facts*. Company C, a foreign contracting party, provides goods to Agency N in 2015. The terms of the contract require that payment be made to Company C by Agency N in two $5 million installments in 2015. Company C has a TIN that begins with "98" and is not entitled to relief pursuant to an international agreement with the United States, such as relief pursuant to a nondiscrimination provision of a qualified income tax treaty. Some of the goods are manufactured in Country R, which is a party to an international procurement agreement with the United States, with the remainder being manufactured in Country S, a country that is not a party to an international procurement agreement with the United States. Company C uses a reasonable allocation method based on the information available to it at the time in accordance with § 1.5000C–1(e)(3) to estimate that $3 million is the nonexempt amount that is allocated to the goods produced in Country S. Company C submits a valid and complete Section 5000C Certificate to Agency N in the time and manner required by §§ 1.5000C–1 through 1.5000C–7 that provides that the nonexempt amount is $3 million. In 2015, Agency N pays Company C in two installments pursuant to the terms of the contract.

(ii) *Analysis*. Using a reasonable allocation method to determine the estimated nonexempt amount, Company C determines that pursuant to section 5000C and §§ 1.5000C–1 through 1.5000C–7, tax of $30,000 (2 percent of the $5 million payment, or $100,000 multiplied by a fraction, the numerator of which is the estimated nonexempt amount, $3 million, and the denominator of which is the estimated total contract price, or $10 million) is imposed on each payment made to Company C. Because Company C has timely submitted a Section 5000C Certificate explaining the basis for this allocation, Agency N withholds $30,000 on each payment made to Company C. Agency N must deposit each $30,000 withholding tax under the rules in § 1.5000C–3 no later than the 15th day of the month following the month in which each payment is made. Agency N must also complete Forms 1042 and 1042–S and furnish copies of Form 1042–S to Company C. Agency N must retain a copy of the Form 1042 and the Form 1042–S for at least three years from the due date for the Form 1042 pursuant to § 1.5000C–3(c)(1). Provided that Agency N properly withholds on the nonexempt portion as required under section 5000C and §§ 1.5000C–1 through 1.5000C–7 and that Company C's estimate of the nonexempt amount is the actual nonexempt amount, Company C does not have an additional tax liability or a U.S. tax return filing obligation as a result of receiving the payments.

Example 5. Foreign contracting party liable for additional tax under Section 5000C not fully withheld upon due to errors on the Section 5000C Certificate. (i) *Facts*. The facts are the same as in *Example 4*, except that the Section 5000C Certificate submitted to Agency N by Company C erroneously provides that the estimated nonexempt amount is $1.5 million instead of $3 million. As a result, Agency N only withholds $15,000 (2 percent of the $5 million payment multiplied by a fraction (the numerator of which is the estimated nonexempt amount stated on the Section 5000C Certificate, $1.5 million, and the denominator of which is the estimated total contract price, or $10 million)) on each payment made to Company C. Agency N neither discovered nor had reason to know that the information on the Section 5000C Certificate was incorrect or unreliable. After both payments have been made and after the filing due date for Form 1042 for 2015, Company C determines that the estimated nonexempt amount should have been stated as $3 million on the Section 5000C Certificate.

(ii) *Analysis*. The tax imposed under section 5000C on Company C as a result of the receipt of specified Federal procurement payments is $60,000 and this amount has not been fully satisfied by withholding by Agency N. Accordingly, Company C must remit additional tax of $30,000 ($60,000 tax liability less $30,000 amounts already withheld by Agency N) and file its required return, a Form 1120–F, "U.S. Income Tax Return of a Foreign Corporation," for 2015 to report this tax liability, as required by § 1.5000C–4. Company C must explain its corrected allocation method in its Form 1120–F. Company C must also attach a copy of the Form 1042–S it received from Agency N to Form 1120–F.

Example 6. Foreign contracting party submits revised Section 5000C Certificate due to change in circumstances. (i) *Facts*. The facts are the same as in *Example 4*, except that, after the first payment, Company C changes its business so that all of the goods manufactured with respect to the second payment are manufactured in Country R. Prior to the second payment, Company C submits a revised Section 5000C Certificate indicating this change in circumstance pursuant to § 1.5000C–2(d)(6).

(ii) *Analysis*. Agency N withholds $30,000 on the first payment made to Company C and does not withhold on the second payment. Company C does not have an additional tax liability or a U.S. tax return filing obligation as a result of receiving the payments.

§ 1.5000C–7 Effective/applicability date.

Section 5000C applies to specified Federal procurement payments received pursuant to contracts entered into on and after January 2, 2011. Sections 1.5000C–1 through 1.5000C–7 apply on and after November 15, 2016. Contracting parties and acquiring agencies may rely upon the rules in the regulations before such date. If a foreign contracting party fully satisfies its tax and filing obligations under section 5000C with respect to any payments received in tax years ending before November 15, 2016 on or before the later of November 15, 2016 or the due date for the foreign person's income tax return for the year in which the payment was received in a manner consistent with the final regulations, penalties will not be asserted on the foreign contracting parties with respect to those payments or returns.

PART 301—PROCEDURE AND ADMINISTRATION

Par. 4. The authority citation for part 301 continues to read in part as follows:

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

Par. 5. Section 301.6114–1 is amended by adding paragraph (c)(1)(ix) and revising paragraph (e) to read as follows:

§ 301.6114–1 Treaty-based return positions.

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(c) * * *

(1) * * *

(ix) Notwithstanding paragraph (b)(1) of this section, that a nondiscrimination provision of a qualified income tax treaty, as defined in Treas. Reg. § 1.5000C–1(c)(13), exempts a payment from tax under section 5000C, but only if the foreign person claiming such relief has provided a Section 5000C Certificate (such as Form W–14, "Certificate of Foreign Contracting Party Receiving Federal Procurement Payments") to the acquiring agency in accordance with section 5000C and the regulations thereunder.

* * * * *

(e) *Effective/applicability date*—(1) *In general*. This section is effective for taxable years of the taxpayer for which the due date for filing returns (without extensions) occurs after December 31, 1988. However, if—

(i) A taxpayer has filed a return for such a taxable year, without complying with the reporting requirement of this section, before November 13, 1989, or

(ii) A taxpayer is not otherwise than by paragraph (a) of this section required to file a return for a taxable year before November 13, 1989, such taxpayer must file (apart from any earlier filed return) the statement required by paragraph (d) of this section before June 12, 1990, by mailing the required statement to the Internal Revenue Service, P.O. Box 21086, Philadelphia, PA 19114. Any such statement filed apart from a return must be dated, signed and sworn to by the taxpayer under the penalties of perjury. In addition, with respect to any return due (without extensions) on or before March 10, 1990, the reporting required by paragraph (a) of this section must be made no later than June 12, 1990. If a taxpayer files or has filed a return on or before November 13, 1989, that provides substantially the same information required by paragraph (d) of this section, no additional submission will be required. Foreign insurers and reinsurers subject to reporting described in paragraph (c)(7)(ii) of this section must so report for calendar years 1988 and 1989 no later than August 15, 1990.

(2) *Section 5000C*. Paragraph (c)(1)(ix) of this section applies to payments made on and after November 15, 2016 pursuant to contracts entered into on and after January 2, 2011. However, a taxpayer that receives payments exempt from tax under section 5000C by reason of a qualified income tax treaty before November 15, 2016 is not required to disclose this position on Form 8833, provided it has properly relied on Notice 2015–35, I.R.B. 2016–14, 533, in claiming the exemption.* * * * *

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 6. The authority citation for part 602 continues to read in part as follows:

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

Par. 7. In § 602.101, paragraph (b) is amended by adding entries in numerical order to the table to read as follows:

§ 602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB Control No.
* * * * *	
1.5000C–2	1545-0096
	1545-2263
1.5000C–3	1545-0096
	1545-2263
1.5000C–4	1545-1223
	1545-0074
* * * * *	

John M. Dalrymple,
Deputy Commissioner for Services and Enforcement.

Approved: July 22, 2016.

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

(Filed by the Office of the Federal Register on August 17, 2016, 8:45 a.m., and published in the issue of the Federal Register for August 18, 2016, 81 F.R. 55133)

Part III. Administrative, Procedural, and Miscellaneous

26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.

Rev. Proc. 2016–43

SECTION 1. PURPOSE

This revenue procedure provides the monthly national average premium for qualified health plans that have a bronze level of coverage and are offered though Exchanges for taxpayers to use in determining their maximum individual shared responsibility payment under § 5000A(c)(1)(B) of the Internal Revenue Code and § 1.5000A–4 of the Income Tax Regulations.

SECTION 2. BACKGROUND

.01 Section 5000A provides that if a taxpayer, or an individual for whom the taxpayer is liable, is without minimum essential coverage for one or more months in a taxable year, then the taxpayer is liable for the individual shared responsibility payment when filing his or her federal income tax return, unless an exemption applies. *See* § 5000A(a), (b)(1). In general, under § 5000A a taxpayer is liable for any individual who is a dependent, as defined in § 152, of the taxpayer. *See* §§ 5000A(b)(3)(A) and 1.5000A–1(c). Married individuals who file a joint return for a taxable year are jointly liable for any individual shared responsibility payment for a month included in the taxable year. *See* §§ 5000A(b)(3)(B) and 1.5000A–1(c)(3).

.02 For each taxable year, the individual shared responsibility payment is the lesser of (1) the sum of the monthly penalty amounts, or (2) the sum of the monthly national average bronze plan premiums for the shared responsibility family. *See* § 1.5000A–4(a). The monthly national average bronze plan premium means, for a month for which a shared responsibility payment is imposed, 1/12 of the annual national average premium for qualified health plans that (1) have a bronze level of coverage, (2) would provide coverage for the taxpayer's shared responsibility family members, and (3) are offered through Exchanges for plan years beginning in a calendar year with or within which the taxable year ends. *See* §§ 5000A(c)(1)(B) and 1.5000A–4(c). Shared responsibility family means, for a month in a taxable year, all nonexempt individuals for whom the taxpayer and the taxpayer's spouse, if the taxpayer is married and files a joint return with the spouse, are liable for the shared responsibility payment under § 5000A for that taxable year. *See* § 1.5000A–1(d)(17).

.03 Revenue Procedure 2014–46, 2014–12 C.B. 367, describes the methodology used to determine the monthly national average bronze plan premium and provides the premium amount for 2014. Revenue Procedure 2015–15, 2015–5 I.R.B. 564, provides the premium amount for 2015.

SECTION 3. MONTHLY NATIONAL AVERAGE BRONZE PLAN PREMIUM

.01 *Monthly National Average Bronze Plan Premium*. For purposes of § 5000A(c)(1)(B) and § 1.5000A–4, the monthly national average premium for qualified health plans that have a bronze level of coverage and are offered through Exchanges is $223 per individual.

.02 *Maximum Monthly National Average Bronze Plan Premium*. For purposes of § 5000A(c)(1)(B) and § 1.5000A–4, the maximum monthly national average premium for qualified health plans that have a bronze level of coverage and are offered through Exchanges is $1,115 for a shared responsibility family with five or more members.

SECTION 4. EFFECTIVE DATE

This revenue procedure is effective for taxable years ending after December 31, 2015.

SECTION 5. EFFECT ON OTHER DOCUMENTS

Revenue Procedure 2015–15 is superseded.

SECTION 6. DRAFTING INFORMATION

The principal author of this revenue procedure is John B. Lovelace of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Mr. Lovelace at (202) 317-7006 (not a toll-free number).

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26 CFR 601.601: Rules and regulations.(Also: §§ 141, 145, 1.141–3, 1.145–2)

Rev. Proc. 2016–44

SECTION 1. PURPOSE

This revenue procedure provides safe harbor conditions under which a management contract does not result in private business use of property financed with governmental tax-exempt bonds under § 141(b) of the Internal Revenue Code or cause the modified private business use test for property financed with qualified 501(c)(3) bonds under § 145(a)(2)(B) to be met.

SECTION 2. BACKGROUND

.01 Section 103(a) provides that, except as provided in § 103(b), gross income does not include interest on any State or local bond. Section 103(b)(1) provides that § 103(a) shall not apply to any private activity bond that is not a qualified bond (within the meaning of section 141). Section 141(a) provides that the term "private activity bond" means any bond issued as part of an issue (1) that meets the private business use test and private security or payment test, or (2) that meets the private loan financing test.

.02 Section 141(b)(1) provides generally that an issue meets the private business use test if more than 10 percent of the proceeds of the issue are to be used for any private business use. Section 141(b)(6) defines "private business use" as use (directly or indirectly) in a trade or business carried on by any person other than a governmental unit. For this purpose, any activity carried on by a person other than a natural person must be treated as a trade or business use.

.03 Section 1.141–3(a)(1) of the Income Tax Regulations provides, in part, that the 10 percent private business use test of § 141(b)(1) is met if more than 10 percent of the proceeds of an issue is used in a trade or business of a nongovernmental person. For this purpose, the use of financed property is treated as the direct use of proceeds. Section 1.141–3(a)(2) provides that, in determining whether an issue meets the private business use test, it is necessary to look at both indirect and direct use of proceeds. Proceeds are treated as used in the trade or business of a nongovernmental person if a nongovernmental person, as a result of a single transaction or a series of related transactions, uses property acquired with the proceeds of an issue.

.04 Section 1.141–3(b)(1) provides that both actual and beneficial use by a nongovernmental person may be treated as private business use. In most cases, the private business use test is met only if a nongovernmental person has special legal entitlements to use the financed property under an arrangement with the issuer. In general, a nongovernmental person is treated as a private business user as a result of ownership; actual or beneficial use of property pursuant to a lease, a management contract, or an incentive payment contract; or certain other arrangements such as a take or pay or other output-type contract.

.05 Section 1.141–3(b)(3) provides generally that the lease of financed property to a nongovernmental person is private business use of that property. For this purpose, any arrangement that is properly characterized as a lease for federal income tax purposes is treated as a lease. Section 1.141–3(b)(3) further provides that, in determining whether a management contract is properly characterized as a lease, it is necessary to consider all the facts and circumstances, including the following factors: (1) the degree of control over the property that is exercised by the nongovernmental person; and (2) whether a nongovernmental person bears the risk of loss of the financed property.

.06 Section 1.141–3(b)(4)(i) provides generally that a management contract with respect to financed property may result in private business use of that property, based on all of the facts and circumstances. A management contract with respect to financed property generally results in private business use of that property if the contract provides for compensation for services rendered with compensation based, in whole or in part, on a share of net profits from the operations of the facility. Section 1.141–3(b)(4)(iv) provides generally that a management contract with respect to financed property results in private business use of that property if the service provider is treated as the lessee or owner of financed property for federal income tax purposes.

.07 Section 1.141–3(b)(4)(ii) defines "management contract" as a management, service, or incentive payment contract between a governmental person and a service provider under which the service provider provides services involving all, a portion, or any function, of a facility. For example, a contract for the provision of management services for an entire hospital, a contract for management services for a specific department of a hospital, and an incentive payment contract for physician services to patients of a hospital are each treated as a management contract.

.08 Section 1.141–3(b)(4)(iii) provides that the following arrangements generally are not treated as management contracts that give rise to private business use: (A) contracts for services that are solely incidental to the primary governmental function or functions of a financed facility (for example, contracts for janitorial, office equipment repair, hospital billing, or similar services); (B) the mere granting of admitting privileges by a hospital to a doctor, even if those privileges are conditioned on the provision of de minimis services if those privileges are available to all qualified physicians in the area, consistent with the size and nature of the hospital's facilities; (C) a contract to provide for the operation of a facility or system of facilities that consists primarily of public utility property, if the only compensation is the reimbursement of actual and direct expenses of the service provider and reasonable administrative overhead expenses of the service provider; and (D) a contract to provide for services, if the only compensation is the reimbursement of the service provider for actual and direct expenses paid by the service provider to unrelated parties.

.09 Section 141(e) provides, in part, that the term "qualified bond" includes a qualified 501(c)(3) bond if certain requirements stated therein are met. Section 145(a) provides generally that "qualified 501(c)(3) bond" means any private activity bond issued as part of an issue if (1) all property that is to be provided by the net proceeds of the issue is to be owned by a 501(c)(3) organization or a governmental unit, and (2) such bond would not be a private activity bond if (A) 501(c)(3) organizations were treated as governmental units with respect to their activities that do not constitute unrelated trades or businesses, determined by applying § 513(a), and (B) § 141(b)(1) and (2) were applied by substituting "5 percent" for "10 percent" each place it appears and by substituting "net proceeds" for "proceeds" each place it appears. Section 1.145–2 provides that, with certain exceptions and modifications, §§ 1.141–0 through 1.141–15 apply to § 145(a).

.10 Rev. Proc. 97–13, 1997–1 C.B. 632, modified by Rev. Proc. 2001–39, 2001–2 C.B. 38, and amplified by Notice 2014–67, 2014–46 I.R.B. 822, sets forth conditions under which a management contract does not result in private business use under § 141 or cause the modified private business use test under § 145(a)(2)(B) to be met. These conditions include constraints on net profits arrangements, the permitted term of the management contract, the types of compensation, and the relationship between the parties.

.11 Rev. Proc. 97–13 as originally issued (the original safe harbors) specifies various permitted terms of contracts that depend on the extent to which the compensation is a fixed amount (that is, the greater the percentage of fixed compensation, the longer the permitted term of the management contract). For example, the original safe harbors permit (i) contracts of up to 15 years if at least 95 percent of the compensation consists of a periodic fixed fee, and (ii) contracts of two to five years if greater percentages of the compensation consist of variable fees, depending on the particular type of variable fee. Subsequently, in Notice 2014–67, the Treasury Department and the Internal Revenue Service expanded these safe harbors to address certain developments involving accountable care organizations after the enactment of the Patient Protection and Affordable Care Act, Pub. L. 111–148, 124 Stat. 119 (Affordable Care Act), and also to allow a broader range of variable compensation arrangements for shorter-term management contracts of up to five years. This revenue procedure builds upon the amplifications in Notice 2014–67 by taking a more flexible and less formulaic approach toward variable compensation for longer-term management contracts of up to 30 years. The safe harbor under this revenue procedure generally permits any type of fixed or variable compensation that is reasonable compensation for services rendered under the contract. This revenue procedure includes constraints on net profits arrangements and the relationship between the parties (as under the original safe harbors), but applies a more principles-based approach focusing on governmental control over projects, governmental bearing of risk of loss, economic lives of managed projects, and consistency of tax positions taken by the service provider.

SECTION 3. SCOPE

This revenue procedure applies to a management contract (as defined in section 4.02 of this revenue procedure) involving managed property (as defined in section 4.03 of this revenue procedure) financed with the proceeds of an issue of governmental bonds (as defined in § 1.141–1(b)) or qualified 501(c)(3) bonds under § 145.

SECTION 4. DEFINITIONS

For purposes of this revenue procedure, the following definitions apply:

.01 *Eligible expense reimbursement arrangement* means a management contract under which the only compensation consists of reimbursements of actual and direct expenses paid by the service provider to unrelated parties and reasonable related administrative overhead expenses of the service provider.

.02 *Management contract* means a management, service, or incentive payment contract between a qualified user and a service provider under which the service provider provides services for a managed property. A management contract does not include a contract or portion of a contract for the provision of services before a managed property is placed in service (for example, pre-operating services for construction design or construction management).

.03 *Managed property* means the portion of a project (as defined in § 1.141–6(a)(3)) with respect to which a service provider provides services.

.04 *Qualified user* means, for projects (as defined in § 1.141–6(a)(3)) financed with governmental bonds, any governmental person (as defined in § 1.141–1(b)) or, for projects financed with qualified 501(c)(3) bonds, any governmental person or 501(c)(3) organization with respect to its activities which do not constitute an unrelated trade or business, determined by applying § 513(a).

.05 *Service provider* means any person other than a qualified user that provides services to, or for the benefit of, a qualified user under a management contract.

.06 *Unrelated parties* means persons other than a related party (as defined in § 1.150–1(b)) or a service provider's employee.

SECTION 5. SAFE HARBOR CONDITIONS UNDER WHICH MANAGEMENT CONTRACTS DO NOT RESULT IN PRIVATE BUSINESS USE

.01 *In general*. If a management contract meets all of the applicable conditions of sections 5.02 through section 5.07 of this revenue procedure, or is an eligible expense reimbursement arrangement, the management contract does not result in private business use under § 141(b) or 145(a)(2)(B). Further, under section 5.08 of this revenue procedure, use functionally related and subordinate to a management contract that meets these conditions does not result in private business use.

.02 *General financial requirements*.

(1) *In general*. The payments to the service provider under the contract must be reasonable compensation for services rendered during the term of the contract. Compensation includes payments to reimburse actual and direct expenses paid by the service provider and related administrative overhead expenses of the service provider.

(2) *No net profits arrangements*. The contract must not provide to the service provider a share of net profits from the operation of the managed property. Compensation to the service provider will not be treated as providing a share of net profits if no element of the compensation takes into account, or is contingent upon, either the managed property's net profits or both the managed property's revenues and expenses for any fiscal period. For this purpose, the elements of the compensation are the eligibility for, the amount of, and the timing of the payment of the compensation. Further, solely for purposes of determining whether the amount of the compensation meets the requirements of this section 5.02(2), any reimbursements of actual and direct expenses paid by the service provider to unrelated parties are disregarded as compensation. Incentive compensation will not be treated as providing a share of net profits if the eligibility for the incentive compensation is determined by the service provider's performance in meeting one or more standards that measure quality of services, performance, or productivity, and the amount and the timing of the payment of the compensation meet the requirements of this section 5.02(2).

(3) *No bearing of net losses of the managed property*.

(a) The contract must not, in substance, impose upon the service provider the burden of bearing any share of net losses from the operation of the managed property. An arrangement will not be treated as requiring the service provider to bear a share of net losses if:

(i) The determination of the amount of the service provider's compensation and the amount of any expenses to be paid by the service provider (and not reimbursed), separately and collectively, do not take into account either the managed property's net losses or both the managed property's revenues and expenses for any fiscal period; and

(ii) The timing of the payment of compensation is not contingent upon the managed property's net losses.

(b) For example, a service provider whose compensation is reduced by a stated dollar amount (or one of multiple stated dollar amounts) for failure to keep the managed property's expenses below a specified target (or one of multiple specified targets) will not be treated as bearing a share of net losses as a result of this reduction.

.03 *Term of the contract and revisions*. The term of the contract, including all renewal options (as defined in § 1.141–1(b)), is no greater than the lesser of 30 years or 80 percent of the weighted average reasonably expected economic life of the managed property. For this purpose, economic life is determined in the same manner as under § 147(b), but without regard to § 147(b)(3)(B)(ii), as of the beginning of the term of the contract. A contract that is materially modified with respect to any matters relevant to this section 5 is retested under this section 5 as a new contract as of the date of the material modification.

.04 *Control over use of the managed property*. The qualified user must exercise a significant degree of control over the use of the managed property. This control requirement is met if the contract requires the qualified user to approve the annual budget of the managed property, capital expenditures with respect to the managed property, each disposition of property that is part of the managed property, rates charged for the use of the managed property, and the general nature and type of use of the managed property (for example, the type of services). For this purpose, for example, a qualified user may show approval of capital expenditures for a managed property by approving an annual budget for capital expenditures described by functional purpose and specific maximum amounts; and a qualified user may show approval of dispositions of property that is part of the managed property in a similar manner. Further, a qualified user may show approval of rates charged for use of the managed property by either expressly approving such rates (or the methodology for setting such rates) or by including in the contract a requirement that the service provider charge rates that are reasonable and customary as specifically determined by an independent third party.

.05 *Risk of loss of the managed property*. The qualified user must bear the risk of loss upon damage or destruction of the managed property (for example, upon force majeure). A qualified user does not fail to meet this risk of loss requirement as a result of insuring against risk of loss through a third party or imposing upon the service provider a penalty for failure to operate the managed property in accordance with the standards set forth in the management contract.

.06 *No inconsistent tax position*. The service provider must agree that it is not entitled to and will not take any tax position that is inconsistent with being a service provider to the qualified user with respect to the managed property. For example, the service provider must agree not to take any depreciation or amortization, investment tax credit, or deduction for any payment as rent with respect to the managed property.

.07 *No circumstances substantially limiting exercise of rights*.

(1) *In general*. The service provider must not have any role or relationship with the qualified user that, in effect, substantially limits the qualified user's ability to exercise its rights under the contract, based on all the facts and circumstances.

(2) *Safe harbor*. As a safe harbor, a service provider will not be treated as having a role or relationship prohibited under section 5.07(1) of this revenue procedure if:

(a) No more than 20 percent of the voting power of the governing body of the qualified user in the aggregate is vested in the directors, officers, shareholders, partners, members, and employees of the service provider;

(b) The governing body of the qualified user does not include the chief executive officer of the service provider or the chairperson (or equivalent executive) of the service provider's governing body; and

(c) The chief executive officer of the service provider is not the chief executive officer of the qualified user or any of the qualified user's related parties (as defined in § 1.150–1(b)).

(3) For purposes of section 5.07(2) of this revenue procedure, the phrase "service provider" includes related parties (as defined in § 1.150–1(b)) and the phrase "chief executive officer" includes a person with equivalent management responsibilities.

.08 *Functionally related and subordinate use*. A service provider's use of a project (as defined in § 1.141–6(a)(3)) that is functionally related and subordinate to performance of its services under a management contract for managed property that consists of all or a portion of that project and that meets the requirements of this section 5 does not result in private business use (for example, use of storage areas to store equipment used to perform activities required under a management contract that meets the requirements of this section 5 does not result in private business use).

SECTION 6. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 97–13 and Rev. Proc. 2001–39 are modified and superseded. Section 3.02 of Notice 2014–67 is modified and superseded. All other sections of Notice 2014–67 remain in effect.

SECTION 7. DATE OF APPLICABILITY

The safe harbors in this revenue procedure apply to any management contract that is entered into on or after August 22, 2016, and an issuer may apply these safe harbors to any management contract that was entered into before August 22, 2016. In addition, an issuer may apply the safe harbors in Rev. Proc. 97–13, as modified by Rev. Proc. 2001–39 and amplified by Notice 2014–67, to a management contract that is entered into before August 18, 2017 and that is not materially modified or extended on or after August 18, 2017 (other than pursuant to a renewal option as defined in § 1.141–1(b)).

SECTION 8. DRAFTING INFORMATION

The principal authors of this revenue procedure are Johanna Som de Cerff and David White of the Office of Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue procedure, contact David White on (202) 317-6980 (not a toll free number).

Part IV. Items of General Interest

User Fees for Installment Agreements

REG–108792–16

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed amendments to the regulations that provide user fees for installment agreements. The proposed amendments affect taxpayers who wish to pay their liabilities through installment agreements. The proposed effective date for these proposed amendments to the regulations is January 1, 2017. This document also provides a notice of public hearing on these proposed amendments to the regulations.

DATES: Written or electronic comments must be received by October 6, 2016. Outlines of topics to be discussed at the public hearing scheduled for October 19, 2016, at 2:00 pm must be received by October 6, 2016.

ADDRESSES: Send submissions to: Internal Revenue Service, CC:PA:LPD:PR (REG–108792–16), Room 5203, Post Office Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–108792–16), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC 20224 or sent electronically via the Federal eRulemaking Portal at *http://www.regulations.gov* (indicate IRS and REG–108792–16). The public hearing will be held in the Main IR Auditorium beginning at 2:00 pm in the Internal Revenue Service Building, 1111 Constitution Avenue, NW., Washington, DC 20224.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed amendments to the regulations, M. Pilar Puerto at (202) 317-5437; concerning submissions of comments, the hearing, or to be placed on the building access list to attend the hearing, Regina Johnson, at (202) 317-6901; concerning cost methodology, Eva Williams, at (202) 803-9728 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed regulations that would amend §§ 300.1 and 300.2 of the User Fee Regulations (26 CFR part 300), which provide for a user fee applicable to installment agreements under section 6159 of the Internal Revenue Code (Code).

Section 6159 authorizes the IRS to enter into an agreement with any taxpayer for the payment of tax in installments to the extent the IRS determines that entering into the installment agreement will facilitate the full or partial collection of the tax. Section 301.6159–1(a). Installment agreements are voluntary, and taxpayers may request an installment agreement in person, by completing the appropriate forms and mailing them to the IRS, online, or over the telephone. Before entering into an installment agreement, the IRS may examine the taxpayer's financial position to determine whether such an agreement is appropriate. See Internal Revenue Manual (IRM) 5.14. If the IRS accepts the installment agreement, the IRS must process the payments made by the taxpayer and monitor the taxpayer's compliance with the terms of the agreement. The terms of an agreement generally require the taxpayer to pay the minimum monthly payment on time, file all required tax returns on time, and pay all taxes in-full and on time. See Form 433–D, Installment Agreement. In addition, section 6159(d) requires that the IRS review partial payment installment agreements at least once every two years.

Under § 300.1, the IRS currently charges three rates for installment agreements. The user fee, in general, is $120 for an installment agreement. The user fee is reduced to $52 for a direct debit installment agreement, which is an agreement whereby the taxpayer authorizes the IRS to request the monthly electronic transfer of funds from the taxpayer's bank account to the IRS. The user fee is $43 notwithstanding the method of payment if the taxpayer is a low-income taxpayer, as defined below.

Under § 300.2, the IRS currently charges $50 for restructuring or reinstating an installment agreement that is in default. An installment agreement is deemed to be in default when a taxpayer fails to meet any of the conditions of the installment agreement. See IRM 5.14. Currently, there is no exception to this fee for low-income taxpayers.

Explanation of Provisions

A. *Overview*

To bring user fee rates for installment agreements in line with the full cost to the IRS of providing these taxpayer specific services, the proposed regulations under §§ 300.1 and 300.2 would increase the user fee for the existing installment agreement types and introduce two new types of online installment agreements, each subject to a separate user fee. Five of these proposed user fee rates are based on the full cost of establishing and monitoring installment agreements. The sixth rate is for low-income taxpayers.

- Regular Installment Agreements – A taxpayer contacts the IRS in person, by phone, or by mail and sets up an agreement to make manual payments over a period of time either by mailing a check or electronically through the Electronic Federal Tax Payment System (EFTPS). The proposed fee for entering into a regular installment agreement is $225.
- Direct Debit Installment Agreements – A taxpayer contacts the IRS by phone or mail and sets up an agreement to make automatic payments over a period of time through a direct debit from a bank account. The proposed fee for entering into a direct debit installment agreement is $107.
- Online Payment Agreements – A taxpayer sets up an installment agreement through *http://www.irs.gov* and agrees to make manual payments over a period of time either by mailing a check or electronically through the EFTPS. The proposed fee for entering into an online payment agreement is $149.

- Direct Debit Online Payment Agreements – A taxpayer sets up an installment agreement through *http://www.irs.gov* and agrees to make automatic payments over a period of time through a direct debit from a bank account. The proposed fee for entering into a direct debit online payment agreement is $31.
- Restructured/Reinstated Installment Agreements – A taxpayer modifies a previously established installment agreement or reinstates an installment agreement on which the taxpayer has defaulted. The proposed fee for restructuring or reinstating an installment agreement is $89.
- Low-Income Rate – A rate that applies when a low-income taxpayer enters into any type of installment agreement, other than a direct debit online payment agreement, and when a low-income taxpayer restructures or reinstates any installment agreement. A low-income taxpayer is a taxpayer that has income at or below 250 percent of the dollar criteria established by the poverty guidelines updated annually in the **Federal Register** by the U.S. Department of Health and Human Services. Section 300.1(b)(2). The proposed low-income rate is $43.

B. *User Fee Authority*

The Independent Offices Appropriations Act (IOAA) (31 U.S.C. 9701) authorizes each agency to promulgate regulations establishing the charge for services provided by the agency (user fees). The IOAA provides that these user fee regulations are subject to policies prescribed by the President and shall be as uniform as practicable. Those policies are currently set forth in the Office of Management and Budget (OMB) Circular A–25, 58 FR 38142 (July 15, 1993; OMB Circular).

The IOAA states that the services provided by an agency should be self-sustaining to the extent possible. 31 U.S.C. 9701(a). The OMB Circular states that agencies that provide services that confer special benefits on identifiable recipients beyond those accruing to the general public are to establish user fees that recover the full cost of providing those services. The OMB Circular requires that agencies identify all services that confer special benefits and determine whether user fees should be assessed for those services.

Agencies are to review user fees biennially and update them as necessary to reflect changes in the cost of providing the underlying services. During this biennial review, an agency must calculate the full cost of providing each service, taking into account all direct and indirect costs to any part of the U.S. government. The full cost of providing a service includes, but is not limited to, salaries, retirement benefits, rents, utilities, travel, and management costs, as well as an appropriate allocation of overhead and other support costs associated with providing the service.

An agency should set the user fee at an amount that recovers the full cost of providing the service unless the agency requests, and the OMB grants, an exception to the full cost requirement. The OMB may grant exceptions only where the cost of collecting the fees would represent an unduly large part of the fee for the activity or any other condition exists that, in the opinion of the agency head, justifies an exception. When the OMB grants an exception, the agency does not collect the full cost of providing the service and therefore must fund the remaining cost of providing the service from other available funding sources. By doing so, the agency subsidizes the cost of the service to the recipients of reduced-fee services even though the service confers a special benefit on those recipients who should otherwise be required to pay the full costs of receiving that benefit as provided for by the IOAA and the OMB Circular.

C. *Installment Agreement User Fee*

The installment agreement program confers a special benefit on identifiable recipients beyond those accruing to the general public. Specifically, a taxpayer that is granted an installment agreement is allowed to pay an outstanding tax obligation over time without being subjected to IRS levy related to these taxes during this term of repayment. See section 6331(k)(2) of the Code and § 301.6159–1(f). Section 6331(k)(2) generally prohibits the IRS from levying to collect taxes while a request to enter into an installment agreement is pending with the IRS, for 30 days after the rejection of a proposed installment agreement, and for 30 days immediately following the termination of an installment agreement. If, prior to the expiration of the 30-day period following the rejection or termination of an installment agreement, the taxpayer appeals the rejection or termination decision, no levy may be made while the rejection or termination is being considered by Appeals. Because of these special benefits the IOAA and the OMB Circular authorize the IRS to charge a user fee for an installment agreement that reflects the full cost of providing the service of the installment agreement program to the taxpayer.

The installment agreement user fees were last changed in 2014. As required by the IOAA and the OMB Circular, the IRS completed its 2015 biennial review of the installment agreement program and determined that the full cost of a regular installment agreement is $225, and the full cost of a direct debit installment agreement is $107. The IRS determined that the full cost of a regular online payment agreement is $149, and the full cost for a direct debit online payment agreement is $31. The IRS determined that the full cost of restructuring or reinstating an installment agreement is $89.

The proposed regulations adopt the full cost amounts as the new user fees for the various types of installment agreements. Historically, the IRS charged a user fee that recovered less than the full cost of an installment agreement to make the service more accessible to a broader range of taxpayers. However, in light of constraints on IRS resources for tax administration, the Treasury Department and the IRS have determined that it is necessary to recoup the full costs of the installment agreement program. The IRS will continue its practice of providing services subject to user fees at less than full cost where there is a compelling tax administration reason to do so. Therefore, these proposed regulations do not increase the reduced user fee for offers submitted by low-income taxpayers and introduce a reduced fee for requests by low-income taxpayers to restructure or reinstate defaulted installment agreements.

The proposed fees reflect the IRS's determination to continue to provide a wide variety of installment agreement options to taxpayers and, as required by the OMB Circular, to determine the full cost for each option. Since the enactment of the installment agreement program, the IRS has periodically developed new ways for taxpayers to enter into and pay for installment agreements, such as through online payment agreements and direct debit online payment agreements. These new installment agreement types have not had their own separate user fee, but instead have been included in the existing user fee structure. In recent years, taxpayers' use of the online installment agreement options have increased, justifying a separate fee structure for the online installment agreement options.

Consistent with introducing these new fees, the most recent full cost analysis of the installment agreement program has been refined to more precisely account for the costs associated with administering the various types of installment agreements available to taxpayers. Requesting installment agreements in person or over the phone and receiving payment through means other than direct debit is more costly for the IRS to administer, and the proposed user fees reflect these costs. Similarly, this recent analysis has resulted in the availability of reduced user fees to taxpayers for those options that cost less for the IRS to administer. By offering a range of installment agreement options at a range of fees, the IRS is assisting taxpayers in coming into compliance with their tax payment obligations, which benefits tax administration and provides an enhanced service to taxpayers.

D. *Calculation of User Fees Generally*

User fee calculations begin by first determining the full cost for the service. The IRS follows the guidance provided by the OMB Circular to compute the full cost of the service, which includes all indirect and direct costs to any part of the U.S. government including but not limited to direct and indirect personnel costs, physical overhead, rents, utilities, travel, and management costs. The IRS's cost methodology is described below.

Once the total amount of direct and indirect costs associated with a service is determined, the IRS follows the guidance in the OMB Circular to determine the costs associated with providing the service to each recipient, which represents the average per unit cost of that service. This average per unit cost is the amount of the user fee that will recover the full cost of the service.

The IRS follows generally accepted accounting principles (GAAP), as established by the Federal Accounting Standards Advisory Board (FASAB) in calculating the full cost of providing services. The FASAB Handbook of Accounting Standards and Other Pronouncements, as amended, which is available at *http://files.fasab.gov/pdffiles/2015_fasab_handbook.pdf*, includes the Statement of Federal Financial Accounting Standards No. 4: Managerial Cost Accounting Concepts and Standards for the Federal Government (SFFAS No.4). SFFAS No. 4 establishes internal costing standards under GAAP to accurately measure and manage the full cost of federal programs. The methodology described below is in accordance with SFFAS No. 4.

1. *Cost center allocation*

The IRS determines the cost of its services and the activities involved in producing them through a cost accounting system that tracks costs to organizational units. The lowest organizational unit in the IRS's cost accounting system is called a cost center. Cost centers are usually separate offices that are distinguished by subject-matter area of responsibility or geographic region. All costs of operating a cost center are recorded in the IRS's cost accounting system and allocated to that cost center. The costs allocated to a cost center are the direct costs for the cost center's activities as well as all indirect costs, including overhead, associated with that cost center. Each cost is recorded in only one cost center.

2. *Determining the per unit cost*

To establish the per unit cost, the total cost of providing the service is divided by the volume of services provided. The volume of services provided includes both services for which a fee is charged as well as subsidized services. The subsidized services are those where OMB has approved an exception to the full cost requirement, for example, to charge a reduced fee to low-income taxpayers. The volume of subsidized services is included in the total volume of services provided to ensure that the IRS, and not those who are paying full cost, subsidizes the cost of the reduced-full cost services.

3. *Cost estimation of direct labor and benefits*

Not all cost centers are fully devoted to only one service for which the IRS charges a user fee. Some cost centers work on a number of different services. In these cases, the IRS estimates the cost incurred in those cost centers attributable to the service for which a user fee is being calculated by measuring the time required to accomplish activities related to the service, and estimating the average time required to accomplish these activities. The average time required to accomplish these activities is multiplied by the relevant organizational unit's average labor and benefits cost per unit of time to determine the labor and benefits cost incurred to provide the service. To determine the full cost, the IRS then adds an appropriate overhead charge as discussed below.

4. *Calculating overhead*

Overhead is an indirect cost of operating an organization that cannot be immediately associated with an activity that the organization performs. Overhead includes costs of resources that are jointly or commonly consumed by one or more organizational unit's activities but are not specifically identifiable to a single activity.

These costs can include:

- General management and administrative services of sustaining and support organizations.
- Facilities management and ground maintenance services (security, rent, utilities, and building maintenance).
- Procurement and contracting services.
- Financial management and accounting services.
- Information technology services.
- Services to acquire and operate property, plants and equipment.
- Publication, reproduction, and graphics and video services.

- Research, analytical, and statistical services.
- Human resources/personnel services.
- Library and legal services.

To calculate the overhead allocable to a service, the IRS first calculates the Corporate Overhead rate and then multiplies the Corporate Overhead rate by the direct labor and benefits costs determined as discussed above. The IRS calculates the Corporate Overhead rate annually based on cost elements underlying the Statement of Net Cost included in the IRS Annual Financial Statements, which are audited by the Government Accountability Office. The Corporate Overhead rate is the ratio of the sum of the IRS's indirect labor and benefits costs from the supporting and sustaining organizational units—those that do not interact directly with taxpayers—and all non-labor costs to the IRS's labor and benefits costs of its organizational units that interact directly with taxpayers.

The Corporate Overhead rate of 65.85 percent for costs reviewed during FY 2015 was calculated based on FY 2014 costs as follows:

Indirect Labor and Benefits Costs	$1,693,339,843
Non-Labor Costs	+ *$2,832,262,970*
Total Indirect Costs	$4,525,602,813
Direct Labor and Benefits Costs	÷ *$6,872,934,473*
Corporate Overhead Rate	*65.85%*

E. *Calculation of Installment Agreement User Fee*

The full cost analysis considers the common components of each of the five installment agreement types as well as each type's unique cost drivers. The costs for each type of installment agreement are broadly categorized into two groups: (1) costs incurred by the IRS to establish the installment agreements and (2) costs incurred by the IRS to maintain and monitor the installment agreements.

The upfront costs for establishing installment agreements requested in person, in writing, or over the phone are significantly higher than those for online payment agreements. For that reason, the upfront costs for establishing installment agreements requested in person, in writing, or over the phone are determined separately and allocated only to installment agreements requested in person, in writing, or over the phone. In contrast, the only upfront costs to establish online payment agreements through *http://www.irs.gov* are the costs of the online payment agreement system such as annual maintenance and system enhancements, which are only allocated to online payment agreements.

After installment agreements are established, costs to maintain and monitor them, including routine notices to the taxpayers, vary significantly based on the type of installment agreement. Direct debit installment agreements and direct debit online payment agreements have lower maintenance and monitoring costs because they do not require as much support on an ongoing basis as installment agreements not paid via direct debit. Payments under direct debit installment agreements and direct debit online payment agreements are automatically debited from the taxpayer's bank account. Because payments for direct debit installment agreements and direct debit online payment agreements are automatically debited from taxpayers' accounts without requiring taxpayers to initiate each payment, the IRS does not send monthly payment notices and in general sends fewer notices related to these agreements compared to installment agreements not paid via direct debit. Correspondingly, direct debit installment agreements and direct debit online payment agreements require less IRS time responding to taxpayer inquiries resulting from these notices than do installment agreements not paid via direct debit.

1. *Establishing installment agreements*

The IRS allocates costs attributed to establishing installment agreements based on whether the installment agreement is a non-online installment agreement or an online payment agreement.

a. Non-Online Installment Agreements

For non-online installment agreements, the IRS identified the activities conducted across various organizations to establish agreements, obtained the time spent on the activities through various time tracking systems, obtained the labor and benefits rates for employees from the financial system for FY 2013 and 2014 who spent time establishing agreements, and averaged those costs to create an annualized average cost. The average labor and benefits costs to establish non-online installment agreements is $110,143,952, calculated as follows:

Collection Field Function	$53,268,552
Compliance Services Collection Operations	$19,989,943
Automated Collection System	$19,377,987
Customer Service Toll-Free	$6,183,764
Appeals Staff Labor and Benefits	$8,624,615
Field Assistance	$1,894,976
Examination	$804,115
Average Labor and Benefits Costs to Establish Non-Online Installment Agreements	$110,143,952

Because the non-labor costs for notices and telecommunication, which includes the costs of paper, postage and phone service, related to installment agreements can be identified, the IRS considered them to be direct costs for the installment agreement program. Accordingly, the IRS modified the calculation of the Corporate Overhead rate to exclude these notices and telecommunication costs from the total indirect costs in the calculation of the Corporate Overhead rate used for purposes of allocating Corporate Overhead to the installment agreement program (adjusted Corporate Overhead). The adjusted Corporate Overhead rate used for the entire installment agreement program is 60.89 percent, calculated as follows:

Indirect Labor and Benefits Costs	$1,693,339,843
Non-Labor Costs	+ $2,832,262,970
Non-Labor Costs for Notices and Telecommunication	($211,959,052)
Adjusted Total Indirect Costs	$4,313,643,761

Direct Labor and Benefits Costs	$6,872,934,473
Non-Labor Costs for Notices and Telecommunication	+ $211,959,052
Adjusted Direct Labor and Benefits Costs	$7,084,893,526
Adjusted Total Indirect Costs	$4,313,643,761
Adjusted Direct Labor and Benefits Costs	÷ $7,084,893,526
Adjusted Corporate Overhead Rate	*60.89%*

The IRS applied the adjusted Corporate Overhead rate to the labor and benefits costs to calculate the total labor and benefits cost for establishing non-online installment agreements as follows:

Labor and Benefits Costs to Establish Non-Online Installment Agreements	$110,143,952
Adjusted Corporate Overhead Rate (60.89%)	$67,066,653
Total Labor and Benefits and Adjusted Overhead Costs to Establish Non-Online Installment Agreements	$177,210,605

There are also non-labor costs attributed to establishing non-online installment agreements. Because these costs are non-labor, the IRS does not allocate any overhead to determine the total costs. The total non-labor costs for establishing non-online installment agreements are $636,046, calculated as follows:

Telecommunications	$145,169
Automated Collection System	$274,664
Customer Service Toll-Free	$216,213
Total Non-Labor Costs to Establish Non-Online Installment Agreements	$636,046

The total costs for establishing non-online installment agreements are $177,846,650, calculated as follows:

Total Labor and Benefits and Adjusted Overhead Costs to Establish Non-Online Installment Agreements	$177,210,605
Total Non-Labor Costs to Establish Non-Online Installment Agreements	$636,046
Total Costs to Establish Non-Online Installment Agreements	$177,846,650

To determine the unit cost to establish non-online installment agreements, the IRS divided the total cost by the average volume of non-online installment agreements. The IRS determined the volume of non-online installment agreements by averaging the volumes of new agreements entered into in FY 2013 and FY 2014. The unit cost was calculated as follows:

Total Costs to Establish Non-Online Installment Agreements	$177,846,650
Average Annual Volume	2,175,142
Unit Cost to Establish Non-Online Installment Agreements	$81.76

b. Online Installment Agreements

For online payment agreements, the only cost to establish those agreements is the cost for the online payment agreement system that allows taxpayers to set up the agreements. In FY 2014, the IRS performed a substantial enhancement to this system at a cost of $4,200,000. The IRS amortizes system enhancements over a six year period; therefore, for FY 2014 through FY 2020 the annual amortized system cost for online payment agreements is $700,000. In addition to the annual amortized cost, the IRS incurs $200,000 in annual system maintenance costs for this system. The total annual cost for the online payment agreement system is $900,000. The use of online payment agreements is trending upward and the IRS expects this upward trend to continue as more taxpayers utilize the IRS's online systems. To reflect the IRS's expectation of increased use of online systems, the IRS adjusted upward the average volume of online payment agreements received in FY 2013 and FY 2014 consistent with that expectation. The total cost to establish online payment agreements is $6, calculated as follows:

Amortized System Upgrade	$700,000
Annual System Maintenance Cost	$200,000
Average Yearly System Cost	$900,000
Average Annual Volume	150,000
Unit Cost to Establish Online Payment Agreement	$6

2. *Maintaining and monitoring installment agreements*

The costs for maintaining and monitoring installment agreements consist of the costs of monitoring and telecommunications labor and benefits, an allocation of overhead to these labor costs, and notice and telecommunication non-labor costs.

The IRS identified the activities conducted across various business units to monitor installment agreements, obtained the time spent on the activities through various time tracking systems, obtained the labor and benefits rates for these personnel from the financial system for FY 2013 and 2014, and determined the average annual cost for monitoring installment agreements.

The IRS allocated the costs attributed to maintaining and monitoring installment agreements based on whether the agreement is a direct debit agreement (Direct Debit Installment Agreement or Direct Debit Online Payment Agreement), a non-direct debit agreement (Regular Agreement or Online Payment Agreement), or a Restructured/Reinstated Installment Agreement. The following sections describe the costs allocated to various types of installment agreements for maintaining and monitoring.

The IRS continuously monitors all installment agreements for accounts not meeting the terms of the agreement, for returned payments, and various other circumstances that result in a need to contact the taxpayer. When these circumstances arise, the IRS reviews the account and sends a notice to the taxpayer, as needed, to resolve the condition. The IRS maintains a system that measures the hours of correspondence labor by type of notice sent to taxpayers.

Generally, the IRS uses the costs for two years and averages those costs to determine the cost of an activity. However, for this component of cost, the IRS used existing data for the hours spent in FY 2014 on correspondence labor related to monitoring installment agreements and calculated total labor and benefits for those hours. The IRS does not believe including an additional year of data would result in a significant difference in the result. In the future, the IRS intends to use the average cost of two years to calculate this cost component. The total annual cost of correspondence for monitoring agreements labor and benefits is $5,807,847.

The IRS divided the total annual labor and benefits cost of correspondence for monitoring agreements by the total agreements in inventory at the end of FY 2014. The total inventory was 3,973,208, resulting in annual labor and benefits cost per agreement of $1.46. The IRS converted the annual cost of correspondence for monitoring agreements labor and benefits to a per-agreement cost by dividing the annual cost per installment agreement by 12 months to calculate the monthly cost per installment agreement. The IRS then multiplied the monthly cost per installment agreement by 40.31 months, the average term of installment agreements (in months), to calculate the unit cost over the life of the installment agreement.

Total Annual Cost of Correspondence for Monitoring Agreements Labor and Benefits	$5,807,847
Total Agreements in Inventory at End of FY 2014	3,973,208
Annual Labor and Benefits Cost per Agreement	$1.46
Monthly Cost Per Agreement (Annual Labor and Benefits Cost per Agreement divided by 12 months)	$0.12
Average Term of Installment Agreement (in months)	40.31
Unit Cost of Correspondence for Monitoring Agreements Labor and Benefits Over the Life of Installment Agreement	$4.91

There is not a significant difference in the cost of monitoring regular and direct debit installment agreements; therefore, each type of agreement is allocated the same ratio of monitoring costs. Restructured/reinstated installment agreements are not allocated any monitoring costs because monitoring costs for restructured/reinstated agreements are recovered in the original user fee. The unit cost of correspondence for monitoring agreements labor and benefits per installment agreement is shown below:

	Regular Agreement	Direct Debit Installment Agreement	Restructured/Reinstated Installment Agreement
Unit Cost of Correspondence for Monitoring Agreements Labor and Benefits Over the Life of Installment Agreement	$4.91	$4.91	$0

The IRS maintains a system that calculates the number of seconds spent on the phone by type of call. To determine the telecommunications labor and benefits costs to maintain and monitor installment agreements, IRS first analyzed the time spent on phone calls related to monitoring and maintaining installment agreements, rather than establishing one. The total seconds are converted into hours and hourly salary and benefits rates are applied.

The average labor and benefits costs for responding to installment agreement questions are $58,917,275 for FY 2013 and FY 2014. These costs are accumulated by type of installment agreement. To determine the annual unit cost per type of agreement, the IRS used the total volume of the corresponding installment agreements in inventory at the end of FY 2014 as the baseline for the number of installment agreements that generate telecommunications costs of responding to questions. The IRS divided the average labor and benefits costs separated by type of agreement by the total agreements in inventory at the end of FY 2014 for each type of agreement. The IRS converted the annual cost of correspondence for telecommunications labor and benefits to a per-agreement cost as follows:

	Non-direct Debit Installment Agreement	Direct Debit Installment Agreement	Restructured/Reinstated Agreement
Average Telecommunications Labor and Benefits Costs	$55,872,940	$2,014,736	$1,029,598
Volume of Installment Agreements in Inventory at end of FY 2014 by Type	3,084,844	888,364	1,082,303
Annual Unit Cost Per Installment Agreement	$18.11	$2.27	$0.95
Monthly Cost Per Installment Agreement 4 (Annual Unit Cost Per Installment Agreement divided by 12 months)	$1.51	$0.19	$0.08
Average Term of Installment Agreement (in months)	40.31	40.31	40.31
Unit Cost for Telecommunications Labor and Benefits Over the Life of the Installment Agreement	$60.84	$7.62	$3.20

Next, the IRS determined the appropriate allocation of overhead for installment agreements. As noted above, the IRS adjusted the Corporate Overhead Rate for the installment agreement program down to 60.89 percent. The IRS applied this adjusted Corporate Overhead rate to the total labor and benefits costs for monitoring and telecommunications calculated above. The total labor unit cost including the adjusted Corporate Overhead allocated to each type installment agreement is as follows:

	Non-direct Debit Installment Agreement	Direct Debit Installment Agreement	Restructured/Reinstated Agreement
Unit Cost of Correspondence for Monitoring Agreements Labor and Benefits Over the Life of Installment Agreement	$4.91	$4.91	$0
Unit Cost for Telecommunications Labor and Benefits Over the Life of the Installment Agreement	$60.84	$7.62	$3.20
Subtotal	$65.75	$12.53	$3.20
Adjusted Corporate Overhead (60.89%)	$40.03	$7.63	$1.95
Maintain and Monitor Labor and Benefits Unit Cost	$105.78	$20.16	$5.15

The final element of the cost analysis for maintaining and monitoring installment agreements is the cost of non-labor notice and telecommunications. The IRS maintains a system for tracking notices and telecommunication costs. Each type of notice has a known number of pages, postage, and telecommunication costs responding to taxpayer inquiries related to the notices. The average annual non-labor cost for all notices and telecommunication related to installment agreements is $36,219,659. The IRS divided the total average notice and telecommunication non-labor cost by the total volume of agreements in inventory at the end of FY 2014 to determine the annual notice and telecommunication non-labor cost per installment agreement. The IRS converted the annual cost of notice and telecommunications to a per-agreement cost as follows:

	Regular Installment Agreement	Direct Debit Installment Agreement	Restructured/Reinstated Agreement
Average Annual Non-Labor Cost of All Notices	$33,005,331	$1,190,147	$608,206
Average Annual Non-Labor Cost of Telecommunication	$1,342,810	$48,421	$24,745
Total Average Notice and Telecommunication Non-Labor Costs	$34,348,141	$1,238,568	$632,950
Total Volume of Agreements in Inventory at end of FY 2014	3,084,844	888,364	1,082,303
Annual Notice and Telecommunication Non-Labor Cost Per Installment Agreement	$11.13	$1.39	$0.58
Monthly Notice and Telecommunication Non-Labor Cost Per Installment Agreement (Annual Notice and Telecommunication Non-Labor Cost divided by 12 months)	$0.93	$0.12	$0.05
Average Term of Installment Agreement (in months)	40.31	40.31	40.31
Unit Cost for Notice and Telecommunication Non-Labor Over the Life of the Installment Agreement	$37.40	$4.68	$1.96

The unit costs for maintaining and monitoring an installment agreement based on the total cost of maintaining and monitoring all installment agreements are as follows:

	Regular Installment Agreement	Direct Debit Installment Agreement	Restructured/Reinstated Agreement
Maintain and Monitor Labor Unit Costs	$105.78	$20.16	$5.15
Maintain and Monitor Non-Labor Unit Cost	$37.40	$4.68	$1.96
Total Maintain and Monitor Unit Cost	$143.18	$24.84	$7.11

3. *Per unit full cost of each type of installment agreement*

The per unit full cost and rates per each type of installment agreement are as follows:

	Regular Agreement	Direct Debit Installment Agreement	Restructured/Reinstated Installment Agreement	Direct Debit Online Payment Agreements	Online Payment Agreements
Unit Cost to Establish	$81.76	$81.76	$81.76	$6.00	$6.00
Unit Cost to Maintain and Monitor	$143.18	$24.84	$7.11	$24.84	$143.18
Per Unit Full Cost	$224.94	$106.60	$88.87	$30.84	$149.18
Rate	$225	$107	$89	$31	$149

4. *Low income installment agreement user fee*

The proposed regulations maintain the low-income taxpayer user fee of $43 for regular installment agreements and direct debit installment agreements and extend the low-income taxpayer user fee of $43 to restructured/reinstated installment agreements and online payment agreements. When the IRS first instituted the $43 user fee for low-income taxpayers, it determined that this amount would not unduly burden or disproportionately dissuade low-income taxpayers from seeking installment agreements. Historically, approximately one-third of all installment agreement requests have come from low-income taxpayers, a percentage that has remained relatively consistent since the introduction of the $43 low-income taxpayer rate. In light of this, the IRS has determined to maintain the existing $43 user fee for low-income taxpayers and to extend this reduced user fee to restructured/reinstated installment agreements and online payment agreements requested by low-income taxpayers. Because the full cost of direct debit online payment agreements of $31 is less than the low-income taxpayer user fee, all taxpayers will be charged the same $31 user fee for direct debit online payment agreements.

Special Analyses

Certain IRS regulations, including this one, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory impact 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 information that follows. The economic impact of these regulations on any small entity would result from the entity being required to pay a fee prescribed by these regulations in order to obtain a particular service. The dollar amount of the fee is not, however, substantial enough to have a significant economic impact on any entity subject to the fee. Low-income taxpayers and taxpayers entering into direct debit online payment agreements will be charged a lower fee, which lessens the economic impact of these regulations. Accordingly, 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 Public Hearing

Before these proposed amendments to the regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the "ADDRESSES" heading. The Treasury Department and the IRS request comments on all aspects of the proposed regulations. All comments will be available at *www.regulations.gov* or upon request.

A public hearing has been scheduled for October 19, 2016, beginning at 2:00 pm in the Main IR Auditorium of the Internal Revenue Service Building, 1111 Constitution Avenue NW., Washington, DC. 20224. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written comments or electronic comments by October 6, 2016 and submit an outline of the topics to be discussed and the amount of time to be devoted to each topic (a signed original and 8 copies) by October 6, 2016. 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 Maria Del Pilar Puerto of the Office of Associate Chief Counsel (Procedure and Administration). Other personnel from the Treasury Department and the IRS participated in their development.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 300 is proposed to be amended as follows:

PART 300—USER FEES

Paragraph 1. The authority citation for part 300 continues to read as follows:

Authority: 31 U.S.C. 9701.

Par. 2. In § 300.1, paragraphs (b) and (d) are revised to read as follows:

§ 300.1 Installment agreement fee.

* * * * *

(b) *Fee*. The fee for entering into an installment agreement before January 1, 2017, is $120. The fee for entering into an installment agreement on or after January 1, 2017, is $225. A reduced fee applies in the following situations:

(1) For installment agreements entered into before January 1, 2017, the fee is $52 when the taxpayer pays by way of a direct debit from the taxpayer's bank account. The fee is $107 when the taxpayer pays by way of a direct debit from the taxpayer's bank account for installment agreements entered into on or after January 1, 2017;

(2) For online payment agreements entered into before January 1, 2017, the fee is $120, except that the fee is $52 when the taxpayer pays by way of a direct debit from the taxpayer's bank account. The fee is $149 for entering into online payment agreements on or after January 1, 2017, except that the fee is $31 when the taxpayer pays by way of a direct debit from the taxpayer's bank account; and

(3) Notwithstanding the type of installment agreement and method of payment, the fee is $43 if the taxpayer is a low-income taxpayer, that is, an individual who falls at or below 250 percent of the dollar criteria established by the poverty guidelines updated annually in the **Federal Register** by the U.S. Department of Health and Human Services under authority of section 673(2) of the Omnibus Budget Reconciliation Act of 1981 (95 Stat. 357, 511), or such other measure that is adopted by the Secretary, except that the fee is $31 when the taxpayer pays by way of a direct debit from the taxpayer's bank account with respect to online payment agreements entered into on or after January 1, 2017;

* * * * *

(d) *Effective/applicability date*. This section is applicable beginning January 1, 2017.

Par. 3. In § 300.2, paragraphs (b) and (d) are revised to read as follows:

§ 300.2 Restructuring or reinstatement of installment agreement fee.

* * * * *

(b) *Fee*. The fee for restructuring or reinstating an installment agreement before January 1, 2017, is $50. The fee for restructuring or reinstating an installment agreement on or after January 1, 2017, is $89. If the taxpayer is a low-income taxpayer, that is, an individual who falls at or below 250 percent of the dollar criteria established by the poverty guidelines updated annually in the **Federal Register** by the U.S. Department of Health and Human Services under authority of section 673(2) of the Omnibus Budget Reconciliation Act of 1981 (95 Stat. 357, 511), or such other measure that is adopted by the Secretary, then the fee for restructuring or reinstating an installment agreement on or after January 1, 2017 is $43.

* * * * *

(d) *Effective/applicability date*. This section is applicable beginning January 1, 2017.

John Dalrymple,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on August 19, 2016, 8:45 a.m., and published in the issue of the Federal Register for August 22, 2016, 81 F.R. 56543)

Estate, Gift, and Generation-Skipping Transfer Taxes; Restrictions on Liquidation of an Interest

REG–163113–02

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations concerning the valuation of interests in corporations and partnerships for estate, gift, and generation-skipping transfer (GST) tax purposes. Specifically, these proposed regulations concern the treatment of certain lapsing rights and restrictions on liquidation in determining the value of the transferred interests. These proposed regulations affect certain transferors of interests in corporations and partnerships and are necessary to prevent the undervaluation of such transferred interests.

DATES: Written and electronic comments must be received by November 2, 2016. Outlines of topics to be discussed at the public hearing scheduled for December 1, 2016, must be received by November 2, 2016.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–163113–02), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions also may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:PA:LPD:PR (REG–163113–02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224, or sent electronically via the Federal eRulemaking portal at www.regulations.gov (IRS REG–163113–02). The public hearing will be held in the Auditorium, Internal Revenue Service Building, 1111 Constitution Avenue, NW, Washington, DC 20224.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, John D. MacEachen, (202) 317-6859; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Regina L. Johnson at (202) 317-6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Section 2704 of the Internal Revenue Code provides special valuation rules for purposes of subtitle B (relating to estate, gift, and GST taxes) for valuing intra-family transfers of interests in corporations and partnerships subject to lapsing voting or liquidation rights and restrictions on liquidation. Lapses of voting or liquidation rights are treated as a transfer of the excess of the fair market value of all interests held by the transferor, determined as if the voting or liquidation rights were nonlapsing, over the fair market value of such interests after the lapse. Certain restrictions on liquidation are disregarded in determining the fair market value of the transferred interest. The legislative history of section 2704 states that the provision is intended, in part, to prevent results similar to that in *Estate of Harrison v. Commissioner*, T.C. Memo. 1987–8. Informal S. Rep. on S. 3209, 136 Cong. Rec. S15629–4 (October 18, 1990); H.R. Conf. Rep. No. 101–964, 2374, 2842 (October 27, 1990).

In *Harrison*, the decedent and two of his children each held a general partner interest in a partnership immediately before the decedent's death. The decedent also held all of the limited partner interests in the partnership. Because any general partner could liquidate the partnership during life, each general partner could cause all partners to obtain the full value of such partner's partnership interests. A general partner's right to liquidate the partnership lapsed on the death of that partner. In determining the estate tax value of the decedent's limited partner interest, the court concluded that the right of the decedent to liquidate the partnership (and thus readily obtain the full value of the limited partner interest) could not be taken into account because that right lapsed at death. As a result, the Court determined the value for transfer tax purposes of the limited partner interest to be less than its value either in the hands of the decedent immediately before death or in the hands of his family (the other general partners) immediately after death.

Section 2704(a)(1) provides generally that, if there is a lapse of any voting or liquidation right in a corporation or a partnership and the individual holding such right immediately before the lapse and members of such individual's family hold, both before and after the lapse, control of the entity, such lapse shall be treated as a transfer by such individual by gift, or a transfer which is includible in the gross estate, whichever is applicable. The amount of the transfer is the fair market value of all interests held by the individual immediately before the lapse (determined as if the voting and liquidation rights were nonlapsing) over the fair market value of such interests after the lapse.

Section 25.2704–1(a)(2)(v) of the current Gift Tax Regulations defines a liquidation right as the right or ability, including by reason of aggregate voting power, to compel the entity to acquire all or a portion of the holder's equity interest in the entity, whether or not its exercise would result in the complete liquidation of the entity.

Section 25.2704–1(c)(1) provides a rule that a lapse of a liquidation right occurs at the time a presently exercisable liquidation right is restricted or eliminated. However, under § 25.2704–1(c)(1), a transfer of an interest that results in the lapse of a liquidation right generally is not subject to this rule if the rights with respect to the transferred interest are not restricted or eliminated. The effect of this exception is that the inter vivos transfer of a minority interest by the holder of an interest with the aggregate voting power to compel the entity to acquire the holder's interest is not treated as a lapse even though the transfer results in the loss of the transferor's presently exercisable liquidation right.

The Treasury Department and the IRS, however, believe that this exception should not apply when the inter vivos transfer that results in the loss of the power to liquidate occurs on the decedent's deathbed. *Cf. Estate of Murphy v. Commissioner*, T.C. Memo. 1990–472 (rejecting "attempts to avoid taxation of the control value of stock holdings through bifurcation of the blocks"). Such transfers generally have minimal economic effects, but result in a transfer tax value that is less than the value of the interest either in the hands of the decedent prior to death or in the hands of the decedent's family immediately after death. *See Harrison*, *supra*. The enactment of section 2704 was intended to prevent this result. *See* Informal S. Rep. on S. 3209, *supra*; H.R. Conf. Rep. No. 101–964, *supra*. *See also* section 2704(a)(3) (conferring on the Secretary broad regulatory authority to apply section 2704(a) to the lapse of rights similar to voting and liquidation rights). The Treasury Department and the IRS have concluded that the regulatory exception created in § 25.2704–1(c)(1) should apply only to transfers occurring more than three years before death, where the loss of control over liquidation is likely to have a more substantive effect. A bright-line test will avoid the fact-intensive inquiry underlying a determination of a donor's subjective motive which is administratively burdensome for both taxpayers and the IRS. *Cf.* section 2035(a) (replacing the contemplation of death presumption of prior law with a bright-line, three-year test). Accordingly, the proposed regulations treat transfers occurring within three years of death that result in the lapse of a liquidation right as transfers occurring at death for purposes of section 2704(a).

Section 2704(b)(1) provides generally that, if a transferor transfers an interest in a corporation or partnership to (or for the benefit of) a member of the transferor's family, and the transferor and members of the transferor's family hold, immediately before the transfer, control of the entity, any "applicable restriction" is disregarded in valuing the transferred interest. Under section 2704(b)(2), an applicable restriction is defined as a restriction that effectively limits the ability of the entity to liquidate, but which, after the transfer, either in whole or in part, will lapse or may be removed by the transferor or the transferor's family, either alone or collectively. Section 2704(b)(3)(B) excepts from the definition of an applicable restriction any restriction "imposed, or required to be imposed, by any Federal or State law."

Section 2704(b)(4) provides that the Secretary may by regulations provide that other restrictions shall be disregarded in determining the value of any interest in a corporation or a partnership transferred to a member of the transferor's family if the restriction has the effect of reducing the value of the transferred interest for transfer tax purposes but does not ultimately reduce the value of the interest to the transferee.

Section 25.2704–2(b) provides, in part, that an applicable restriction "is a limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction."

The Treasury Department and the IRS have determined that the current regulations have been rendered substantially ineffective in implementing the purpose and intent of the statute by changes in state laws and by other subsequent developments. First, courts have concluded that, under the current regulations, section 2704(b) applies only to restrictions on the ability to liquidate an entire entity, and not to restrictions on the ability to liquidate a transferred interest in that entity. *Kerr v. Commissioner*, 113 T.C. 449, 473 (1999), *aff'd*, 292 F.3rd 490 (5th Cir. 2002). Thus, a restriction on the ability to liquidate an individual interest is not an applicable restriction under the current regulations.

Second, as noted above, the current regulations except from the definition of an applicable restriction a restriction on liquidation that is no more restrictive than that of the state law that would apply in the absence of the restriction. The Tax Court viewed this as a regulatory expansion of the statutory exception to the application of section 2704(b) contained in section 2704(b)(3)(B) that excepts "any restriction imposed, or required to be imposed, by any Federal or State law." *Kerr*, 113 T.C. at 472. Since the promulgation of the current regulations, many state statutes governing limited partnerships have been revised to allow liquidation of the entity only on the unanimous vote of all owners (unless provided otherwise in the partnership agreement), and to eliminate the statutory default provision that had allowed a limited partner to liquidate his or her limited partner interest. Instead, statutes in these jurisdictions typically now provide that a limited partner may not withdraw from the partnership unless the partnership agreement provides otherwise. *See*, *e.g.*, Tex. Bus. Orgs. Ann. § 153.110 (West 2016) (limited partner may withdraw as specified in the partnership agreement); Uniform Limited Partnership Act (2001) § 601(a), 6A U.L.A. 348, 448 (Supp. 2015) (limited partner has no right to withdraw before completion of the winding up of the partnership). Further, other state statutes have been revised to create elective restrictions on liquidation. *See*, *e.g.*, Nev. Rev. Stat. § 87A.427 (2016) (limited partnership electing to be restricted limited partnership may not make any distributions for a 10-year period). Each of these statutes is designed to be at least as restrictive as the maximum restriction on liquidation that could be imposed in a partnership agreement. The result is that the provisions of a partnership agreement restricting liquidation generally fall within the regulatory exception for restrictions that are no more restrictive than those under state law, and thus do not constitute applicable restrictions under the current regulations.

Third, taxpayers have attempted to avoid the application of section 2704(b) through the transfer of a partnership interest to an assignee rather than to a partner. Again relying on the regulatory exception for restrictions that are no more restrictive than those under state law, and the fact that an assignee is allocated partnership income, gain, loss, etc., but does not have (and thus may not exercise) the rights or powers of a partner, taxpayers argue that an assignee's inability to cause the partnership to liquidate his or her partnership interest is no greater a restriction than that imposed upon assignees under state law. *Kerr*, 113 T.C. at 463–64; *Estate of Jones v. Commissioner*, 116 T.C. 121, 129–30 (2001). Taxpayers thus argue that the assignee status of the transferred interest is not an applicable restriction.

Finally, taxpayers have avoided the application of section 2704(b) through the transfer of a nominal partnership interest to a nonfamily member, such as a charity or an employee, to ensure that the family alone does not have the power to remove a restriction. *Kerr*, 292 F.3rd at 494.

As the Tax Court noted in *Kerr*, Congress granted the Secretary broad discretion in section 2704(b)(4) to promulgate regulations identifying restrictions not covered by section 2704(b) that nevertheless should be disregarded for transfer tax valuation purposes. 113 T.C. at 474. The Treasury Department and the IRS have concluded that, as was recognized by Congress when enacting section 2704(b), there are additional restrictions that may affect adversely the transfer tax value of an interest but that do not reduce the value of the interest to the family-member transferee, and thus should be disregarded for transfer tax valuation purposes. H.R. Conf. Rep. No. 101–964, *supra*, at 1138. The Treasury Department and the IRS have determined that such restrictions include: (a) a restriction on the ability to liquidate the transferred interest; and (b) any restrictions attendant upon the nature or extent of the property to be received in exchange for the liquidated interest, or the timing of the payment of that property.

Further, the Treasury Department and the IRS have concluded that the grant of an insubstantial interest in the entity to a nonfamily member should not preclude the application of section 2704(b) because, in reality, such nonfamily member interest generally does not constrain the family's ability to remove a restriction on the liquidation of an individual interest. *Cf. Kerr*, 292 F.3rd at 494 (noting that a charity receiving a partnership interest would "convert its interests into cash as soon as possible, so long as it believed the transaction to be in its best interest and that it would receive fair market value for its interest"). The interest of such nonfamily members does not affect the family's control of the entity, but rather, when combined with a requirement that all holders approve liquidation, is designed to reduce the transfer tax value of the family-held interests while not ultimately reducing the value of those interests to the family member transferees. The enactment of section 2704 was intended to prevent this result. See section 2704(b)(4) (conferring on the Secretary broad regulatory authority to apply section 2704(b) to other restrictions if the restriction has the effect of reducing the value of the transferred interest for transfer tax purposes but does not ultimately reduce the value of the interest to the transferee). The Treasury Department and the IRS have concluded that the presence of a nonfamily-member interest should be recognized only where the interest is an economically substantial and longstanding one that is likely to have a more substantive effect. A bright-line test will avoid the fact-intensive inquiry underlying a determination of whether the interest of the nonfamily member effectively constrains the family's ability to liquidate the entity. Accordingly, the proposed regulations disregard the interest held by a nonfamily member that has been held less than three years before the date of the transfer, that constitutes less than 10 percent of the value of all of the equity interests, that when combined with the interests of other nonfamily members constitutes less than 20 percent of the value of all of the equity interests, or that lacks a right to put the interest to the entity and receive a minimum value.

Finally, since the promulgation of §§ 301.7701–1 through 301.7701–3 of the Procedure and Administration Regulations (the check-the-box regulations), an entity's classification for federal tax purposes may differ substantially from the entity's structure or form under local law. In addition, many taxpayers now utilize a limited liability company (LLC) as the preferred entity to hold family assets or business interests. The Treasury Department and the IRS have concluded that the regulations under section 2704 should be updated to reflect these significant developments.

Explanation of Provisions

The proposed regulations would amend § 25.2701–2 to address what constitutes control of an LLC or other entity or arrangement that is not a corporation, partnership, or limited partnership. The proposed regulations would amend § 25.2704–1 to address deathbed transfers that result in the lapse of a liquidation right and to clarify the treatment of a transfer that results in the creation of an assignee interest. The proposed regulations would amend § 25.2704–2 to refine the definition of the term "applicable restriction" by eliminating the comparison to the liquidation limitations of state law. Further, the proposed regulations would add a new section, § 25.2704–3, to address restrictions on the liquidation of an individual interest in an entity and the effect of insubstantial interests held by persons who are not members of the family.

Covered Entities

The proposed regulations would clarify, in §§ 25.2704–1 through 25.2704–3, that section 2704 applies to corporations, partnerships, LLC's, and other entities and arrangements that are business entities within the meaning of § 301.7701–2(a), regardless of whether the entity or arrangement is domestic or foreign, regardless of how the entity or arrangement is classified for other federal tax purposes, and regardless of whether the entity or arrangement is disregarded as an entity separate from its owner for other federal tax purposes.

Classification of the Entity

Section 2704 speaks in terms of corporations and partnerships. Under the proposed regulations, a corporation is any business entity described in § 301.7701–2(b)(1), (3), (4), (5), (6), (7), or (8), an S corporation within the meaning of section 1361(a)(1), and a qualified subchapter S subsidiary within the meaning of section 1361(b)(3)(B). For this purpose, a qualified subchapter S subsidiary is treated as a corporation that is separate from its parent owner. For most purposes under the proposed regulations, a partnership would be any other business entity within the meaning of § 301.7701–1(a), regardless of how the entity is classified for federal tax purposes.

However, these proposed regulations address two situations in which it is necessary to go beyond this division of entities into only the two categories of corporation and partnership. These situations (specifically, the test to determine control of an entity, and the test to determine whether a restriction is imposed under state law) require consideration of the differences among various types of business entities under the local law under which those entities are created and governed. As a result, for purposes of the test to determine control of an entity and to determine whether a restriction is imposed under state law, the proposed regulations would provide that in the case of any business entity or arrangement that is not a corporation, the form of the entity or arrangement would be determined under local law, regardless of how it is classified for other federal tax purposes, and regardless of whether it is disregarded as an entity separate from its owner for other federal tax purposes. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, under which the entity or arrangement is created or organized. Thus, in applying these two tests, there would be three types of entities: corporations, partnerships (including limited partnerships), and other business entities (which would include LLCs that are not S corporations) as determined under local law.

Control of the Entity

Section 2704(c)(1) incorporates the definition of control found in section 2701(b)(2). Control of a corporation, partnership, or limited partnership is defined in sections 2701(b)(2)(A) and (B). The proposed regulations would clarify, in § 25.2701–2, that control of an LLC or of any other entity or arrangement that is not a corporation, partnership, or limited partnership would constitute the holding of at least 50 percent of either the capital or profits interests of the entity or arrangement, or the holding of any equity interest with the ability to cause the full or partial liquidation of the entity or arrangement. *Cf.* section 2701(b)(2)(B)(ii) (defining control of a limited partnership as including the holding of any interest as a general partner). Further, for purposes of determining control, under the attribution rules of existing § 25.2701–6, an individual, the individual's estate, and members of the individual's family are treated as holding interests held indirectly through a corporation, partnership, trust, or other entity.

Lapses under Section 2704(a)

The proposed regulations would amend § 25.2704–1(a) to confirm that a transfer that results in the restriction or elimination of any of the rights or powers associated with the transferred interest (an assignee interest) is treated as a lapse within the meaning of section 2704(a). This is the case regardless of whether the right or power is exercisable by the transferor after the transfer because the statute is concerned with the lapse of rights associated with the transferred interest. Whether the lapse is of a voting or liquidation right is determined under the general rules of section 25.2704–1.

The proposed regulations also would amend § 25.2704–1(c)(1) to narrow the exception in the definition of a lapse of a liquidation right to transfers occurring three years or more before the transferor's death that do not restrict or eliminate the rights associated with the ownership of the transferred interest. In addition, the proposed regulations would amend § 25.2704–1(c)(2)(i)(B) to conform the existing provision for testing the family's ability to liquidate an interest with the proposed elimination of the comparison with local law, to clarify that the manner in which liquidation may be achieved is irrelevant, and to conform with the proposed provision for disregarding certain nonfamily-member interests in testing the family's ability to remove a restriction in proposed § 25.2704–3 regarding disregarded restrictions.

Applicable Restrictions under Section 2704(b)

The proposed regulations would remove the exception in § 25.2704–2(b) that limits the definition of applicable restriction to limitations that are more restrictive than the limitations that would apply in the absence of the restriction under the local law generally applicable to the entity. As noted above, this exception is not consistent with section 2704(b) to the extent that the transferor and family members have the power to avoid any statutory rule. The proposed regulations also would revise § 25.2704–2(b) to provide that an applicable restriction does include a restriction that is imposed under the terms of the governing documents, as well as a restriction that is imposed under a local law regardless of whether that restriction may be superseded by or pursuant to the governing documents or otherwise. In applying this particular exception to the definition of an applicable restriction, this proposed rule is intended to ensure that a restriction that is not imposed or required to be imposed by federal or state law is disregarded without regard to its source.

Further, with regard to the exception for restrictions "imposed, or required to be imposed, by any Federal or State law," in section 2704(b)(3)(B), the proposed regulations would clarify that the terms "federal" and "state" refer only to the United States or any state (including the District of Columbia (*see* section 7701(a)(10)), but do not include any other jurisdiction.

A restriction is imposed or required to be imposed by law if the restriction cannot be removed or overridden and it is mandated by the applicable law, is required to be included in the governing documents, or otherwise is made mandatory. In addition, a restriction imposed by a state law, even if that restriction may not be removed or overridden directly or indirectly, nevertheless would constitute an applicable restriction in two situations. In each situation, although the statute itself is mandatory and cannot be overridden, another statute is available to be used for the entity's governing law that does not require the mandatory restriction, thus in effect making the purportedly mandatory provision elective. The first situation is that in which the state law is limited in its application to certain narrow classes of entities, particularly those types of entities most likely to be subject to transfers described in section 2704, that is, family-controlled entities. The second situation is that in which, although the state law under which the entity was created imposed a mandatory restriction that could not be removed or overridden, either at the time the entity was organized or at some subsequent time, that state's law also provided an optional provision or an alternative statute for the creation and governance of that same type of entity that did not mandate the restriction. Thus, an optional provision is one for the same category of entity that did not include the restriction or that allowed it to be removed or overridden, or that made the restriction optional, or permitted the restriction to be superseded, whether by the entity's governing documents or otherwise. For purposes of determining whether a restriction is imposed on an entity under state law, there would be only three types of entities, specifically, the three categories of entities described in § 25.2701–2(b)(5) of the proposed regulations: corporations; partnerships (including limited partnerships); and other business entities. A similar proposed rule applies to the additional restrictions discussed later in this preamble.

If an applicable restriction is disregarded, the fair market value of the transferred interest is determined under generally applicable valuation principles as if the restriction does not exist (that is, as if the governing documents and the local law are silent on the question), and thus, there is deemed to be no such restriction on liquidation of the entity.

Disregarded Restrictions

A new class of restrictions is described in the proposed regulations that would be disregarded, described as "disregarded restrictions." This class of restrictions is identified pursuant to the authority contained in section 2704(b)(4). Note that, although it may appear that sections 2703 and 2704(b) overlap, they do not. While section 2703 and the corresponding regulations currently address restrictions on the sale or use of individual interests in family-controlled entities, the proposed regulations would address restrictions on the liquidation or redemption of such interests.

Under § 25.2704–3 of the proposed regulations, in the case of a family-controlled entity, any restriction described below on a shareholder's, partner's, member's, or other owner's right to liquidate his or her interest in the entity will be disregarded if the restriction will lapse at any time after the transfer, or if the transferor, or the transferor and family members, without regard to certain interests held by nonfamily members, may remove or override the restriction. Under the proposed regulations, such a disregarded restriction includes one that: (a) limits the ability of the holder of the interest to liquidate the interest; (b) limits the liquidation proceeds to an amount that is less than a minimum value; (c) defers the payment of the liquidation proceeds for more than six months; or (d) permits the payment of the liquidation proceeds in any manner other than in cash or other property, other than certain notes.

"Minimum value" is the interest's share of the net value of the entity on the date of liquidation or redemption. The net value of the entity is the fair market value, as determined under section 2031 or 2512 and the applicable regulations, of the property held by the entity, reduced by the outstanding obligations of the entity. Solely for purposes of determining minimum value, the only outstanding obligations of the entity that may be taken into account are those that would be allowable (if paid) as deductions under section 2053 if those obligations instead were claims against an estate. For example, and subject to the foregoing limitation on outstanding obligations, if the entity holds an operating business, the rules of § 20.2031–2(f)(2) or 20.2031–3 apply in the case of a testamentary transfer and the rules of § 25.2512–2(f)(2) or 25.2512–3 apply in the case of an inter vivos transfer. The minimum value of the interest is the net value of the entity multiplied by the interest's share of the entity. For this purpose, the interest's share is determined by taking into account any capital, profits, and other rights inherent in the interest in the entity.

A disregarded restriction includes limitations on the time and manner of payment of the liquidation proceeds. Such limitations include provisions permitting deferral of full payment beyond six months or permitting payment in any manner other than in cash or property. For this purpose, the term "property" does not include a note or other obligation issued directly or indirectly by the entity, other holders of an interest in the entity, or persons related to either. An exception is made for the note of an entity engaged in an active trade or business to the extent that (a) the liquidation proceeds are not attributable to passive assets within the meaning of section 6166(b)(9)(B), and (b) the note is adequately secured, requires periodic payments on a non-deferred basis, is issued at market interest rates, and has a fair market value (when discounted to present value) equal to the liquidation proceeds. A fair market value determination assumes a cash sale. *See* Section 2 of Rev. Rul. 59–60, 1959–1 C.B. 237 (defining fair market value and stating that "[c]ourt decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing to trade. . ."). Thus, in the absence of immediate payment of the liquidation proceeds, the fair market value of any note falling within this exception must equal the fair market value of the liquidation proceeds on the date of liquidation or redemption.

Exceptions that apply to applicable restrictions under the current and these proposed regulations also apply to this new class of disregarded restrictions. One of the exceptions applicable to the definition of a disregarded restriction applies if (a) each holder of an interest in the entity has an enforceable "put" right to receive, on liquidation or redemption of the holder's interest, cash and/or other property with a value that is at least equal to the minimum value previously described, (b) the full amount of such cash and other property must be paid within six months after the holder gives notice to the entity of the holder's intent to liquidate any part or all of the holder's interest and/or withdraw from the entity, and (c) such other property does not include a note or other obligation issued directly or indirectly by the entity, by one or more holders of interests in the entity, or by a person related either to the entity or to any holder of an interest in the entity. However, in the case of an entity engaged in an active trade or business, at least 60 percent of whose value consists of the non-passive assets of that trade or business, and to the extent that the liquidation proceeds are not attributable to passive assets within the meaning of section 6166(b)(9)(B), such proceeds may include a note or other obligation if such note is adequately secured, requires periodic payments on a non-deferred basis, is issued at market interest rates, and has a fair market value on the date of the liquidation or redemption equal to the liquidation proceeds. A similar exception is made to the definition of an applicable restriction in proposed § 25.2704–2(b)(4).

In determining whether the transferor and/or the transferor's family has the ability to remove a restriction included in this new class of disregarded restrictions, any interest in the entity held by a person who is not a member of the transferor's family is disregarded if, at the time of the transfer, the interest: (a) has been held by such person for less than three years; (b) constitutes less than 10 percent of the value of all of the equity interests in a corporation, or constitutes less than 10 percent of the capital and profits interests in a business entity described in § 301.7701–2(a) other than a corporation (for example, less than a 10-percent interest in the capital and profits of a partnership); (c) when combined with the interests of all other persons who are not members of the transferor's family, constitutes less than 20 percent of the value of all of the equity interests in a corporation, or constitutes less than 20 percent of the capital and profits interests in a business entity other than a corporation (for example, less than a 20-percent interest in the capital and profits of a partnership); or (d) any such person, as the owner of an interest, does not have an enforceable right to receive in exchange for such interest, on no more than six months' prior notice, the minimum value referred to in the definition of a disregarded restriction. If an interest is disregarded, the determination of whether the family has the ability to remove the restriction will be made assuming that the remaining interests are the sole interests in the entity.

Finally, if a restriction is disregarded under proposed § 25.2704–3, the fair market value of the interest in the entity is determined assuming that the disregarded restriction did not exist, either in the governing documents or applicable law. Fair market value is determined under generally accepted valuation principles, including any appropriate discounts or premiums, subject to the assumptions described in this paragraph.

Coordination with Marital and Charitable Deductions

Section 2704(b) applies to intra-family transfers for all purposes of subtitle B relating to estate, gift and GST taxes. Therefore, to the extent that an interest qualifies for the gift or estate tax marital deduction and must be valued by taking into account the special valuation assumptions of section 2704(b), the same value generally will apply in computing the marital deduction attributable to that interest. The value of the estate tax marital deduction may be further affected, however, by other factors justifying a different value, such as the application of a control premium. *See, e.g.*, *Estate of Chenoweth v. Commissioner*, 88 T.C. 1577 (1987).

Section 2704(b) does not apply to transfers to nonfamily members and thus has no application in valuing an interest passing to charity or to a person other than a family member. If part of an entity interest includible in the gross estate passes to family members and part of that interest passes to nonfamily members, and if (taking into account the proposed rules regarding the treatment of certain interests held by nonfamily members) the part passing to the decedent's family members is valued under section 2704(b), then the proposed regulations provide that the part passing to the family members is treated as a property interest separate from the part passing to nonfamily members. The fair market value of the part passing to the family members is determined taking into account the special valuation assumptions of section 2704(b), as well as any other relevant factors, such as those supporting a control premium. The fair market value of the part passing to the nonfamily member(s) is determined in a similar manner, but without the special valuation assumptions of section 2704(b). Thus, if the sole nonfamily member receiving an interest is a charity, the interest generally will have the same value for both estate tax inclusion and deduction purposes. If the interest passing to nonfamily members, however, is divided between charities and other nonfamily members, additional considerations (not prescribed by section 2704) may apply, resulting in a different value for charitable deduction purposes. *See*, *e.g.*, *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981).

Effective Dates

The amendments to § 25.2701–2 are proposed to be effective on and after the date of publication of a Treasury decision adopting these rules as final regulations in the **Federal Register.** The amendments to § 25.2704–1 are proposed to apply to lapses of rights created after October 8, 1990, occurring on or after the date these regulations are published as final regulations in the **Federal Register.** The amendments to § 25.2704–2 are proposed to apply to transfers of property subject to restrictions created after October 8, 1990, occurring on or after the date these regulations are published as final regulations in the **Federal Register.** Section 25.2704–3 is proposed to apply to transfers of property subject to restrictions created after October 8, 1990, occurring 30 or more days after the date these regulations are published as final regulations in the **Federal Register.**

Special Analyses

Certain IRS regulations, including this one, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory impact assessment is not required. Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that this regulation will not have a significant economic impact on a substantial number of small entities. The proposed regulations affect the transfer tax liability of individuals who transfer an interest in certain closely held entities and not the entities themselves. The proposed regulations do not affect the structure of such entities, but only the assumptions under which they are valued for federal transfer tax purposes. In addition, any economic impact on entities affected by section 2704, large or small, is derived from the operation of the statute, or its intended application, and not from the proposed regulations in this notice of proposed rulemaking. Accordingly, a regulatory flexibility analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this regulation has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely (in the manner described in "ADDRESSES") to the IRS. The Treasury Department and the IRS request comments on all aspects of the proposed regulations. All comments will be available at www.regulations.gov, or upon request.

A public hearing on these proposed regulations has been scheduled for December 1, 2016, beginning at 10 a.m. in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC 20224. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit comments by November 2, 2016, and submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by November 2, 2016.

A period of 10 minutes will be allotted to each person for making comments. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is John D. MacEachen, Office of the Associate Chief Counsel (Passthroughs and Special Industries). Other personnel from the Treasury Department and the IRS participated in their development.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 25 is proposed to be amended as follows:

PART 25—GIFT TAX; GIFTS MADE AFTER DECEMBER 31, 1954

Par. 1. The authority citation for part 25 is amended by adding entries in numerical order to read in part as follows:

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

Section 25.2701–2 also issued under 26 U.S.C. 2701(e).

Section 25.2704–1 also issued under 26 U.S.C. 2704(a).

Sections 25.2704–2 and 25.2704–3 also issued under 26 U.S.C. 2704(b).

* * * * *

Par. 2. Section 25.2701–2 is amended as follows:

1. In paragraph (b)(5)(i), the first sentence is revised and five sentences are added before the last sentence.

2. Paragraph (b)(5)(iv) is added.

The revision and additions read as follows:

§ 25.2701–2 Special valuation rules for applicable retained interests.

* * * * *

(b) * * *

(5) * * *

(i) * * * For purposes of section 2701, a controlled entity is a corporation, partnership, or any other entity or arrangement that is a business entity within the meaning of § 301.7701–2(a) of this chapter controlled, immediately before a transfer, by the transferor, applicable family members, and/or any lineal descendants of the parents of the transferor or the transferor's spouse. The form of the entity determines the applicable test for control. For purposes of determining the form of the entity, any business entity described in § 301.7701–2(b)(1), (3), (4), (5), (6), (7), or (8) of this chapter, an S corporation within the meaning of section 1361(a)(1), and a qualified subchapter S subsidiary within the meaning of section 1361(b)(3)(B) is a corporation. For this purpose, a qualified subchapter S subsidiary is treated as a corporation separate from its parent corporation. In the case of any business entity that is not a corporation under these provisions, the form of the entity is determined under local law, regardless of how the entity is classified for federal tax purposes or whether it is disregarded as an entity separate from its owner for federal tax purposes. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, under whose laws the entity is created or organized. * * *

* * * * *

(iv) *Other business entities*. In the case of any entity or arrangement that is not a corporation, partnership, or limited partnership, control means the holding of at least 50 percent of either the capital interests or the profits interests in the entity or arrangement. In addition, control means the holding of any equity interest with the ability to cause the liquidation of the entity or arrangement in whole or in part.

* * * * *

Par. 3. Section 25.2701–8 is amended as follows:

1. The existing text is designated as paragraph (a).

2. The first sentence of newly designated paragraph (a) is revised and paragraph (b) is added.

The revision and addition reads as follows:

§ 25.2701–8 Effective dates.

(a) Except as provided in paragraph (b) of this section, §§ 25.2701–1 through 25.2701–4 and §§ 25.2701–6 and 25.2701–7 are effective as of January 28, 1992. * * *

(b) The first six sentences of § 25.2701–2(b)(5)(i) and (iv) are effective on the date these regulations are published as final regulations in the **Federal Register.**

Par. 4. Section 25.2704–1 is amended as follows:

1. In paragraph (a)(1), the first two sentences are revised and four sentences are added before the third sentence.

2. In paragraph (a)(2)(i), a sentence is added at the end.

3. Paragraph (a)(2)(iii) is removed.

4. Paragraphs (a)(2)(iv) through (vi) are redesignated as paragraphs (a)(2)(iii) through (v), respectively.

5. In newly designated paragraph (a)(2)(iii), a sentence is added before the third sentence.

6. Paragraph (a)(4) is revised.

7. Paragraph (a)(5) is added.

8. In paragraph (c)(1), the second sentence is revised and a sentence is added at the end.

9. Paragraph (c)(2)(i)(B) is revised.

10. In paragraph (f) *Example 4*, the third and fourth sentences are revised and a sentence is added at the end.

11. In paragraph (f) *Example 6*, the third sentence is removed.

12. In paragraph (f) *Example 7*, the third and fourth sentences are revised and a sentence is added at the end.

The revisions and additions read as follows:

§ 25.2704–1 Lapse of certain rights.

(a) * * *

(1) * * * For purposes of subtitle B (relating to estate, gift, and generation-skipping transfer taxes), the lapse of a voting or a liquidation right in a corporation or a partnership (an entity), whether domestic or foreign, is a transfer by the individual directly or indirectly holding the right immediately prior to its lapse (the holder) to the extent provided in paragraphs (b) and (c) of this section. This section applies only if the entity is controlled by the holder and/or members of the holder's family immediately before and after the lapse. For purposes of this section, a corporation is any business entity described in § 301.7701–2(b)(1), (3), (4), (5), (6), (7), or (8) of this chapter, an S corporation within the meaning of section 1361(a)(1), and a qualified subchapter S subsidiary within the meaning of section 1361(b)(3)(B). For this purpose, a qualified subchapter S subsidiary is treated as a corporation separate from its parent corporation. A partnership is any other business entity within the meaning of § 301.7701–2(a) of this chapter regardless of how that entity is classified for federal tax purposes. Thus, for example, the term partnership includes a limited liability company that is not an S corporation, whether or not it is disregarded as an entity separate from its owner for federal tax purposes. * * *

(2) * * *

(i) * * * For purposes of determining whether the group consisting of the holder, the holder's estate and members of the holder's family control the entity, a member of the group is also treated as holding any interest held indirectly by such member through a corporation, partnership, trust, or other entity under the rules contained in § 25.2701–6.

* * * * *

(iii) * * * In the case of a limited liability company, the right of a member to participate in company management is a voting right. * * *

* * * * *

(4) *Source of right or lapse.* A voting right or a liquidation right may be conferred by or lapse by reason of local law, the governing documents, an agreement, or otherwise. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, that governs voting or liquidation rights.

(5) *Assignee interests.* A transfer that results in the restriction or elimination of the transferee's ability to exercise the voting or liquidation rights that were associated with the interest while held by the transferor is a lapse of those rights. For example, the transfer of a partnership interest to an assignee that neither has nor may exercise the voting or liquidation rights of a partner is a lapse of the voting and liquidation rights associated with the transferred interest.

(c) * * *

(1) * * * Except as otherwise provided, a transfer of an interest occurring more than three years before the transferor's death that results in the lapse of a voting or liquidation right is not subject to this section if the rights with respect to the transferred interest are not restricted or eliminated. * * * The lapse of a voting or liquidation right as a result of the transfer of an interest within three years of the transferor's death is treated as a lapse occurring on the transferor's date of death, includible in the gross estate pursuant to section 2704(a).

(2) * * * *

(i) * * * *

(B) *Ability to liquidate.* Whether an interest can be liquidated immediately after the lapse is determined under the local law generally applicable to the entity, as modified by the governing documents of the entity, but without regard to any restriction (in the governing documents, applicable local law, or otherwise) described in section 2704(b) and the regulations thereunder. The manner in which the interest may be liquidated is irrelevant for this purpose, whether by voting, taking other action authorized by the governing documents or applicable local law, revising the governing documents, merging the entity with an entity whose governing documents permit liquidation of the interest, terminating the entity, or otherwise. For purposes of making this determination, an interest held by a person other than a member of the holder's family (a nonfamily-member interest) may be disregarded. Whether a nonfamily-member interest is disregarded is determined under § 25.2704–3(b)(4), applying that section as if, by its terms, it also applies to the question of whether the holder (or the holder's estate) and members of the holder's family may liquidate an interest immediately after the lapse.

* * * * *

(f) * * *

Example 4. * * * More than three years before D's death, D transfers one-half of D's stock in equal shares to D's three children (14 percent each). Section 2704(a) does not apply to the loss of D's ability to liquidate Y because the voting rights with respect to the transferred shares are not restricted or eliminated by reason of the transfer, and the transfer occurs more than three years before D's death. However, had the transfers occurred within three years of D's death, the transfers would have been treated as the lapse of D's liquidation right occurring at D's death.

* * * * *

Example 7. * * * More than three years before D's death, D transfers 30 shares of common stock to D's child. The transfer is not a lapse of a liquidation right with respect to the common stock because the voting rights that enabled D to liquidate prior to the transfer are not restricted or eliminated, and the transfer occurs more than three years before D's death. * * * However, had the transfer occurred within three years of D's death, the transfer would have been treated as the lapse of D's liquidation right with respect to the common stock occurring at D's death.

Par. 5. Section 25.2704–2 is amended as follows:

1. Paragraphs (a) and (b) are revised.

2. Paragraphs (c) and (d) are designated as paragraphs (e) and (g), respectively.

3. New paragraphs (c), (d), and (f) are added.

4. The first sentence of newly designated paragraph (e) is revised.

5. The third sentences of newly designated paragraph (g) *Example 1.* and *Example 3.* are removed.

6. The third sentence of newly designated paragraph (g) *Example 5.* is revised.

The revisions and additions read as follows:

§ 25.2704–2 Transfers subject to applicable restrictions.

(a) *In general.* For purposes of subtitle B (relating to estate, gift, and generation-skipping transfer taxes), if an interest in a corporation or a partnership (an entity), whether domestic or foreign, is transferred to or for the benefit of a member of the transferor's family, and the transferor and/or members of the transferor's family control the entity immediately before the transfer, any applicable restriction is disregarded in valuing the transferred interest. For purposes of this section, a corporation is any business entity described in § 301.7701–2(b)(1), (3), (4), (5), (6), (7), or (8) of this chapter, an S corporation within the meaning of section 1361(a)(1), and a qualified subchapter S subsidiary within the meaning of section 1361(b)(3)(B). For this purpose, a qualified subchapter S subsidiary is treated as a corporation separate from its parent corporation. A partnership is any other business entity within the meaning of § 301.7701–2(a) of this chapter, regardless of how that entity is classified for federal tax purposes. Thus, for example, the term partnership includes a limited liability company that is not an S corporation, whether or not it is disregarded as an entity separate from its owner for federal tax purposes.

(b) *Applicable restriction defined*—(1) *In general.* The term *applicable restriction* means a limitation on the ability to liquidate the entity, in whole or in part (as opposed to a particular holder's interest in the entity), if, after the transfer, that limitation either lapses or may be removed by the transferor, the transferor's estate, and/or any member of the transferor's family, either alone or collectively. See § 25.2704–3 for restrictions on the ability to liquidate a particular holder's interest in the entity.

(2) *Source of limitation*. An applicable restriction includes a restriction that is imposed under the terms of the governing documents (for example, the corporation's by-laws, the partnership agreement, or other governing documents), a buy-sell agreement, a redemption agreement, or an assignment or deed of gift, or any other document, agreement, or arrangement; and a restriction imposed under local law regardless of whether that restriction may be superseded by or pursuant to the governing documents or otherwise. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, that governs the applicability of the restriction. For an exception for restrictions imposed or required to be imposed by federal or state law, see paragraph (b)(4)(ii) of this section.

(3) *Lapse or removal of limitation*. A restriction is an applicable restriction only to the extent that either the restriction by its terms will lapse at any time after the transfer, or the restriction may be removed after the transfer by any one or more members, either alone or collectively, of the group consisting of the transferor, the transferor's estate, and members of the transferor's family. For purposes of determining whether the ability to remove the restriction is held by any member(s) of this group, members are treated as holding the interests attributed to them under the rules contained in § 25.2701–6, in addition to interests held directly. The manner in which the restriction may be removed is irrelevant for this purpose, whether by voting, taking other action authorized by the governing documents or applicable local law, removing the restriction from the governing documents, revising the governing documents to override the restriction prescribed under local law in the absence of a contrary provision in the governing documents, merging the entity with an entity whose governing documents do not contain the restriction, terminating the entity, or otherwise.

(4) *Exceptions*. A restriction described in this paragraph (b)(4) is not an applicable restriction.

(i) *Commercially reasonable restriction*. An applicable restriction does not include a commercially reasonable restriction on liquidation imposed by an unrelated person providing capital to the entity for the entity's trade or business operations, whether in the form of debt or equity. An unrelated person is any person whose relationship to the transferor, the transferee, or any member of the family of either is not described in section 267(b), provided that for purposes of this section the term *fiduciary of a trust* as used in section 267(b) does not include a bank as defined in section 581 that is publicly held.

(ii) *Imposed by federal or state law*. An applicable restriction does not include a restriction imposed or required to be imposed by federal or state law. For this purpose, federal or state law means the laws of the United States, of any state thereof, or of the District of Columbia, but does not include the laws of any other jurisdiction. A provision of law that applies only in the absence of a contrary provision in the governing documents or that may be superseded with regard to a particular entity (whether by the shareholders, partners, members and/or managers of the entity or otherwise) is not a restriction that is imposed or required to be imposed by federal or state law. A law that is limited in its application to certain narrow classes of entities, particularly those types of entities (such as family-controlled entities) most likely to be subject to transfers described in section 2704, is not a restriction that is imposed or required to be imposed by federal or state law. For example, a law requiring a restriction that may not be removed or superseded and that applies only to family-controlled entities that otherwise would be subject to the rules of section 2704 is an applicable restriction. In addition, a restriction is not imposed or required to be imposed by federal or state law if that law also provides (either at the time the entity was organized or at some subsequent time) an optional provision that does not include the restriction or that allows it to be removed or overridden, or that provides a different statute for the creation and governance of that same type of entity that does not mandate the restriction, makes the restriction optional, or permits the restriction to be superseded, whether by the entity's governing documents or otherwise. For purposes of determining the type of entity, there are only three types of entities, specifically, the three categories of entities described in § 25.2701–2(b)(5): corporations; partnerships (including limited partnerships); and other business entities.

(iii) *Certain rights under section 2703*. An option, right to use property, or agreement that is subject to section 2703 is not an applicable restriction.

(iv) *Put right of each holder*. Any restriction that otherwise would constitute an applicable restriction under this section will not be considered an applicable restriction if each holder of an interest in the entity has a put right as described in § 25.2704–3(b)(6).

(c) *Other definitions*. For the definition of the term *controlled entity*, see § 25.2701–2(b)(5). For the definition of the term *member of the family*, see § 25.2702–2(a)(1).

(d) *Attribution*. An individual, the individual's estate, and members of the individual's family are treated as also holding any interest held indirectly by such person through a corporation, partnership, trust, or other entity under the rules contained in § 25.2701–6.

(e) * * * If an applicable restriction is disregarded under this section, the fair market value of the transferred interest is determined under generally applicable valuation principles as if the restriction (whether in the governing documents, applicable law, or both) does not exist. * * *

(f) *Certain transfers at death to multiple persons*. Solely for purposes of section 2704(b), if part of a decedent's interest in an entity includible in the gross estate passes by reason of death to one or more members of the decedent's family and part of that includible interest passes to one or more persons who are not members of the decedent's family, and if the part passing to the members of the decedent's family is to be valued pursuant to paragraph (e) of this section, then that part is treated as a single, separate property interest. In that case, the part passing to one or more persons who are not members of the decedent's family is also treated as a single, separate property interest. See paragraph (g) *Ex. 4* of § 25.2704–3.

(g) * * *

Example 5. * * * The preferred stock carries a right to liquidate X that cannot be exercised until 1999. * * *

* * * * *

§ 25.2704–3 [Redesignated as § 25.2704–4]

Par. 6. Section 25.2704–3 is redesignated as § 25.2704–4.

Par. 7. New § 25.2704–3 is added to read as follows.

§ 25.2704–3 Transfers subject to disregarded restrictions.

(a) *In general*. For purposes of subtitle B (relating to estate, gift and generation-skipping transfer taxes), and notwithstanding any provision of § 25.2704–2, if an interest in a corporation or a partnership (an entity), whether domestic or foreign, is transferred to or for the benefit of a member of the transferor's family, and the transferor and/or members of the transferor's family control the entity immediately before the transfer, any restriction described in paragraph (b) of this section is disregarded, and the transferred interest is valued as provided in paragraph (f) of this section. For purposes of this section, a corporation is any business entity described in § 301.7701–2(b)(1), (3), (4), (5), (6), (7), or (8) of this chapter, an S corporation within the meaning of section 1361(a)(1), and a qualified subchapter S subsidiary within the meaning of section 1361(b)(3)(B). For this purpose, a qualified subchapter S subsidiary is treated as a corporation separate from its parent corporation. A partnership is any other business entity within the meaning of § 301.7701–2(a) of this chapter, regardless of how that entity is classified for federal tax purposes. Thus, for example, the term partnership includes a limited liability company that is not an S corporation, whether or not it is disregarded as an entity separate from its owner for federal tax purposes.

(b) *Disregarded restrictions defined*—(1) *In general*. The term *disregarded restriction* means a restriction that is a limitation on the ability to redeem or liquidate an interest in an entity that is described in any one or more of paragraphs (b)(1)(i) through (iv) of this section, if the restriction, in whole or in part, either lapses after the transfer or can be removed by the transferor or any member of the transferor's family (subject to paragraph (b)(4) of this section), either alone or collectively.

(i) The provision limits or permits the limitation of the ability of the holder of the interest to compel liquidation or redemption of the interest.

(ii) The provision limits or permits the limitation of the amount that may be received by the holder of the interest on liquidation or redemption of the interest to an amount that is less than a minimum value. The term *minimum value* means the interest's share of the net value of the entity determined on the date of liquidation or redemption. The net value of the entity is the fair market value, as determined under section 2031 or 2512 and the applicable regulations, of the property held by the entity, reduced by the outstanding obligations of the entity. Solely for purposes of determining minimum value, the only outstanding obligations of the entity that may be taken into account are those that would be allowable (if paid) as deductions under section 2053 if those obligations instead were claims against an estate. For example, and subject to the foregoing limitation on outstanding obligations, if the entity holds an operating business, the rules of § 20.2031–2(f)(2) or § 20.2031–3 of this chapter apply in the case of a testamentary transfer and the rules of § 25.2512–2(f)(2) or § 25.2512–3 apply in the case of an inter vivos transfer. The minimum value of the interest is the net value of the entity multiplied by the interest's share of the entity. For this purpose, the interest's share is determined by taking into account any capital, profits, and other rights inherent in the interest in the entity. If the property held by the entity directly or indirectly includes an interest in another entity, and if a transfer of an interest in that other entity by the same transferor (had that transferor owned the interest directly) would be subject to section 2704(b), then the entity will be treated as owning a share of the property held by the other entity, determined and valued in accordance with the provisions of section 2704(b) and the regulations thereunder.

(iii) The provision defers or permits the deferral of the payment of the full amount of the liquidation or redemption proceeds for more than six months after the date the holder gives notice to the entity of the holder's intent to have the holder's interest liquidated or redeemed.

(iv) The provision authorizes or permits the payment of any portion of the full amount of the liquidation or redemption proceeds in any manner other than in cash or property. Solely for this purpose, except as provided in the following sentence, a note or other obligation issued directly or indirectly by the entity, by one or more holders of interests in the entity, or by a person related to either the entity or any holder of an interest in the entity, is deemed not to be property. In the case of an entity engaged in an active trade or business, at least 60 percent of whose value consists of the non-passive assets of that trade or business, and to the extent that the liquidation proceeds are not attributable to passive assets within the meaning of section 6166(b)(9)(B), such proceeds may include such a note or other obligation if such note or other obligation is adequately secured, requires periodic payments on a non-deferred basis, is issued at market interest rates, and has a fair market value on the date of liquidation or redemption equal to the liquidation proceeds. See § 25.2512–8. For purposes of this paragraph (b)(1)(iv), a related person is any person whose relationship to the entity or to any holder of an interest in the entity is described in section 267(b), provided that for this purpose the term *fiduciary of a trust* as used in section 267(b) does not include a bank as defined in section 581 that is publicly held.

(2) *Source of limitation*. A disregarded restriction includes a restriction that is imposed under the terms of the governing documents (for example, the corporation's by-laws, the partnership agreement, or other governing documents), a buy-sell agreement, a redemption agreement, or an assignment or deed of gift, or any other document, agreement, or arrangement; and a restriction imposed under local law regardless of whether that restriction may be superseded by or pursuant to the governing documents or otherwise. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, which governs the applicability of the restriction. For an exception for restrictions imposed or required to be imposed by federal or state law, see paragraph (b)(5)(iii) of this section.

(3) *Lapse or removal of limitation*. A restriction is a disregarded restriction only to the extent that the restriction either will lapse by its terms at any time after the transfer or may be removed after the transfer by any one or more members, either alone or collectively, of the group consisting of the transferor, the transferor's estate, and members of the transferor's family. For purposes of determining whether the ability to remove the restriction is held by any one or more members of this group, members are treated as holding interests attributed to them under the rules contained in § 25.2701–6, in addition to interests held directly. See also paragraph (b)(4) of this section. The manner in which the restriction may be removed is irrelevant for this purpose, whether by voting, taking other action authorized by the governing documents or applicable local law, removing the restriction from the governing documents, revising the governing documents to override the restriction prescribed under local law in the absence of a contrary provision in the governing documents, merging the entity with an entity whose governing documents do not contain the restriction, terminating the entity, or otherwise.

(4) *Certain interests held by nonfamily members disregarded*—(i) *In general*. In the case of a transfer to or for the benefit of a member of the transferor's family, for purposes of determining whether the transferor (or the transferor's estate) or any member of the transferor's family, either alone or collectively, may remove a restriction within the meaning of this paragraph (b), an interest held by a person other than a member of the transferor's family (a nonfamily-member interest) is disregarded unless all of the following are satisfied:

(A) The interest has been held by the nonfamily member for at least three years immediately before the transfer;

(B) On the date of the transfer, in the case of a corporation, the interest constitutes at least 10 percent of the value of all of the equity interests in the corporation, and, in the case of a business entity within the meaning of § 301.7701–2(a) of this chapter other than a corporation, the interest constitutes at least a 10-percent interest in the business entity, for example, a 10-percent interest in the capital and profits of a partnership;

(C) On the date of the transfer, in the case of a corporation, the total of the equity interests in the corporation held by shareholders who are not members of the transferor's family constitutes at least 20 percent of the value of all of the equity interests in the corporation, and, in the case of a business entity within the meaning of § 301.7701–2(a) of this chapter other than a corporation, the total interests in the entity held by owners who are not members of the transferor's family is at least 20 percent of all the interests in the entity, for example, a 20-percent interest in the capital and profits of a partnership; and

(D) Each nonfamily member, as owner, has a put right as described in paragraph (b)(6) of this section.

(ii) *Effect of disregarding a nonfamily-member interest*. If a nonfamily-member interest is disregarded under this section, the rules of this section are applied as if all interests other than disregarded nonfamily-member interests constitute all of the interests in the entity.

(iii) *Attribution*. In applying the 10-percent and 20-percent tests when the property held by the corporation or other business entity is, in whole or in part, an interest in another entity, the attribution rules of paragraph (d) of this section apply both in determining the interest held by a nonfamily member, and in measuring the interests owned through other entities.

(5) *Exceptions*. A restriction described in this paragraph (b)(5) is not a disregarded restriction.

(i) *Applicable restriction.* A disregarded restriction does not include an applicable restriction on the liquidation of the entity as defined in and governed by § 25.2704–2.

(ii) *Commercially reasonable restriction*. A disregarded restriction does not include a commercially reasonable restriction on liquidation imposed by an unrelated person providing capital to the entity for the entity's trade or business operations whether in the form of debt or equity. An unrelated person is any person whose relationship to the transferor, the transferee, or any member of the family of either is not described in section 267(b), provided that for purposes of this section the term *fiduciary of a trust* as used in section 267(b) does not include a bank as defined in section 581 that is publicly held.

(iii) *Requirement of federal or state law*. A disregarded restriction does not include a restriction imposed or required to be imposed by federal or state law. For this purpose, federal or state law means the laws of the United States, of any state thereof, or of the District of Columbia, but does not include the laws of any other jurisdiction. A provision of law that applies only in the absence of a contrary provision in the governing documents or that may be superseded with regard to a particular entity (whether by the shareholders, partners, members and/or managers of the entity or otherwise) is not a restriction that is imposed or required to be imposed by federal or state law. A law that is limited in its application to certain narrow classes of entities, particularly those types of entities (such as family-controlled entities) most likely to be subject to transfers described in section 2704, is not a restriction that is imposed or required to be imposed by federal or state law. For example, a law requiring a restriction that may not be removed or superseded and that applies only to family-controlled entities that otherwise would be subject to the rules of section 2704 is a disregarded restriction. In addition, a restriction is not imposed or required to be imposed by federal or state law if that law also provides (either at the time the entity was organized or at some subsequent time) an optional provision that does not include the restriction or that allows it to be removed or overridden, or that provides a different statute for the creation and governance of that same type of entity that does not mandate the restriction, makes the restriction optional, or permits the restriction to be superseded, whether by the entity's governing documents or otherwise. For purposes of determining the type of entity, there are only three types of entities, specifically, the three categories of entities described in § 25.2701–2(b)(5): corporations; partnerships (including limited partnerships); and other business entities.

(iv) *Certain rights described in section 2703*. An option, right to use property, or agreement that is subject to section 2703 is not a restriction for purposes of this paragraph (b).

(v) *Right to put interest to entity*. Any restriction that otherwise would constitute a disregarded restriction under this section will not be considered a disregarded restriction if each holder of an interest in the entity has a put right as described in paragraph (b)(6) of this section.

(6) *Put right*. The term *put right* means a right, enforceable under applicable local law, to receive from the entity or from one or more other holders, on liquidation or redemption of the holder's interest, within six months after the date the holder gives notice of the holder's intent to withdraw, cash and/or other property with a value that is at least equal to the minimum value of the interest determined as of the date of the liquidation or redemption. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, that governs liquidation or redemption rights with regard to interests in the entity. For purposes of this paragraph (b)(6), the term *other property* does not include a note or other obligation issued directly or indirectly by the entity, by one or more holders of interests in the entity, or by one or more persons related either to the entity or to any holder of an interest in the entity. However, in the case of an entity engaged in an active trade or business, at least 60 percent of whose value consists of the non-passive assets of that trade or business, and to the extent that the liquidation proceeds are not attributable to passive assets within the meaning of section 6166(b)(9)(B), the term *other property* does include a note or other obligation if such note or other obligation is adequately secured, requires periodic payments on a non-deferred basis, is issued at market interest rates, and has a fair market value on the date of liquidation or redemption equal to the liquidation proceeds. See § 25.2512–8. The minimum value of the interest is the interest's share of the net value of the entity, as defined in paragraph (b)(1)(ii) of this section.

(c) *Other definitions*. For the definition of the term *controlled entity*, see § 25.2701–2(b)(5). For the definition of the term *member of the family*, see § 25.2702–2(a)(1).

(d) *Attribution*. An individual, the individual's estate, and members of the individual's family, as well as any other person, also are treated as holding any interest held indirectly by such person through a corporation, partnership, trust, or other entity under the rules contained in § 25.2701–6.

(e) *Certain transfers at death to multiple persons*. Solely for purposes of section 2704(b), if part of a decedent's interest in an entity includible in the gross estate passes by reason of death to one or more members of the decedent's family and part of that includible interest passes to one or more persons who are nonfamily members of the decedent, and if the part passing to the members of the decedent's family is to be valued pursuant to paragraph (f) of this section, then that part is treated as a single, separate property interest. In that case, the part passing to one or more persons who are not members of the decedent's family is also treated as a single, separate property interest. See paragraph (g) *Example 4* of this section.

(f) *Effect of disregarding a restriction*. If a restriction is disregarded under this section, the fair market value of the transferred interest is determined under generally applicable valuation principles as if the disregarded restriction does not exist in the governing documents, local law, or otherwise. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, under which the entity is created or organized.

(g) *Examples*. The following examples illustrate the provisions of this section.

Example 1. (i) D and D's children, A and B, are partners in Limited Partnership X that was created on July 1, 2016. D owns a 98 percent limited partner interest, and A and B each own a 1 percent general partner interest. The partnership agreement provides that the partnership will dissolve and liquidate on June 30, 2066, or by the earlier agreement of all the partners, but otherwise prohibits the withdrawal of a limited partner. Under applicable local law, a limited partner may withdraw from a limited partnership at the time, or on the occurrence of events, specified in the partnership agreement. Under the partnership agreement, the approval of all partners is required to amend the agreement. None of these provisions is mandated by local law. D transfers a 33 percent limited partner interest to A and a 33 percent limited partner interest to B.

(ii) By prohibiting the withdrawal of a limited partner, the partnership agreement imposes a restriction on the ability of a partner to liquidate the partner's interest in the partnership that is not required to be imposed by law and that may be removed by the transferor and members of the transferor's family, acting collectively, by agreeing to amend the partnership agreement. Therefore, under section 2704(b) and paragraph (a) of this section, the restriction on a limited partner's ability to liquidate that partner's interest is disregarded in determining the value of each transferred interest. Accordingly, the amount of each transfer is the fair market value of the 33 percent limited partner interest determined under generally applicable valuation principles taking into account all relevant factors affecting value including the rights determined under the governing documents and local law and assuming that the disregarded restriction does not exist in the governing documents, local law, or otherwise. See paragraphs (b)(1)(i) and (f) of this section.

Example 2. The facts are the same as in *Example 1*, except that, both before and after the transfer, A's partnership interests are held in an irrevocable trust of which A is the sole income beneficiary. The trustee is a publicly-held bank. A is treated as holding the interests held by the trust under the rules contained in § 25.2701–6. The result is the same as in *Example 1*.

Example 3. The facts are the same as in *Example 1*, except that, on D's subsequent death, D's remaining 32 percent limited partner interest passes outright to D's surviving spouse, S, who is a U.S. citizen. In valuing the 32 percent interest for purposes of determining both the amount includible in the gross estate and the amount allowable as a marital deduction, the analysis and result are as described in *Example 1*.

Example 4. (i) The facts are the same as in *Example 1*, except that D made no gifts and, on D's subsequent death pursuant to D's will, a 53 percent limited partner interest passes to D's surviving spouse who is a U.S. citizen, a 25 percent limited partner interest passes to C, an unrelated individual, and a 20 percent limited partner interest passes to E, a charity. The restriction on a limited partner's ability to liquidate that partner's interest is a disregarded restriction. In determining whether D's estate and/or D's family may remove the disregarded restriction after the transfer occurring on D's death, the interests of C and E are disregarded because these interests were not held by C and E for at least three years prior to D's death, nor do C and E have the right to withdraw on six months' notice and receive their respective interest's share of the minimum value of X. Thus, the 53 percent interest passing to D's surviving spouse is subject to section 2704(b). D's gross estate will be deemed to include two separate assets: a 53 percent limited partner interest subject to section 2704(b), and a 45 percent limited partner interest not subject to section 2704.

(ii) The fair market value of the 53 percent interest is determined for both inclusion and deduction purposes under generally applicable valuation principles taking into account all relevant factors affecting value, including the rights determined under the governing documents and local law, and assuming that the disregarded restriction does not exist in the governing documents, local law, or otherwise. The 45 percent interest passing to nonfamily members is not subject to section 2704(b), and will be valued as a single interest for inclusion purposes under generally applicable valuation principles, taking into account all relevant factors affecting value including the rights determined under the governing documents and local law as well as the restriction on a limited partner's ability to liquidate that partner's interest. The 20 percent passing to charity will be valued in a similar manner for purposes of determining the allowable charitable deduction. Assuming that, under the facts and circumstances, the 45 percent interest and the 20 percent interest are subject to the same discount factor, the charitable deduction will equal four-ninths of the value of the 45 percent interest.

Example 5. (i) D and D's children, A and B, are partners in Limited Partnership Y. D owns a 98 percent limited partner interest, and A and B each own a 1 percent general partner interest. The partnership agreement provides that a limited partner may withdraw from the partnership at any time by giving six months' notice to the general partner. On withdrawal, the partner is entitled to receive the fair market value of his or her partnership interest payable over a five-year period. Under the partnership agreement, the approval of all partners is required to amend the agreement. None of these provisions are mandated by local law. D transfers a 33 percent limited partner interest to A and a 33 percent limited partner interest to B. Under paragraph (b)(1)(iii) of this section, the provision requiring that a withdrawing partner give at least six months' notice before withdrawing provides a reasonable waiting period and does not cause the restriction to be disregarded in valuing the transferred interests. However, the provision limiting the amount the partner may receive on withdrawal to the fair market value of the partnership interest, and permitting that amount to be paid over a five-year period, may limit the amount the partner may receive on withdrawal to less than the minimum value described in paragraph (b)(1)(ii) of this section and allows the delay of payment beyond the period described in paragraph (b)(1)(iii) of this section. The partnership agreement imposes a restriction on the ability of a partner to liquidate the partner's interest in the partnership that is not required to be imposed by law and that may be removed by the transferor and members of the transferor's family, acting collectively, by agreeing to amend the partnership agreement.

(ii) Under section 2704(b) and paragraph (a) of this section, the restriction on a limited partner's ability to liquidate that partner's interest is disregarded in determining the value of the transferred interests. Accordingly, the amount of each transfer is the fair market value of the 33 percent limited partner interest, determined under generally applicable valuation principles taking into account all relevant factors affecting value, including the rights determined under the governing documents and local law, and assuming that the disregarded restriction does not exist in the governing documents, local law, or otherwise. See paragraph (f) of this section.

Example 6. The facts are the same as in *Example 5*, except that D sells a 33 percent limited partner interest to A and a 33 percent limited partner interest to B for fair market value (but without taking into account the special valuation assumptions of section 2704(b)). Because section 2704(b) also is relevant in determining whether a gift has been made, D has made a gift to each child of the excess of the value of the transfer to each child as determined in *Example 5* over the consideration received by D from that child.

Example 7. The facts are the same as in *Example 5,* except, in a transaction unrelated to D's prior transfers to A and B, D withdraws from the partnership and immediately receives the fair market value (but without taking into account the special valuation assumptions of section 2704(b)) of D's remaining 32 percent limited partner interest. Because a gift to a partnership is deemed to be a gift to the other partners, D has made a gift to each child of one-half of the excess of the value of the 32 percent limited partner interest as determined in *Example 5* over the consideration received by D from the partnership.

Example 8. D and D's children, A and B, organize Limited Liability Company X under the laws of State Y. D, A, and B each contribute cash to X. Under the operating agreement, X maintains a capital account for each member. The capital accounts are adjusted to reflect each member's contributions to and distributions from X and each member's share of profits and losses of X. On liquidation, capital account balances control distributions. Profits and losses are allocated on the basis of units issued to each member, which are not in proportion to capital. D holds 98 units, A and B each hold 1 unit. D is designated in the operating agreement as the manager of X with the ability to cause the liquidation of X. X is not a corporation. Under the laws of State Y, X is neither a partnership nor a limited partnership. D and D's family have control of X because they hold at least 50 percent of the profits interests (or capital interests) of X. Further, D and D's family have control of X because D holds an interest with the ability to cause the liquidation of X.

Example 9. The facts are the same as in *Example 8,* except that, under the operating agreement, all distributions are made to members based on the units held, which in turn is based on contributions to capital. Further, X elects to be treated as a corporation for federal tax purposes. Under § 25.2701–2(b)(5), D and D's family have control of X (which is not a corporation and, under local law, is not a partnership or limited partnership) because they hold at least 50 percent of the capital interests in X. Further, D and D's family have control of X because D holds an interest with the ability to cause the liquidation of X.

Example 10. D owns a 1 percent general partner interest and a 74 percent limited partner interest in Limited Partnership X, which in turn holds a 50 percent limited partner interest in Limited Partnership Y and a 50 percent limited partner interest in Limited Partnership Z. D owns the remaining interests in partnerships Y and Z. A, an unrelated individual, has owned a 25 percent limited partner interest in partnership X for more than 3 years. The governing documents of all three partnerships permit liquidation of the entity on the agreement of the owners of 90 percent of the interests but, with the exception of A's interest, prohibit the withdrawal of a limited partner. A may withdraw on 6-months' notice and receive A's interest's share of the minimum value of partnership X as defined in paragraph (b)(1)(ii) of this section, which share includes a share of the minimum value of partnership Y and of partnership Z. Under the governing documents of all three partnerships, the approval of all partners is required to amend the documents. D transfers a 40 percent limited partner interest in partnership Y to D's children. For purposes of determining whether D and/or D's family members have the ability to remove a restriction after the transfer, A is treated as owning a 12.5 percent (.25 x.50) interest in partnership Y, thus more than a 10 percent interest, but less than a 20 percent interest, in partnership Y. Accordingly, under paragraph (b)(4)(i)(C) of this section, A's interest is disregarded for purposes of determining whether D and D's family hold the right to remove a restriction after the transfer (resulting in D and D's children being deemed to own 100 percent of Y for this purpose). However, if D instead had transferred a 40 percent limited partner interest in partnership X to D's children, A's ownership of a 25 percent interest in partnership X would not have been disregarded, with the result that D and D's family would not have had the ability to remove a restriction after the transfer.

Example 11. (i) D owns 85 of the outstanding shares of X, a corporation, and A, an unrelated individual, owns the remaining 15 shares. Under X's governing documents, the approval of the shareholders holding 75 percent of the outstanding stock is required to liquidate X. With the exception of nonfamily members, a shareholder may not withdraw from X. Nonfamily members may withdraw on six months' notice and receive their interest's share of the minimum value of X as defined in paragraph (b)(1)(ii) of this section. D transfers 10 shares to C, a charity. Four years later, D dies. D bequeaths 10 shares to B, an unrelated individual, and the remaining 65 shares to trusts for the benefit of D's family.

(ii) The prohibition on withdrawal is a restriction described in paragraph (b)(1)(i) of this section. In determining whether D's estate and/or D's family may remove the restriction after the transfer occurring on D's death, the interest of B is disregarded because it was not held by B for at least three years prior to D's death. The interests of A and C, however, are not disregarded, because each held an interest of at least 10 percent for at least three years prior to D's death, the total of those interests represents at least 20 percent of X, and each had the right to withdraw on six months' notice and receive their interest's share of the minimum value of X. As a result, D and D's family hold 65 of the deemed total of 90 shares in X, or 72 percent, which is less than the 75 percent needed to liquidate X. Thus, D and D's family do not have the ability to remove the restriction after the transfer, and section 2704(b) does not apply in valuing D's interest in X for federal estate tax purposes.

Par. 8. Newly designated § 25.2704–4 is amended as follows:

1. The undesignated text is designated as paragraph (a).

2. In the first and second sentences of newly designated paragraph (a), the language "Section" is removed and the language "Except as provided in paragraph (b) of this section, § " is added in its place.

3. Paragraph (b) is added.

The addition reads as follows:

§ 25.2704–4 Effective date.

* * * * *

(b)(1) With respect to § 25.2704–1, the first six sentences of paragraph (a)(1), the last sentence of paragraph (a)(2)(i), the third sentence of paragraph (a)(2)(iii), the first and last sentences of paragraph (a)(4), paragraph (a)(5), the second and last sentences of paragraph (c)(1), paragraph (c)(2)(i)(B), and *Examples 4*, *6* and *7* of paragraph (f), apply to lapses of rights created after October 8, 1990, occurring on or after the date these regulations are published as final regulations in the **Federal Register.**

(2) With respect to § 25.2704–2, paragraphs (a), (b), (c), (d), and (f), the first sentence of paragraph (e), and *Examples 1*, *3* and *5* of paragraph (g) apply to transfersof property subject to restrictions created after October 8, 1990, occurring on or after the date these regulations are published as final regulations in the **Federal Register.**

(3) Section 25.2704–3 applies to transfers of property subject to restrictions created after October 8, 1990, occurring 30 or more days after the date these regulations are published as final regulations in the **Federal Register.**

John Dalrymple,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on August 02, 2016, 11:15 a.m., and published in the issue of the Federal Register for August 04, 2016, 81 F.R. 51413)

Definition of Terms

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

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

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

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

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

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

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

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

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

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

Abbreviations

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

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

Numerical Finding List[1]

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[1]A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2016–01 through 2016–26 is in Internal Revenue Bulletin 2016–26, dated June 27, 2016.

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