Internal Revenue
bulletin

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HIGHLIGHTS OF THIS ISSUE

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

INCOME TAX

Rev. Rul. 2003–52, page 960.
Spin off. In the described situation, the division of a farm business to permit the principal managing shareholders to go their separate ways, promote family harmony, and further the personal estate planning of the principal managing shareholders' parents satisfies the business purpose requirement of section 1.355–2(b) of the regulations.

Rev. Rul. 2003–53, page 969.
Special use value; farms; interest rates. The 2003 interest rates to be used in computing the special use value of farm real property for which an election is made under section 2032A of the Code are listed for estates of decedents.

Rev. Rul. 2003–55, page 961.
Spin off. This ruling discusses whether the corporate business purpose requirement of section 1.355–2(b)(1) of the regulations is satisfied if, as a result of an unexpected deterioration of market conditions, the controlled corporation is unable to complete the stock offering that motivated the distribution.

Rev. Rul. 2003–57, page 959.
Medical expenses. This ruling holds that amounts paid by individuals for procedures that are directed to improving appearance and do not promote the proper function of the body are not expenses for medical care deductible under section 213 of the Code unless the procedure is necessary to correct a deformity arising from a birth defect, disfiguring disease, or injury.

Rev. Rul. 2003–58, page 959.
Medical expenses. This ruling holds that amounts paid by an individual for medicines that may be purchased without a prescription of a physician are not deductible under section 213 of the Code, but amounts paid by an individual for equipment, supplies, or diagnostic devices that may be purchased without a prescription of a physician may be deductible under section 213.

T.D. 9057, page 964.
REG–152524–02, page 979.
A corporation that files a consolidated return that acquires a subsidiary may elect to waive all or a portion of that subsidiary's loss carryovers from a separate return limitation year. Waived loss carryovers are deemed to have expired. Generally, such an election is irrevocable. Temporary and proposed regulations under section 1502 of the Code provide guidance on when a corporation may make a limited amendment to a previous election to waive these loss carryovers. In addition, these regulations permit a selling group to reapportion separate, subgroup, and consolidated section 382 limitations so that an acquiring group may use the loss carryovers that are no longer subject to the previous election. A public hearing on the proposed regulations is scheduled for August 6, 2003.

T.D. 9058, page 962.
Final regulations under section 817A of the Code affect insurance companies that define the interest rate to be used with respect to certain insurance contracts that guarantee higher returns for an initial, temporary period. Notice 97–32 revoked.

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Finding Lists begin on page ii.
Index for January through May begins on page vi.

Department of the Treasury
Internal Revenue Service

REG–164754–01, page 975.
Proposed regulations under section 61 of the Code provide guidance for federal income, gift, and employment tax purposes on the valuation of economic benefits provided under a split-dollar life insurance arrangement. The regulations supplement proposed regulations published in the Federal Register on July 9, 2002 (REG–164754–01, 2002–30 I.R.B. 212) that provide comprehensive guidance on split-dollar life insurance arrangements for federal income, gift, and employment tax purposes. A public hearing is scheduled for July 29, 2003.

Notice 2003–28, page 971.
This notice clarifies that an Indian Tribal Government (ITG) or an organization an ITG has authorized to place Indian children is an authorized placement agency for purposes of section 32(c)(3)(B)(iii).

Rev. Proc. 2003–39, page 971.
Like-kind exchanges; LKE programs. Safe harbor rules are provided under section 1031 of the Code, which allows for deferral of gain realized on a like-kind exchange of property, with respect to programs involving ongoing exchanges of tangible personal property using a single intermediary ("LKE Programs").

The IRS Mission

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Introduction

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

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

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

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

The Bulletin is divided into four parts as follows:

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

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

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

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

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

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

Section 213.—Medical, Dental, etc., Expenses

26 CFR 1.213–1: Medical, dental, etc., expenses.

Medical expenses. Amounts paid by individuals for procedures that are directed to improving appearance and do not promote the proper function of the body are not expenses for medical care deductible under section 213 of the Code unless the procedure is necessary to correct a deformity arising from a birth defect, disfiguring disease, or injury. Therefore, breast reconstruction surgery following a mastectomy for cancer and vision correction surgery such as LASIK are deductible under section 213, but teeth whitening procedures are not deductible under section 213.

Rev. Rul. 2003–57

ISSUE

Are amounts paid by individuals for breast reconstruction surgery, vision correction surgery, and teeth whitening medical care expenses within the meaning of § 213(d) and deductible under § 213 of the Internal Revenue Code?

FACTS

Taxpayer *A* undergoes mastectomy surgery that removes a breast as part of treatment for cancer and pays a surgeon to reconstruct the breast. Taxpayer *B* wears glasses to correct myopia and pays a doctor to perform laser eye surgery to correct the myopia. Taxpayer *C*'s teeth are discolored as a result of age. *C* pays a dentist to perform a teeth-whitening procedure. *A*, *B*, and *C* are not compensated for their expenses by insurance or otherwise.

LAW AND ANALYSIS

Section 213(a) allows a deduction for expenses paid during the taxable year, not compensated for by insurance or otherwise, for medical care of the taxpayer, spouse, or dependent, to the extent the expenses exceed 7.5 percent of adjusted gross income. Under § 213(d)(1)(A), medical care includes amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body.

Medical care does not include cosmetic surgery or other similar procedures, unless the surgery or procedure is necessary to ameliorate a deformity arising from, or directly related to, a congenital abnormality, a personal injury resulting from an accident or trauma, or a disfiguring disease. Section 213(d)(9)(A). Cosmetic surgery means any procedure that is directed at improving the patient's appearance and does not meaningfully promote the proper function of the body or prevent or treat illness or disease. Section 213(d)(9)(B).

A's cancer is a disfiguring disease because the treatment results in the loss of *A*'s breast. Accordingly, the breast reconstruction surgery ameliorates a deformity directly related to a disease and the cost is an expense for medical care within the meaning of § 213(d) that *A* may deduct under § 213 (subject to the limitations of that section).

The cost of *B*'s laser eye surgery is allowed under § 213(d)(9) because the surgery is a procedure that meaningfully promotes the proper function of the body. Vision correction with eyeglasses or contact lenses qualifies as medical care. See Rev. Rul. 74–429, 1974–2 C.B. 83. Eye surgery to correct defective vision, including laser procedures such as LASIK and radial keratotomy, corrects a dysfunction of the body. Accordingly, the cost of the laser eye surgery is an expense for medical care within the meaning of § 213(d) that *B* may deduct under § 213 (subject to the limitations of that section).

In contrast, the teeth-whitening procedure does not treat a physical or mental disease or promote the proper function of the body, but is directed at improving *C*'s appearance. The discoloration is not a deformity and is not caused by a disfiguring disease or treatment. Accordingly, *C* may not deduct the cost of whitening teeth as an expense for medical care.

HOLDING

Amounts paid by individuals for breast reconstruction surgery following a mastectomy for cancer and for vision correction surgery are medical care expenses under § 213(d) and are deductible under § 213 (subject to the limitations of that section). Amounts paid by individuals to whiten teeth discolored as a result of age are not medical care expenses under § 213(d) and are not deductible.

DRAFTING INFORMATION

The principal author of this revenue ruling is John T. Sapienza, Jr., of the Office of the Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Mr. Sapienza at (202) 622–7900 (not a toll-free call).

Medical expenses. Uncompensated amounts paid by individuals for medicines or drugs that may be purchased without a prescription of a physician are not deductible under section 213 of the Code. Amounts paid for equipment, supplies, or diagnostic devices may be expenses for medical care deductible under section 213.

Rev. Rul. 2003–58

ISSUES

(1) Are amounts paid by an individual for medicines that may be purchased without a prescription of a physician deductible under § 213 of the Internal Revenue Code?

(2) Are amounts paid by an individual for equipment, supplies, or diagnostic devices that may be purchased without a prescription of a physician deductible under § 213?

FACTS

Taxpayer *A* has an injured leg and uses crutches to enhance mobility while the leg is healing. *A* uses bandages to cover torn skin on the leg. *A*'s physician recommends that *A* take aspirin to treat pain in the leg. *A* also has diabetes and uses a blood sugar test kit to monitor *A*'s blood sugar level. *A* is not compensated for these expenses by insurance or otherwise.

LAW AND ANALYSIS

Section 213(a) allows a deduction for expenses paid during the taxable year, not compensated for by insurance or otherwise, for medical care of the taxpayer, spouse, or dependent, to the extent the expenses exceed 7.5 percent of adjusted gross income. Under § 213(d)(1), medical care includes amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body.

Section 213(b) permits an amount paid for a medicine or drug to be taken into account for purposes of the § 213 deduction for medical care expenses only if the medicine or drug is a prescribed drug or insulin. Section 213(d)(3) defines a prescribed drug as a drug or biological that requires a prescription of a physician for its use by an individual. Because aspirin is a drug and does not require a physician's prescription for use by an individual, pursuant to § 213(b), its cost may not be taken into account under § 213, even if a physician recommends its use to a patient. Accordingly, *A* may not deduct the cost of the aspirin under § 213.

However, § 213(b) does not apply to items that are not medicines or drugs, including equipment such as crutches, supplies such as bandages, and diagnostic devices such as blood sugar test kits. Such items may qualify as medical care if they otherwise meet the definition in § 213(d)(1). In this case, the crutches and bandages mitigate the effect of *A*'s injured leg and the blood sugar test kit monitors and assists in treating *A*'s diabetes. Therefore, the costs of these items are amounts paid for medical care under § 213(d)(1) and are deductible, subject to the limitations of § 213.

HOLDINGS

(1) Amounts paid by an individual for medicines or drugs that may be purchased without a prescription of a physician are not taken into account pursuant to § 213(b) and are not deductible under § 213.

(2) Amounts paid by an individual for equipment, supplies, or diagnostic devices may be expenses for medical care deductible under § 213 (subject to the other limitations of that section).

DRAFTING INFORMATION

The principal author of this revenue ruling is John T. Sapienza, Jr., of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Mr. Sapienza at (202) 622–7900 (not a toll-free call).

Section 355.—Distribution of Stock and Securities of a Controlled Corporation

26 CFR 1.355–2(b): Independent business purpose.

Spin off. In the described situation, the division of a farm business to permit the principal managing shareholders to go their separate ways, promote family harmony, and further the personal estate planning of the principal managing shareholders' parents satisfies the business purpose requirement of section 1.355–2(b) of the regulations.

Rev. Rul. 2003–52

ISSUE

Whether, in the situation described below, the distribution of the stock of a controlled corporation satisfies the business purpose requirement of § 1.355–2(b) of the Income Tax Regulations.

FACTS

Corporation X is a domestic corporation that has been engaged in the farming business for more than five years. The stock of X is owned 25 percent each by Father, age 68, Mother, age 67, Son, and Daughter. Although Father and Mother participate in some major management decisions, most of the management and all of the operational activities are performed by Son, Daughter, and several farmhands. The farm operation consists of breeding and raising livestock and growing grain.

Son and Daughter disagree over the appropriate future direction of X's farming business. Son wishes to expand the livestock business, but Daughter is opposed because this would require substantial borrowing by X. Daughter would prefer to sell the livestock business and concentrate on the grain business. Despite the disagreement, the two siblings have cooperated on the operation of the farm in its historical manner without disruption. Nevertheless, it has prevented each sibling from developing, as he or she sees fit, the business in which he or she is most interested.

Having transferred most of the responsibility for running the farm to the children, Father and Mother remain neutral on the disagreement between their children. However, because of the disagreement, Father and Mother would prefer to bequeath separate interests in the farm business to their children.

For reasons unrelated to X's farm business, Son and Daughter's husband dislike each other. Although this has not impaired the farm's operation to date, Father and Mother believe that requiring Son and Daughter to run a single business together is likely to cause family discord over the long run.

To enable Son and Daughter each to devote his or her undivided attention to, and apply a consistent business strategy to, the farming business in which he or she is most interested, to further the estate planning goals of Father and Mother, and to promote family harmony, X transfers the livestock business to newly formed, wholly owned domestic corporation Y and distributes 50 percent of the Y stock to Son in exchange for all of his stock in X. X distributes the remaining Y stock equally to Father and Mother in exchange for half of their X stock. Going forward, Daughter will manage and operate X and have no stock interest in Y, and Son will manage and operate Y and have no stock interest in X. Father and Mother will also amend their wills to provide that Son and Daughter will inherit stock only in Y and X, respectively. After the distribution, Father and Mother will still each own 25 percent of the outstanding stock of X and Y and will continue to participate in some major management decisions related to the business of each corporation.

Apart from the issue of whether the business purpose requirement of §1.355–2(b) is satisfied, the distribution meets all of the requirements of §§ 368(a)(1)(D) and 355 of the Internal Revenue Code.

LAW

Section 355 provides that if certain requirements are met, a corporation may distribute stock and securities in a controlled corporation to its shareholders and security holders without causing the distributing corporation or the distributees to recognize gain or loss.

To qualify as a distribution described in § 355, a distribution must, in addition to satisfying the statutory requirements of § 355, satisfy certain requirements in the regulations, including the business purpose requirement. Section 1.355–2(b)(1) provides that a distribution must be motivated, in whole or substantial part, by one or more corporate business purposes. A corporate business purpose is a real and substantial non-federal tax purpose germane to the business of the distributing corporation, the controlled corporation, or the affiliated group to which the distributing corporation belongs. Section 1.355–2(b)(2). A shareholder purpose (for example, the personal planning purposes of a shareholder) is not a corporate business purpose. *Id*. Depending upon the facts of a particular case, however, a shareholder purpose for a transaction may be so nearly coextensive with a corporate business purpose as to preclude any distinction between them. *Id*. In such a case, the transaction is carried out for one or more corporate business purposes. *Id*. A transaction motivated in substantial part by a corporate business purpose does not fail the business purpose requirement merely because it is motivated in part by non-federal tax shareholder purposes. Preamble to the § 355 regulations, T.D. 8238, 1989–1 C.B. 92, 94.

In Example (2) of § 1.355–2(b)(5), Corporation X is engaged in two businesses: the manufacture and sale of furniture and the sale of jewelry. The businesses are of equal value. The outstanding stock of X is owned equally by unrelated individuals A and B. A is more interested in the furniture business, while B is more interested in the jewelry business. A and B decide to split up the businesses and go their separate ways. A and B expect that the operations of each business will be enhanced by the separation because each shareholder will be able to devote his undivided attention to the business in which he is more interested and more proficient. Accordingly, X transfers the jewelry business to new corporation Y and distributes the stock of Y to B in exchange for all of B's stock in X. The example concludes that the distribution is carried out for a corporate business purpose, notwithstanding that it is also carried out in part for shareholder purposes.

ANALYSIS

The disagreement of Son and Daughter over the farm's future direction has prevented each sibling from developing, as he or she sees fit, the business in which he or she is most interested. The distribution will eliminate this disagreement and allow each sibling to devote his or her undivided attention to, and apply a consistent business strategy to, the farming business in which he or she is most interested, with the expectation that each business will benefit. Therefore, although the distribution is intended, in part, to further the personal estate planning of Father and Mother and to promote family harmony, it is motivated in substantial part by a real and substantial non-federal tax purpose that is germane to the business of X. Hence, the business purpose requirement of § 1.355–2(b) is satisfied.

HOLDING

In the situation described above, the distribution of the stock of a controlled corporation satisfies the business purpose requirement of § 1.355–2(b).

DRAFTING INFORMATION

The principal author of this revenue ruling is Richard H. Cox of the Office of Associate Chief Counsel (Corporate). For further information regarding this revenue ruling, contact Mr. Cox at (202) 622–7790 (not a toll-free call).

Spin off. If a stock offering business purpose motivates a distribution of controlled corporation stock by a distribution corporation, the inability of the controlled corporation to complete the offering as a result of an unexpected deterioration in market conditions will not prevent the distribution from having satisfied the corporate business purpose requirement of section 1.355–2(b)(1) of the regulations.

Rev. Rul. 2003–55

ISSUE

Is the business purpose requirement of § 1.355–2(b) of the Income Tax Regulations satisfied if the distribution of the stock of a controlled corporation is, at the time of the distribution, motivated, in whole or substantial part, by a corporate business purpose, but that purpose cannot be achieved as the result of an unexpected change in circumstances following the distribution?

FACTS

D is a publicly traded corporation that conducts Business A and Business B directly and Business C through its wholly owned subsidiary C. Business C needs to raise a substantial amount of capital in the near future to invest in plant and equipment and to make acquisitions. D has been advised by its investment banker that the best way to raise this capital is through an initial public offering of C stock after C has been separated from D. The investment banker believes, based on its analysis of comparable situations, and taking into account the current market climate, that such an offering would be more efficient than a stock offering by C or D without first separating from the other because it would raise the needed capital with significantly less dilution of the existing shareholders' interests in the combined enterprises.

In reliance on the investment banker's opinion, D distributes the stock of C to its shareholders, and C prepares to offer its stock to the public as soon as practicable but with a target date approximately six months after the distribution. Following the distribution and before the offering can be undertaken, market conditions unexpectedly deteriorate to such an extent that, in the judgment of C and its advisors, the offering should be postponed. One year after the distribution, conditions have not improved sufficiently to permit the offering to go forward and C funds its capital needs through the sale of debentures.

Apart from the issue of whether the business purpose requirement of § 1.355–2(b) is satisfied, the distribution meets all of the requirements of § 355 of the Internal Revenue Code.

LAW

Section 355 provides that if certain requirements are met, a corporation may distribute stock and securities in a controlled corporation to its shareholders and security holders without causing the distributing corporation or the distributees to recognize gain or loss.

To qualify as a distribution described in § 355, a distribution must, in addition to satisfying the statutory requirements of § 355, satisfy certain requirements in the regulations, including the business purpose requirement. Section 1.355–2(b)(1) provides that a distribution must be motivated, in whole or substantial part, by one or more corporate business purposes. A corporate business purpose is a real and substantial non-federal tax purpose germane to the business of the distributing corporation, the controlled corporation, or the affiliated group to which the distributing corporation belongs. Section 1.355–2(b)(2). The principal reason for the business purpose requirement is to provide nonrecognition treatment only to distributions that are incident to readjustments of corporate structures required by business exigencies and that effect only readjustments of continuing interests in property under modified corporate forms. Section 1.355–2(b)(1).

ANALYSIS

To satisfy the business purpose requirement of § 1.355–2(b)(1), a distribution of controlled corporation stock must be motivated, in whole or substantial part, by a corporate business purpose. A corporate business purpose is a real and substantial non-federal tax purpose germane to the business of the distributing corporation, the controlled corporation, or the affiliated group to which the distributing corporation belongs. The regulations do not require that the corporation in fact succeed in meeting its corporate business purpose, as long as, at the time of the distribution, such a purpose exists and motivates, in whole or substantial part, the distribution. An unexpected change in market or business conditions following a distribution that prevents achievement of the business purpose will not prevent satisfaction of the business purpose requirement. Hence, notwithstanding the fact that, as a result of the unexpected deterioration in market conditions, C does not complete the stock offering that motivated its separation from D, the business purpose requirement of § 1.355–2(b)(1) is satisfied.

HOLDING

The business purpose requirement of § 1.355–2(b) is satisfied if the distribution of the stock of a controlled corporation is, at the time of the distribution, motivated, in whole or substantial part, by a corporate business purpose, but that purpose cannot be achieved as the result of an unexpected change in circumstances following the distribution.

DRAFTING INFORMATION

The principal author of this revenue ruling is Wayne T. Murray of the Office of Associate Chief Counsel (Corporate). For further information regarding this revenue ruling, contact Mr. Murray at (202) 622–7700 (not a toll-free call).

Section 817A.—Special Rules for Modified Guaranteed Contracts

26 CFR 1.817A–1: Certain modified guaranteed contracts.

T.D. 9058

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Guidance Under Section 817A Regarding Modified Guaranteed Contracts

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations affecting insurance companies that define the interest rate to be used with respect to certain insurance contracts that guarantee higher returns for an initial, temporary period. Specifically, the final regulations define the appropriate interest rate to be used in the determination of tax reserves and required interest for certain modified guaranteed contracts. The final regulations also address how temporary guarantee periods that extend past the end of a taxable year are to be taken into account.

DATES: *Effective Date:* These regulations are effective as of May 7, 2003.

Applicability Date: For dates of applicability, see §1.817A–1(d).

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Ann H. Logan, 202–622–3970 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On June 3, 2002, the Treasury Department and the IRS published a notice of proposed rulemaking (REG–248110–96, 2002–26 I.R.B. 19 [67 FR 38214]) under section 817A of the Internal Revenue Code (Code) in the **Federal Register**. The notice was corrected in the **Federal Register** (67 FR 41653) on June 19, 2002. The proposed regulations were designed, in part, to reflect the addition of section 817A to the Code by section 1612 of the Small Business Job Protection Act of 1996, Public Law 104–188 (110 Stat. 1755). No one requested to speak at the public hearing scheduled for August 27, 2002. Accordingly, the public hearing was canceled on August 15, 2002 (67 FR 53327). Comments in response to the notice of proposed rulemaking were received and are addressed in the following Explanation and Summary of Comments. After consideration of all the comments, this document adopts the proposed regulations as revised by this Treasury decision. In addition, previous guidance under section 817A is revoked.

Explanation and Summary of Comments

Two comments were filed with the Office of the Chief Counsel of the Internal Revenue Service. Both commentators generally agreed with the decisions incorporated in the proposed regulations. However, both commentators raised concern as to the interaction of the interest rates to be used for the reserve computations for modified guaranteed contracts (MGCs) with the reserve computation rules of section 811(d). That provision imposes an additional reserve computation rule for contracts that guarantee beyond the end of the taxable year payment or crediting of amounts in the nature of interest in excess of the greater of the prevailing state assumed interest rate or the applicable federal interest rate. In those circumstances, section 811(d) requires that the contract's future guaranteed benefits be determined as though the interest in excess of the greater of the prevailing state assumed interest rate or the applicable federal rate were guaranteed only to the end of the taxable year.

Material was submitted as to the possible distortion of taxable income with respect to MGCs in declining interest rate environments. Notably, in cases where the interest rate required to be used under the regulations as proposed falls below the contract crediting rate during the guarantee period, section 811(d) will operate in a manner that does not match taxable income to actual income. As section 811(d) precludes taking future guaranteed interest amounts into account, examples showed that income distortion could occur under this fact pattern.

After review of the comments, the proposed regulations have been amended to waive section 811(d) throughout the guarantee period of non-equity-indexed MGCs.

Effect on Other Documents

Notice 97–32, 1997–1 C.B. 420, is revoked as of May 7, 2003. Accordingly, the notice may continue to be used by taxpayers if they wish through the effective date of these final regulations.

Special Analyses

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

Drafting Information

The principal author of these proposed regulations is Ann H. Logan, Office of the Associate Chief Counsel (Financial Institutions and Products), Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the IRS and the Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAX

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

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

Section 1.807–2 also issued under 26 U.S.C. 817A(e) * * *

Section 1.811–3 also issued under 26 U.S.C. 817A(e) * * *

Section 1.812–9 also issued under 26 U.S.C. 817A(e) * * *

Section 1.817A–1 also issued under 26 U.S.C. 817A(e) * * *

Par. 2. Section 1.807–2 is added to read as follows:

§1.807–2 Cross-Reference.

For special rules regarding the treatment of modified guaranteed contracts (as defined in section 817A and §1.817A–1(a)(1)), see §1.817A–1.

Par. 3. Section 1.811–3 is added to read as follows:

§1.811–3 Cross-Reference.

For special rules regarding the treatment of modified guaranteed contracts (as defined in section 817A and §1.817A–1(a)(1)), see §1.817A–1.

Par. 4. Section §1.812–9 is added to read as follows:

§1.812–9 Cross-Reference.

For special rules regarding the treatment of modified guaranteed contracts (as defined in section 817A and §1.817A–1(a)(1)), see §1.817A–1.

Par. 5. Sections §1.817A–0 and §1.817A–1 are added to read as follows:

§1.817A–0 Table of contents.

This section lists the captions that appear in section §1.817A–1:

§1.817A–1 Certain modified guaranteed contracts.

§1.817A–1 Certain modified guaranteed contracts.

(a) *Definitions*—(1) *Modified guaranteed contract*. The term *modified guaranteed contract* (MGC) is defined in section 817A(d) as an annuity, life insurance, or pension plan contract (other than a variable contract described in section 817) under which all or parts of the amounts received under the contract are allocated to a segregated account. Assets and reserves in this segregated account must be valued from time to time with reference to market values for annual statement purposes. Further, an MGC must provide either for a net surrender value or for a policyholder's fund (as defined in section 807(e)(1)). If only a portion of a contract is not described in section 817, such portion is treated as a separate contract for purposes of applying section 817A.

(2) *Temporary guarantee period*. An MGC may temporarily guarantee a return other than the permanently guaranteed crediting rate for a period specified in the contract (the *temporary guarantee period*). During the temporary guarantee period, the amount paid to the policyholder upon surrender is usually increased or decreased by a market value adjustment, which is determined by a formula set forth under the terms of the MGC.

(3) *Equity-indexed modified guaranteed contract*. An equity-indexed MGC is an MGC, as defined in paragraph (a)(1) of this section, that provides a return during or at the end of the temporary guarantee period based on the performance of stocks, other equity instruments, or equity-based derivatives.

(4) *Non-equity-indexed modified guaranteed contract*. A non-equity-indexed MGC is an MGC, as defined in paragraph (a)(1)

of this section, that provides a return during or at the end of the temporary guarantee period not based on the performance of stocks, other equity instruments, or equity-based derivatives.

(5) *Current market rate for non-equity-indexed modified guaranteed contracts*. The current market rate for a non-equity-indexed MGC issued by an insurer (whether issued in that tax year or a previous one) is the appropriate Treasury constant maturity interest rate published by the Board of Governors of the Federal Reserve System for the month containing the last day of the insurer's taxable year. The appropriate rate is that rate published for Treasury securities with the shortest published maturity that is greater than (or equal to) the remaining duration of the current temporary guarantee period under the MGC.

(6) *Current market rate for equity-indexed modified guaranteed contracts*. [Reserved]

(b) *Applicable interest rates for non-equity-indexed modified guaranteed contracts*—(1) *Tax reserves during temporary guarantee period*. An insurance company is required to determine the tax reserves for an MGC under sections 807(c)(3) or (d)(2). During a non-equity-indexed MGC's temporary guarantee period, the applicable interest rate to be used under sections 807(c)(3) and (d)(2)(B) is the current market rate, as defined in paragraph (a)(5) of this section.

(2) *Required interest during temporary guarantee period*. During the temporary guarantee period of a non-equity-indexed MGC, the applicable interest rate to be used to determine required interest under section 812(b)(2)(A) is the same current market rate, defined in paragraph (a)(5) of this section, that applies for that period for purposes of sections 807(c)(3) or (d)(2)(B).

(3) *Application of section 811(d)*. An additional reserve computation rule applies under section 811(d) for contracts that guarantee certain interest payments beyond the end of the taxable year. Section 811(d) is waived for non-equity-indexed MGCs.

(4) *Periods after the end of the temporary guarantee period*. For periods after the end of the temporary guarantee period, sections 807(c)(3), 807(d)(2)(B), 811(d), and 812(b)(2)(A) are not modified when applied to non-equity-indexed MGCs. None of these sections are affected by the definition of current market rate contained in paragraph (a)(5) of this section once the temporary guarantee period has expired.

(5) *Examples*. The following examples illustrate this paragraph (b):

Example 1. (i) *IC*, a life insurance company as defined in section 816, issues a MGC (the Contract) on August 1 of 1996. The Contract is an annuity contract that gives rise to life insurance reserves, as defined in section 816(b). *IC* is a calendar year taxpayer. The Contract guarantees that interest will be credited at 8 percent per year for the first 8 contract years and 4 percent per year thereafter. During the 8-year temporary guarantee period, the Contract provides for a market value adjustment based on changes in a published bond index and not on the performance of stocks, other equity instruments or equity based derivatives. *IC* has chosen to avail itself of the provisions of these regulations for 1996 and taxable years thereafter. The 10-year Treasury constant maturity interest rate published for December of 1996 was 6.30 percent. The next shortest maturity published for Treasury constant maturity interest rates is 7 years. As of the end of 1996, the remaining duration of the temporary guarantee period for the Contract was 7 years and 7 months.

(ii) To determine under section 807(d)(2) the end of 1996 reserves for the Contract, *IC* must use a discount interest rate of 6.30 percent for the temporary guarantee period. The interest rate to be used in computing required interest under section 812(b)(2)(A) for 1996 reserves is also 6.30 percent.

(iii) The discount rate applicable to periods outside the 8-year temporary guarantee period is determined under sections 807(c)(3), 807(d)(2)(B), 811(d), and 812(b)(2)(A) without regard to the current market rate.

Example 2. Assume the same facts as in *Example 1* except that it is now the last day of 1998. The remaining duration of the temporary guarantee period under the Contract is now 5 years and 7 months. The 7-year Treasury constant maturity interest rate published for December of 1998 was 4.65 percent. The next shortest duration published for Treasury constant maturity interest rates is 5 years. A discount rate of 4.65 percent is used for the remaining duration of the temporary guarantee period for the purpose of determining a reserve under section 807(d) and for the purpose of determining required interest under section 812(b)(2)(A).

Example 3. Assume the same facts as in *Example 1* except that it is now the last day of 2001. The remaining duration of the temporary guarantee period under the Contract is now 2 years and 7 months. The 3-year Treasury constant maturity interest rate published for December of 2001 was 3.62 percent. The next shortest duration published for Treasury constant maturity interest rates is 2 years. A discount rate of 3.62 percent is used for the remaining duration of the temporary guarantee period for the purpose of determining a reserve under section 807(d) and for the purpose of determining required interest under section 812(b)(2)(A).

(c) *Applicable interest rates for equity-indexed modified guaranteed contracts.* [Reserved.]

(d) *Effective date*. Paragraphs (a), (b), and (d) of this section are effective on May 7, 2003. However, pursuant to section 7805(b)(7), taxpayers may elect to apply those paragraphs retroactively for all taxable years beginning after December 31, 1995, the effective date of section 817A.

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

Approved April 25, 2003.

Pamela F. Olson,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on May 6, 2003, 8:45 a.m., and published in the issue of the Federal Register for May 7, 2003, 68 F.R. 24349)

Section 1502.—Regulations

26 CFR 1.1502–20T: Disposition or deconsolidation of subsidiary stock (temporary).

T.D. 9057

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Guidance Under Section 1502; Amendment of Waiver of Loss Carryovers From Separate Return Limitation Years

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations under section 1502 that permit the amendment of certain elections to waive the loss carryovers of an acquired subsidiary. The text of these temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking (REG–152524–02) on this subject on page 979 of this Bulletin. These regulations apply to corporations filing consolidated returns. This document also provides notice of a public hearing on these temporary and proposed regulations.

DATES: *Effective Date:* These regulations are effective May 7, 2003.

Applicability Date: For dates of applicability, see §1.1502–20T(i)(3)(viii)(C), §1.1502–20T(i)(5)(ii), and §1.1502–32T(b)(4)(vii)(F). The applicability of these sections expires on May 2, 2006.

FOR FURTHER INFORMATION CONTACT: Alison G. Burns or Jeffrey B. Fienberg (202) 622–7930 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these regulations has been previously reviewed and approved by the **Office of Management and Budget** under control number 1545–1774. Responses to this collection of information are required to obtain a benefit. This collection of information is revised by these regulations. These amended regulations are being issued without prior notice and public procedure pursuant to the Administrative Procedure Act (5 U.S.C. 553). For this reason, the revised collection of information contained in these regulations has been reviewed and, pending receipt and evaluation of public comments, approved by the **Office of Management and Budget** under control number 1545–1774.

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

For further information concerning this collection of information, and where to submit comments on the collection of information and the accuracy of the estimated burden, and suggestions for reducing this burden, please refer to the preamble of the cross-referencing notice of proposed rulemaking published in this issue of the Bulletin.

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

Background and Explanation of Provisions

In 1991, the IRS and Treasury Department promulgated §1.1502–20 setting forth rules regarding the extent to which a loss recognized by a member of a consolidated group on the disposition of stock of a subsidiary member of the same group was allowed and the extent to which the basis of subsidiary member stock was required to be reduced prior to its deconsolidation. Section 1.1502–20 provides that a loss recognized by a group member on the disposition of subsidiary member stock is allowable only to the extent it exceeds the sum of "extraordinary gain dispositions," "positive investment adjustments," and "duplicated loss." In addition, it provides that the basis of subsidiary member stock that is deconsolidated is reduced to its value to the extent of the sum of the same amounts immediately prior to its deconsolidation. The duplicated loss amount equals the sum of the aggregated adjusted basis of the assets of the subsidiary (other than any stock and securities that the subsidiary owns in another member), the losses attributable to the subsidiary that are carried forward to the subsidiary's first taxable year following the disposition or deconsolidation, and any deferred deductions of the subsidiary, over the sum of the value of the subsidiary's stock and its liabilities.

Section 1.1502–32(b)(4) provides that, if a subsidiary has a loss carryover from a separate return limitation year when it becomes a member of a consolidated group, the group may make an election to treat all or any portion of the loss carryover as expiring immediately before the subsidiary becomes a member of the consolidated group. This election allows an acquiring group to prevent the loss of stock basis that otherwise would result if the subsidiary's loss carryovers were to expire before the group could absorb them. See §1.1502–32(b)(2)(iii). Section 1.1502–32(b)(4) further provides that, if the subsidiary was a member of another group immediately before it became a member of the consolidated group, the losses are treated as expiring immediately after the subsidiary ceases to be a member of the prior group. The election described in §1.1502–32(b)(4) may be made by identifying either the amount of each loss carryover deemed to expire or the amount of each loss carryover deemed not to expire.

If stock of a subsidiary with loss carryovers is sold by one consolidated group to another and the acquiring group waives all or a portion of the subsidiary's loss carryovers pursuant to §1.1502–32(b)(4), the selling group can exclude the waived loss carryovers from its computation of duplicated loss. In certain cases, the waiver could have the effect of increasing the amount of stock loss allowed on the disposition of subsidiary stock or reducing the basis reduction required on the deconsolidation of subsidiary stock. The IRS and Treasury understand that certain waivers of loss carryovers that were made pursuant to §1.1502–32(b)(4) were made so as to increase the amount of allowed loss on a disposition of subsidiary stock.

In *Rite Aid Corp. v. United States*, 255 F.3d 1357 (Fed. Cir. 2001), the United States Court of Appeals for the Federal Circuit held that the duplicated loss component of §1.1502–20 was an invalid exercise of regulatory authority. In response to the *Rite Aid* decision, on March 7, 2002, the IRS and Treasury Department filed with the **Federal Register** temporary regulations (T.D. 8984, 2002–1 C.B. 668 [11034]) under sections 337(d) and 1502 governing the determination of a consolidated group's allowable stock loss and basis reduction required on a disposition or deconsolidation of subsidiary member stock. Under the temporary regulations, consolidated groups can compute the allowable loss or the basis reduction required on dispositions and deconsolidations of subsidiary stock before March 7, 2002, and certain dispositions and deconsolidations of subsidiary stock on or after March 7, 2002, by applying §1.1502–20 in its entirety, by applying the provisions of §1.1502–20 without regard to the duplicated loss factor of the loss disallowance formula, or by applying the provisions of §1.337(d)–2T. See §1.1502–20T(i)(2).

The IRS and Treasury Department believe that in certain cases in which a selling group elects to compute the allowable loss or the basis reduction required on a disposition or deconsolidation of subsidiary member stock by applying §1.1502–20 without regard to the duplicated loss factor of the loss disallowance formula, or by applying the provisions of §1.337(d)–2T, it is appropriate to permit an acquiring group to amend certain prior waivers of loss carryovers. The following paragraphs describe these cases and the amendments that this document makes to §§1.1502–20T and 1.1502–32T to allow certain amendments to prior waivers of loss carryovers.

Prior Waivers of Loss Carryovers Made to Increase Allowable Loss or Reduce Basis Reduction Required

If a selling group elects to compute the allowable loss or the basis reduction required on a disposition or deconsolidation of subsidiary stock by applying the provisions of §1.1502–20 without regard to the duplicated loss factor of the loss disallowance formula, or by applying the provisions of §1.337(d)–2T, the acquiring group's prior waiver of loss carryovers of the subsidiary or lower-tier corporation of such subsidiary will have no effect on the selling group's allowable loss or the basis reduction required with respect to the disposed of or deconsolidated subsidiary stock. To the extent, therefore, that an acquiring group made an election to waive loss carryovers to increase the allowable loss or to reduce the basis reduction required with respect to the disposed of or deconsolidated subsidiary stock, the IRS and Treasury Department believe that the acquiring group should be permitted to amend such waivers to decrease, to a limited extent, the amounts of loss carryovers deemed to expire.

Accordingly, the regulations contained in this document provide that, if the acquiring group made an election pursuant to §1.1502–32(b)(4) to waive a subsidiary's loss carryovers, that election increased the amount of the allowable loss or reduced the basis reduction required with respect to the disposed of or deconsolidated subsidiary stock, and the selling group elects to compute the allowable loss or the basis reduction required with respect to the disposed of or deconsolidated subsidiary stock by applying the provisions of §1.1502–20 without regard to the duplicated loss factor of the loss disallowance formula, or by applying the provisions of §1.337(d)–2T, then the acquiring group may reduce the amount of any loss carryover deemed to expire (or increase the amount of any loss carryover deemed not to expire) as a result of the election made pursuant to §1.1502–32(b)(4). The aggregate amount of loss carryovers that may be treated as not expiring as a result of such an amendment of a waiver of a loss carryover of the subsidiary the stock of which is disposed of or deconsolidated and any lower-tier corporation of such subsidiary, however, may not exceed the duplicated loss with respect to the disposed of or deconsolidated subsidiary stock. This limitation is intended to ensure that all of the loss carryovers that do not expire as a result of the amendment did, in fact, increase the amount of the allowable loss or reduce the basis reduction required with respect to the disposed of or deconsolidated subsidiary stock. In addition, to enable the acquiring group's use of loss carryovers that are not deemed to expire as a result of such an amendment, these regulations permit a selling group to reapportion separate, subgroup, and consolidated section 382 limitations.

Inadvertent Waivers of Loss Carryovers

A selling group's election to compute the allowable loss or the basis reduction required on a disposition or deconsolidation of subsidiary stock by applying the provisions of §1.1502–20 without regard to the duplicated loss factor of the loss disallowance formula, or by applying the provisions of §1.337(d)–2T, may result in a reduction of the amount of losses treated as reattributed to the selling group pursuant to an election described in §1.1502–20(g). To the extent that losses treated as reattributed to the selling group are reduced, the losses of a subsidiary are increased. In this case, if the acquiring group made an election to waive certain loss carryovers of the subsidiary by identifying those losses that were deemed not to expire, it may have inadvertently waived those losses that are treated as losses of the subsidiary as a result of the election by the selling group. The IRS and Treasury Department believe that such acquiring groups should be permitted to make certain amendments of such waivers.

Accordingly, these regulations permit acquiring groups to amend an election made pursuant to §1.1502–32(b)(4) where the group of which the subsidiary was a member immediately before the acquisition (the prior group) elected to determine the amount of the allowable loss or the basis reduction required with respect to the stock of the subsidiary or a higher-tier corporation of the subsidiary by applying §1.1502–20 without regard to the duplicated loss factor of the loss disallowance formula, or by applying the provisions of §1.337(d)–2T, the subsidiary's loss carryovers are increased by such election by the prior group, and the acquiring group made an election pursuant to §1.1502–32(b)(4) by identifying those losses that would be deemed not to expire. In this case, pursuant to these regulations, the acquiring group may amend its election made pursuant to §1.1502–32(b)(4) to provide that all or a portion of the loss carryovers of the subsidiary that are treated as loss carryovers of the subsidiary as a result of the prior group's election are deemed not to expire.

The regulations contained in this document only permit acquiring groups to reduce the amount of loss carryovers deemed to expire, or increase the amount of loss carryovers deemed not to expire, as a result of an election under §1.1502–32(b)(4). The regulations, however, do not permit acquiring groups to increase the amount of loss carryovers deemed to expire, or reduce the amount of loss carryovers deemed not to expire, as a result of such an election. The regulations, therefore, permit increases, but not decreases, of the amount of loss carryovers available to acquiring groups.

Limited Extension of Time to Apply Alternative Regime

In addition to the provisions described above, the regulations include a limited extension of time for selling groups to make an election to compute the allowable loss or the basis reduction required on a disposition or deconsolidation of subsidiary stock by applying the provisions of §1.1502–20 without regard to the duplicated loss factor of the loss disallowance formula, or by applying the provisions of §1.337(d)–2T, if the acquiring group is otherwise eligible to amend an election under §1.1502–32(b)(4) pursuant to these regulations, but the time period during which the selling group could make its election has or has almost expired.

Additional Adjustments

In promulgating §1.1502–20T and related provisions, the IRS and Treasury have attempted to ameliorate where possible the situation of groups that relied on the provisions of §1.1502–20 in prior periods. The IRS and Treasury recognize that the loss disallowance rule in §1.1502–20 affected the manner in which some transactions were structured. For example, some groups caused subsidiaries to sell their assets rather than engage in stock sales subject to loss disallowance under §1.1502–20. Alternatively, groups may have engaged in deemed asset sales under §338(h)(10). The IRS and Treasury believe that transactions cast in the form of actual or deemed asset sales should not be undone, notwithstanding the possible role of §1.1502–20 in their planning. However, as was the case with the relief provided earlier in §1.1502–20T and its related amendments, the IRS and Treasury have concluded that relief is appropriate and administrable in the situation that is the subject of these temporary regulations.

Special Analyses

In light of the Federal Circuit's decision in *Rite Aid Corp. v. United States*, 255 F.3d 1357 (Fed. Cir. 2001), these temporary regulations are necessary to provide taxpayers with immediate guidance regarding the amendment of certain elections to waive the loss carryovers of an acquired subsidiary. Without such immediate guidance, taxpayers may not be able to avail themselves of the relief provided for in these regulations. Accordingly, good cause is found for dispensing with notice and public procedure pursuant to 5 U.S.C. 553(b)(B) and with a delayed effective date pursuant to 5 U.S.C. 553(d)(1) and (3). For applicability of the Regulatory Flexibility Act, please refer to the cross-reference notice of proposed rulemaking published elsewhere in this issue of the Bulletin. Pursuant to §7805(f) of the Internal Revenue Code, these temporary regulations will be submitted to the Chief Counsel of Advocacy of the Small Business Administration for comment on their impact.

Drafting Information

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

* * * * *

Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Section 1.1502–20T also issued under 26 U.S.C. 1502. * * *

Section 1.1502–32T also issued under 26 U.S.C. 1502. * * *

Par. 2. In §1.1502–20T, paragraph (i)(5) is redesignated as (i)(6).

Par. 3. Section 1.1502–20T is amended by adding paragraphs (i)(3)(viii) and (i)(5) to read as follows:

§1.1502–20T — Disposition or deconsolidation of subsidiary stock (temporary).

* * * * *

(i) * * *

(3) * * *

(viii) *Apportionment of section 382 limitation in the case of an amendment of an election made pursuant to §1.1502–32(b)(4).* (A) *In general*. If, in connection with a disposition or deconsolidation of subsidiary stock, the subsidiary the stock of which was disposed of or deconsolidated became a member of another consolidated group (the acquiring group), and, pursuant to §1.1502–32T(b)(4)(vii), the acquiring group amends an election made pursuant to §1.1502–32(b)(4) to treat all or a portion of the loss carryovers of such subsidiary (or a lower-tier corporation of such subsidiary) as expiring for all federal income tax purposes, then the common parent may reapportion a separate, subgroup, or consolidated section 382 limitation with respect to such subsidiary or lower-tier corporation in a manner consistent with the principles of paragraph (i)(3)(iii)(A) through (D) of this section. Any reapportionment of a section 382 limitation made pursuant to the previous sentence shall have the effects described in paragraph (i)(3)(iii)(D)(*ii*) and (*iii*) of this section. For purposes of this section, a lower-tier corporation is a corporation that was a member of the group of which the subsidiary was a member immediately before becoming a member of the acquiring group and that became a member of the acquiring group as a result of the subsidiary becoming a member of the acquiring group.

(B) *Time and manner of adjustment of apportionment of section 382 limitation*. The common parent must include a statement entitled *Adjustment of Apportionment of Section 382 Limitation in Connection with Amendment of Election under §1.1502–32(b)(4)* with or as part of any timely filed (including any extensions) original return for a taxable year that includes any date on or before May 7, 2003, or with or as part of an amended return filed before the date the original return for the taxable year that includes May 7, 2003, is due (with regard to extensions). The statement must set forth the name and employer identification number (E.I.N.) of the subsidiary and both the original and the adjusted apportionment of a separate section 382 limitation, a subgroup section 382 limitation, and a consolidated section 382 limitation, as applicable. The requirements of this paragraph (i)(3)(viii)(B) will be treated as satisfied if the information required by this paragraph (i)(3)(viii)(B) is included in the statement required by paragraph (i)(4) of this section rather than in a separate statement.

(C) *Effective date*. This paragraph (i)(3)(viii) is applicable on and after May 7, 2003.

* * * * *

(5) *Special time for filing election in the case of a waiver under §1.1502–32(b)(4).* (i) *In general*. Notwithstanding the provisions of paragraph (i)(4) of this section, the election to determine allowable loss or basis reduction provided in this paragraph (i) may be made by including the statement required by paragraph (i)(4) of this section with or as part of an original or amended return that is filed on or before June 15, 2003, if—

(A) the group that includes the acquirer of the subsidiary stock made an election pursuant to §1.1502–32(b)(4) to treat all or a portion of the loss carryovers of the subsidiary (or a lower-tier corporation of such subsidiary) as expiring for all federal income tax purposes;

(B) the timely filing of an election to determine allowable loss or basis reduction by applying the provisions described in paragraph (i)(2)(i) or (ii) of this section would permit the acquiring group to amend its election under §1.1502–32(b)(4) pursuant to §1.1502–32T(b)(4)(vii);

(C) June 6, 2003, is after the date the original return of the consolidated group for the taxable year that includes March 7, 2002, is due (including extensions); and

(D) the statement required by paragraph (i)(4) of this section specifies that the filing of the election is permitted under this paragraph (i)(5).

(ii) Effective date. This paragraph (i)(5) is applicable on and after May 7, 2003.

* * * * *

Par. 4. Section 1.1502–32T is amended by adding paragraph (b)(4)(vii) to read as follows:

§1.1502–32T — Investment adjustments (temporary).

* * * * *

(b) * * *

(4) * * *

(vii) *Special rules for amending waiver of loss carryovers from separate return limitation year*—(A) *Waivers that increased allowable loss or reduced basis reduction required*. If, in connection with the acquisition of S, the group made an election pursuant to §1.1502–32(b)(4) to treat all or any portion of S's loss carryovers as expiring, and the prior group elected to determine the amount of the allowable loss or the basis reduction required with respect to the stock of S or a higher-tier corporation of S by applying the provisions described in §1.1502–20T(i)(2)(i) or (ii), then the group may reduce the amount of any loss carryover deemed to expire (or increase the amount of any loss carryover deemed not to expire) as a result of the election made pursuant to §1.1502–32(b)(4). The aggregate amount of loss carryovers that may be treated as not expiring as a result of amendments made pursuant to this paragraph (b)(4)(vii)(A) with respect to S and any higher- and lower-tier corporation of S may not exceed the amount described in §1.1502–20(c)(1)(iii) with respect to the acquired stock (computed without regard to the effect of the group's election or elections pursuant to §1.1502–32(b)(4), but with regard to the effect of the prior group's election pursuant to §1.1502–20(g), if any, prior to the application of §1.1502–20T(i)(3)). For purposes of determining the aggregate amount of loss carryovers that may be treated as not expiring as a result of amendments made pursuant to this paragraph (b)(4)(vii)(A) with respect to S and any higher- and lower-tier corporation of S, the group may rely on a written notification provided by the prior group. Nothing in this paragraph shall be construed as permitting a group to increase the amount of any loss carryover deemed to expire (or reduce the amount of any loss carryover deemed not to expire) as a result of the election made pursuant to §1.1502–32(b)(4).

(B) *Inadvertent waivers of loss carryovers previously subject to an election described in §1.1502–20(g)*. If, in connection with the acquisition of S, the group made an election pursuant to §1.1502–32(b)(4) to waive loss carryovers of S by identifying the amount of each loss carryover deemed not to expire, the prior group elected to determine the amount of the allowable loss or the basis reduction required with respect to the stock of S or a higher-tier corporation of S by applying the provisions described in §1.1502–20T(i)(2)(i) or (ii), and the amount of S's loss carryovers treated as reattributed to the prior group pursuant to the election described in §1.1502–20(g) is reduced pursuant to §1.1502–20T(i)(3), then the group may amend its election made pursuant to §1.1502–32(b)(4) to provide that all or a portion of the loss carryovers of S that are treated as loss carryovers of S as a result of the prior group's election to apply the provisions described in §1.1502–20T(i)(2)(i) or (ii) are deemed not to expire. This paragraph (b)(4)(vii)(B), however, does not permit a group to reduce the amount of any loss carryover deemed not to expire as a result of the election made pursuant to §1.1502–32(b)(4).

(C) *Time and manner of amending an election under §1.1502–32(b)(4)*. The amendment of an election made pursuant to §1.1502–32(b)(4) must be made in a statement entitled *Amendment of Election to Treat Loss Carryover as Expiring Under §1.1502–32(b)(4) Pursuant to §1.1502–32T(b)(4)(vii)*. The statement must be filed with or as part of any timely filed (including extensions) original return for the taxable year that includes May 7, 2003, or with or as part of an amended return filed before the date the original return for the taxable year that includes May 7, 2003, is due (with regard to extensions). A separate statement shall be filed for each election made pursuant to §1.1502–32(b)(4) that is being amended pursuant to this paragraph (b)(4)(vii). For purposes of making this statement, the group may rely on the statements set forth in a written notification provided by the prior group. The statement filed under this paragraph must include the following—

(*1*) The name and employer identification number (E.I.N.) of S;

(*2*) In the case of an amendment made pursuant to paragraph (b)(4)(vii)(A), a statement that the group has received a written notification from the prior group confirming that the group's prior election or elections pursuant to §1.1502–32(b)(4) had the effect of either increasing the prior group's allowable loss on the disposition of subsidiary stock or reducing the prior group's amount of basis reduction required;

(*3*) The amount of each loss carryover of S deemed to expire (or the amount of loss carryover deemed not to expire) as set forth in the election made pursuant to §1.1502–32(b)(4);

(*4*) The amended amount of each loss carryover of S deemed to expire (or the amended amount of loss carryover deemed not to expire); and

(*5*) In the case of an amendment made pursuant to paragraph (b)(4)(vii)(A) of this section, a statement that the aggregate amount of loss carryovers of S and any higher- and lower-tier corporation of S that will be treated as not expiring as a result of amendments made pursuant to paragraph (b)(4)(vii)(A) of this section will not exceed the amount described in §1.1502–20(c)(1)(iii) with respect to the acquired stock (computed without regard to the effect of the group's election or elections pursuant to §1.1502–32(b)(4), but with regard to the effect of the prior group's election pursuant to §1.1502–20(g), if any, prior to the application of §1.1502–20T(i)(3)).

(D) *Items taken into account in open years*. An amendment to an election made pursuant to §1.1502–32(b)(4) affects the group's items of income, gain, deduction or loss only to the extent that the amendment gives rise, directly or indirectly, to items or amounts that would properly be taken into account in a year for which an assessment of deficiency or a refund for overpayment, as the case may be, is not prevented by any law or rule of law. Under this paragraph, if the year to which a loss previously deemed to expire as a result of an election made pursuant to §1.1502–32(b)(4) is deemed not to expire as a result of an election made pursuant to this paragraph would have been carried back or carried forward is a year for which a refund of overpayment is prevented by law, then to the extent that the absorption of such loss in such year would have affected the tax treatment of another item (*e.g.*, another loss that was absorbed in such year) that has an effect in a year for which a refund of overpayment is not prevented by any law or rule of law, the amendment to the election made pursuant to §1.1502–32(b)(4) will affect the treatment of such other item. Therefore, if the absorption of such loss (the first loss) in a year for which a refund of overpayment is prevented by law would have prevented the absorption of another loss (the second loss) in such year and such second loss would have been carried to and used in a year for which a refund of overpayment is not prevented by any law or rule of law (the other year), the amendment of the election makes the second loss available for use in the other year.

(E) *Higher- and lower-tier corporations of S*. A higher-tier corporation of S is a corporation that was a member of the prior group and, as a result of such higher-tier corporation becoming a member of the group, S became a member of the group. A lower-tier corporation of S is a corporation that was a member of the prior group and became a member of the group as a result of S becoming a member of the group.

(F) *Effective date*. This paragraph (b)(4)(vii) is applicable on and after May 7, 2003.

* * * * *

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

Approved April 25, 2003.

Pamela F. Olson,
Assistant Secretary of the Treasury.

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Section 2032A.—Valuation of Certain Farm, etc., Real Property

26 CFR 20.2032A–4: Method of valuing farm real property.

Special use value; farms; interest rates. The 2003 interest rates to be used in computing the special use value of farm real property for which an election is made under section 203A of the Code are listed for estates of decedents.

Rev. Rul. 2003–53

This revenue ruling contains a list of the average annual effective interest rates on new loans under the Farm Credit Bank system. This revenue ruling also contains a list of the states within each Farm Credit Bank District.

Under § 2032A(e)(7)(A)(ii) of the Internal Revenue Code, rates on new Farm Credit Bank loans are used in computing the special use value of real property used as a farm for which an election is made under § 2032A. The rates in this revenue ruling may be used by estates that value farmland under § 2032A as of a date in 2003.

Average annual effective interest rates, calculated in accordance with § 2032A(e)(7)(A) and § 20.2032A–4(e) of the Estate Tax Regulations, to be used under § 2032A(e)(7)(A)(ii), are set forth in the accompanying Table of Interest Rates (Table 1). The states within each Farm Credit Bank District are set forth in the accompanying Table of Farm Credit Bank Districts (Table 2).

Rev. Rul. 81–170, 1981–1 C.B. 454, contains an illustrative computation of an average annual effective interest rate. The rates applicable for valuation in 2002 are in Rev. Rul. 2002–26, 2002–1 C.B. 906. For rate information for years prior to 2002, see Rev. Rul. 2001–21, 2001–1 C.B. 1144, and other revenue rulings that are referenced therein.

DRAFTING INFORMATION

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

REV. RUL. 2003–53 TABLE 1

TABLE OF INTEREST RATES
(Year of Valuation 2003)

Farm Credit Bank District in Which Property Is Located	Interest Rate
Columbia	9.18
Omaha/Spokane	7.23
Sacramento	6.92
St. Paul	7.36
Springfield	7.26
Texas	7.19
Wichita	7.44

REV. RUL. 2003–53 TABLE 2

TABLE OF FARM CREDIT BANK DISTRICTS

District	States
Columbia	Delaware, District of Columbia, Florida, Georgia, Maryland, North Carolina, Pennsylvania, South Carolina, Virginia, West Virginia.
Omaha/Spokane	Alaska, Idaho, Iowa, Montana, Nebraska, Oregon, South Dakota, Washington, Wyoming.
Sacramento	Arizona, California, Hawaii, Nevada, Utah.
St. Paul	Arkansas, Illinois, Indiana, Kentucky, Michigan, Minnesota, Missouri, North Dakota, Ohio, Tennessee, Wisconsin.
Springfield	Connecticut, Maine, Massachusetts, New Hampshire, New Jersey, New York, Rhode Island, Vermont.
Texas	Alabama, Louisiana, Mississippi, Texas.
Wichita	Colorado, Kansas, New Mexico, Oklahoma.

Part III. Administrative, Procedural, and Miscellaneous

Earned Income Credit and Tribal Child Placements

Notice 2003–28

This notice clarifies the application of the earned income credit for a taxpayer caring for a child placed with the taxpayer by an Indian tribal government (ITG) or an organization an ITG has authorized to place Indian children. Section 32(a)(1) provides for an earned income credit in the case of an eligible individual. Section 32(c)(1)(A)(i) defines an eligible individual as an individual who has a qualifying child for the taxable year. Section 32(c)(3) defines a qualifying child as one who satisfies a relationship test, a residency test, and an age test. Under § 32(c)(3)(B)(i)(III), an eligible foster child satisfies the relationship test. Pursuant to § 32(c)(3)(B)(iii), for taxable years beginning after December 31, 1999, an eligible foster child includes a child placed with the taxpayer by an authorized placement agency whom the taxpayer cares for as the taxpayer's own child (and, for taxable years beginning before January 1, 2002, who has the same principal place of abode as the taxpayer for the taxpayer's entire taxable year). For purposes of § 32(c)(3)(B)(iii), an authorized placement agency includes an ITG and also includes an organization an ITG has authorized to place Indian children (Indian tribal organization). Thus, for taxable years beginning after December 31, 1999, a child placed with a taxpayer by an ITG or an Indian tribal organization qualifies as an eligible foster child, provided the taxpayer cares for the child as his or her own, and, for taxable years beginning before January 1, 2002, the child has the same principal place of abode as the taxpayer for the taxpayer's entire taxable year.

The principal author of this notice is Sylvia F. Hunt of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this notice, contact Ms. Hunt at (202) 622–6080 (not a toll-free call).

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26 CFR 1.1031(a)–1: Property held for productive use in trade or business or for investment; 1.1031(k)–1: Treatment of deferred exchanges.

Rev. Proc. 2003–39

SECTION 1. PURPOSE

This revenue procedure provides safe harbors with respect to programs involving ongoing exchanges of tangible personal property using a single intermediary, as described in section 3.02 of this revenue procedure (an "LKE Program").

SECTION 2. BACKGROUND

.01 Section 1031(a)(1) provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment ("relinquished property") if the property is exchanged solely for property of like kind that is to be held either for productive use in a trade or business or for investment ("replacement property").

.02 Section 1031(a)(3) provides that replacement property received by the taxpayer is not treated as like-kind property if it: (a) is not identified as property to be received in the exchange on or before the day that is 45 days after the date on which the taxpayer transfers the relinquished property (the "45-day identification period"); or (b) is received after the earlier of the date that is 180 days after the date on which the taxpayer transfers the relinquished property, or the due date (determined with regard to extensions) for the transferor's federal income tax return for the year in which the transfer of the relinquished property occurs.

.03 Section 1.1031(k)–1(a) defines a deferred exchange as an exchange in which, pursuant to an agreement, the taxpayer transfers relinquished property and subsequently receives replacement property. In order to constitute a deferred exchange, the transaction must be an exchange (*i.e.*, a transfer of property for property, as distinguished from a transfer of property for money).

.04 Section 1.1031(k)–1(c)(1) provides that any replacement property that is received by the taxpayer before the end of the 45-day identification period will be treated in all events as identified before the end of the 45-day identification period.

.05 Section 1.1031(k)–1(f)(1) provides that if a taxpayer actually or constructively receives money or other property in the full amount of the consideration for the relinquished property before the taxpayer actually receives the replacement property, the transaction will constitute a sale and not a deferred exchange, even though the taxpayer may ultimately receive replacement property.

.06 Section 1.1031(k)–1(g) sets forth safe harbors involving a qualified escrow account, a qualified trust, or a qualified intermediary, the use of which will result in a determination that the taxpayer is not in actual or constructive receipt of money or other property for purposes of § 1031 and the regulations.

.07 Section 1.1031(k)–1(g)(4)(iii) requires that, for an intermediary to be a qualified intermediary, the intermediary must enter into a written "exchange" agreement with the taxpayer and, as required by the exchange agreement, acquire the relinquished property from the taxpayer, transfer the relinquished property, acquire the replacement property, and transfer the replacement property to the taxpayer.

.08 Section 1.1031(k)–1(g)(4)(iv) provides that the intermediary will be treated as acquiring or transferring property, as the case may be, if the intermediary (either on its own behalf or as the agent of any party to the transaction) enters into an agreement for the acquisition or transfer of property and, pursuant to that agreement, the property is transferred.

.09 Section 1.1031(k)–1(g)(4)(v) provides that an intermediary will be treated as entering into an agreement for the acquisition or transfer of property if the taxpayer's rights in the agreement are assigned to the intermediary, and the other parties to the acquisition or transfer agreement are notified in writing of the assignment on or before the date of the relevant transfer of property (the "Assignment Safe Harbor"). Under the Assignment Safe Harbor, there is no requirement that the taxpayer also assign or delegate its obligations arising under the agreement.

.10 Section 1.1031(k)–1(g)(6) provides that an agreement with an escrow holder, trustee or qualified intermediary must expressly limit the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held in the qualified escrow or trust or by the qualified intermediary.

.11 Sections 1.1031(k)–1(g)(3) and (4) provide that the application of the safe harbor requires that in the case of a qualified escrow account, a qualified trust, or a qualified intermediary, the escrow holder, trustee, or intermediary must not be a "disqualified person."

.12 Section 1.1031(k)–1(k)(2) provides that a person that is the agent of the taxpayer at the time of the transaction is a disqualified person. For this purpose, a person who has acted as the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker within the two-year period ending on the date of the transfer of the first of the relinquished properties is treated as an agent of the taxpayer at the time of the transaction. Solely for purposes of §1.1031–1(k)(2), performance of the following services will not be taken into account: (a) services for the taxpayer with respect to exchanges of property intended to qualify for nonrecognition of gain or loss under § 1031; and (b) routine financial, title insurance, escrow, or trust services for the taxpayer by a financial institution, title insurance company, or escrow company.

.13 The Service and Treasury Department have determined that it is in the best interest of sound tax administration to provide taxpayers with guidance regarding the qualification of LKE Programs under § 1031. Accordingly, this revenue procedure provides safe harbors that clarify the application of § 1031 and the regulations thereunder to LKE Programs.

SECTION 3. SCOPE AND DEFINITIONS

.01 *Exclusivity*. This revenue procedure provides safe harbors for certain aspects of the qualification under § 1031 of certain exchanges of property pursuant to LKE Programs. The principles set forth in sections 4 through 6 of this revenue procedure have no application to any federal income tax determinations other than determinations that involve LKE Programs qualifying for one or more of the safe harbors. For a transaction to qualify under § 1031, it must also satisfy the requirements of § 1031 for which safe harbors are not provided in this revenue procedure (*e.g.*, whether property involved in an exchange is considered like-kind property within the meaning of § 1031).

.02 *LKE Program*. For purposes of this revenue procedure, an "LKE Program" is an ongoing program involving multiple exchanges of 100 or more properties. Although LKE Programs may differ in various ways, an LKE Program must have all of the following characteristics:

(1) The taxpayer regularly and routinely enters into agreements to sell tangible personal property as well as agreements to buy tangible personal property;

(2) The taxpayer uses a single, unrelated intermediary to accomplish the exchanges in the LKE Program;

(3) The taxpayer and the intermediary enter into a written agreement ("master exchange agreement");

(4) The master exchange agreement expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the intermediary as provided in § 1.1031(k)–1(g)(6);

(5) In the master exchange agreement, the taxpayer assigns to the intermediary the taxpayer's rights (but not necessarily its obligations) in some or all of its existing and future agreements to sell relinquished property and/or to purchase replacement property;

(6) The taxpayer provides written notice of the assignment to the other party to each existing and future agreement to sell relinquished property and/or to purchase replacement property;

(7) The taxpayer

(a) implements a process that identifies potential replacement property or properties before the end of the identification period for the relinquished property or group of relinquished properties of which it is disposing in each exchange,

(b) complies with the identification requirement by receiving replacement property or properties before the end of the 45-day identification period, or

(c) satisfies the identification requirements by a combination of the approaches in (a) and (b);

(8) The taxpayer implements a process for collecting, holding, and disbursing funds (which may include the use of joint taxpayer and intermediary bank accounts, or accounts in the name of a third party for the benefit of both the taxpayer and the intermediary) that ensures that the intermediary controls the receipt, holding, and disbursement of all funds to which the intermediary is entitled (*i.e.*, proceeds from the sale of relinquished properties);

(9) Relinquished property or properties that are transferred are matched with replacement property or properties that are received in order to determine the gain, if any, recognized on the disposition of the relinquished property and to determine the basis of the replacement property; and

(10) The taxpayer recognizes gain or loss on the disposition of relinquished properties that are not matched with replacement properties, and the taxpayer takes a cost basis in replacement properties that are received but not matched with relinquished properties.

A taxpayer may conduct more than one LKE Program simultaneously. In such a case, each LKE Program is evaluated separately for purposes of determining whether that LKE Program qualifies for the safe harbors of this revenue procedure.

.03 *No Inference*. The Service recognizes that exchanges of property pursuant to LKE Programs may qualify for nonrecognition treatment under § 1031 although they fall outside the safe harbors provided in this revenue procedure. No inference is intended with respect to the federal income tax treatment of transfers of relinquished property and acquisitions of replacement property that do not satisfy the terms of the safe harbors provided in this revenue procedure.

.04 *Scope of Safe Harbors*. Each of the paragraphs under sections 4, 5, and 6 of this revenue procedure is considered a separate and distinct safe harbor. Therefore, a taxpayer who fails to qualify for the benefits of one safe harbor may nevertheless qualify for the benefits of another safe harbor.

SECTION 4. EXCHANGES OF RELINQUISHED PROPERTY AND REPLACEMENT PROPERTY

.01 *Separate and Distinct Exchanges*. In the case of an LKE Program, the taxpayer's transfer of each relinquished property or group of relinquished properties and the taxpayer's corresponding receipt of each replacement property or group of replacement properties with which the relinquished property or group of relinquished properties has been matched by the taxpayer is treated as a separate and distinct exchange for purposes of § 1031. The determination of whether a particular exchange qualifies under § 1031 is made without regard to any other exchange. Thus, if a particular exchange of a relinquished property or group of relinquished properties for a replacement property or group of replacement properties pursuant to an LKE Program fails to qualify under § 1031, such failure will not affect the application of § 1031 to any other exchange pursuant to the LKE Program.

.02 *45-day Identification Period*. Replacement property that is received within the 45-day identification period or that is otherwise properly identified as provided in § 1.1031(k)–1(c) is treated as satisfying the requirement of § 1031(a)(3) that replacement property be identified, notwithstanding that it may not be matched with relinquished property until after the end of the 45-day identification period. The replacement property must, however, be matched no later than the due date (determined with regard to extensions) of the taxpayer's return.

SECTION 5. ACTUAL OR CONSTRUCTIVE RECEIPT OF MONEY OR OTHER PROPERTY

For purposes of this section, any requirement that the taxpayer transfer money or other property to the qualified intermediary will be deemed to be satisfied if the amount of money held by the qualified intermediary and the amount of money in any joint account (as described in § 5.02 of this revenue procedure) equals or exceeds the amount of proceeds from the sale of relinquished property (including the amount that is required to be transferred by the taxpayer) that has not yet been used to acquire replacement property.

.01 *Receipt of Checks and Other Negotiable Instruments*. A taxpayer engaged in an LKE Program will not be considered to be in actual or constructive receipt of money or other property as a result of processing a check or other negotiable instrument made payable to a person other than the taxpayer if:

(1) The check or other negotiable instrument has not been endorsed by the person to whom the check or other negotiable instrument is made payable;

(2) The person to whom the check or other negotiable instrument is made payable is not a disqualified person as defined in § 1.1031(k)–1(k); and

(3) The check or other negotiable instrument is forwarded to or for the benefit of a qualified intermediary or deposited into an account in the name of the qualified intermediary, a joint account, or an account in the name of a third party (other than a disqualified person as defined in § 1.1031(k)–1(k)) for the benefit of both the taxpayer and the qualified intermediary.

.02 *Joint Accounts*. A taxpayer engaged in an LKE Program will not be considered to be in actual or constructive receipt of proceeds from the sale of relinquished property deposited into or held in a joint bank, trust, escrow, or similar account in the name of the taxpayer and the qualified intermediary, or in an account in the name of a third party (other than a disqualified person as defined in § 1.1031(k)–1(k)) for the benefit of both the taxpayer and the qualified intermediary, if:

(1) The account is used to collect, hold, and/or disburse proceeds arising from the sale of relinquished property for the benefit of the qualified intermediary;

(2) The agreement setting forth the terms and conditions with respect to the account requires authorization from the qualified intermediary to transfer proceeds from the sale of relinquished properties out of the account; and

(3) The agreement setting forth the terms of the taxpayer's and qualified intermediary's rights with respect to, or beneficial interest in, the account expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of proceeds from the sale of relinquished property held in the joint account as provided in § 1.1031(k)–1(g)(6).

The account may also be used by the parties for other purposes provided that such use does not undermine the qualified intermediary's right to control the proceeds from the sale of relinquished property.

.03 *Funds Netting*. A taxpayer engaged in an LKE Program will not be considered to be in actual or constructive receipt of money or other property as a result of transferring relinquished property solely because an amount owed by the taxpayer to the buyer (other than a lease security deposit) is netted against the sales price of the relinquished property, provided that, as required by the master exchange agreement, funds equal to the full amount of sales proceeds from the relinquished property are transferred to or for the benefit of the qualified intermediary by the opening of the next day's business. Likewise, a taxpayer acquiring replacement property in a like-kind exchange will not be considered to be in actual or constructive receipt of money or other property solely because an amount owed by the seller to the taxpayer is netted against the purchase price of the property and the qualified intermediary transfers to the taxpayer funds in an amount equal to the amount owed by the seller to the taxpayer so that the qualified intermediary expends the full amount of the purchase price obligation for the replacement property.

.04 *Taxpayer As Lender to Purchaser*. If a taxpayer that is engaged in an LKE Program lends money to the buyer for the purchase of the taxpayer's relinquished property, the taxpayer's receipt of the buyer's promissory note or other evidence of indebtedness will not be considered actual or constructive receipt of money or other property if:

(1) The taxpayer makes similar loans in the ordinary course of its business operations;

(2) The buyer is not obligated to obtain financing from the taxpayer for the purchase of the relinquished property, but rather is free to borrow the funds from another lender;

(3) The taxpayer's loan to the buyer is an arm's-length transaction at the prevailing market terms; and

(4) As required by the master exchange agreement, the taxpayer promptly transfers funds equal to the loan proceeds (plus a market rate of interest on such amount for the period between the date of the sale of the relinquished property and the date of the transfer of the loan proceeds to the qualified intermediary) to or for the benefit of the qualified intermediary.

05. *Application of Lease Security Deposit To Purchase Price*. In the case of a taxpayer that engages in an LKE Program and is the lessor of the property being purchased by the buyer-lessee, the buyer-lessee's application of its lease security deposit to the purchase price of the relinquished property will not be considered actual or constructive receipt of money or other property provided that, as required by the master exchange agreement, the taxpayer promptly transfers funds equal to the lease security deposit (plus a market rate of interest on such amount for the period between the date of the sale of the relin-

quished property and the date of the transfer of the security deposit to the qualified intermediary) to or for the benefit of the qualified intermediary.

SECTION 6. DEFINITION OF QUALIFIED INTERMEDIARY

.01 *In General*. For purposes of determining whether an intermediary is a disqualified person in the context of an LKE Program, the intermediary will not fail to be a qualified intermediary merely because the intermediary:

(1) is assigned the taxpayer's rights in its agreements to sell relinquished properties that ultimately are not matched with replacement properties under the taxpayer's LKE Program;

(2) is assigned the taxpayer's rights in its agreements to buy replacement properties that ultimately are not matched with relinquished properties under the taxpayer's LKE Program;

(3) receives funds with respect to the transfer of relinquished property that ultimately is not matched with replacement property under the taxpayer's LKE Program; or

(4) pays funds with respect to the acquisition of replacement property that ultimately is not matched with relinquished property under the taxpayer's LKE Program.

.02 *Assignment Safe Harbor*. The taxpayer's assignment in the master exchange agreement to the intermediary of the taxpayer's rights (but not necessarily its obligations) in some or all of its existing and future agreements to sell relinquished property and/or to purchase replacement property, and the taxpayer's written notice of the assignment to the other party to each agreement to sell relinquished property and/or to purchase replacement property on or before the date of the relevant transfer of property, will be effective to satisfy the Assignment Safe Harbor and notice requirement under § 1.1031(k)–1(g)(4)(v).

SECTION 7. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1834.

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

The collections of information in this revenue procedure are in sections 5 and 6. This information is required by the Service to provide safe harbors under § 1031 to taxpayers participating in LKE Programs for federal income tax purposes. The likely respondents are finance companies; subsidiaries of manufacturers; or banks that purchases retail leases and retail installment sale contracts from dealers of automobiles or other types of equipment.

The estimated total annual reporting and recordkeeping burden is 8,600 hours.

The estimated annual burden per respondent/recordkeeper varies from 45 minutes to 75 minutes, depending on individual circumstances, with an estimated average of 60 minutes. The estimated number of respondents and recordkeepers is 8,600.

The estimated annual frequency of responses is on occasion.

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

SECTION 8. DRAFTING INFORMATION

The principal author of this revenue procedure is Elizabeth Kaye of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Ms. Kaye at (202) 622–4920 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking and Notice of Public Hearing

Split-Dollar Life Insurance Arrangements

REG–164754–01

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations relating to the valuation of economic benefits under certain equity split-dollar life insurance arrangements. The proposed regulations will provide needed guidance to persons who enter into split-dollar life insurance arrangements. This document also provides notice of a public hearing on the proposed regulations.

DATES: Written or electronic comments must be received by July 8, 2003. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for July 29, 2003, must be received by July 8, 2003.

ADDRESSES: Send submissions to CC:PA:RU (REG–164754–01), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:RU (REG–164754–01), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC or sent electronically, via the IRS Internet site at *www.irs.gov/regs*. The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, please contact Elizabeth Kaye at (202) 622–4920. To be placed on the attendance list for the hearing, please contact LaNita M. Van Dyke at (202) 622–7180.

SUPPLEMENTARY INFORMATION:

Background and Overview of Notice of Proposed Rulemaking

1. *Summary of the Prior Notice of Proposed Rulemaking*

On July 9, 2002, a notice of proposed rulemaking (REG–164754–01, 2002–30 I.R.B. 212 [67 FR 45414]) was published in the **Federal Register** proposing comprehensive rules for the income, gift, and employment taxation of equity and non-equity split-dollar life insurance arrangements (the 2002 proposed regulations). The 2002 proposed regulations will apply to split-dollar life insurance arrangements entered into after the date final regulations are published in the **Federal Register** and to arrangements entered into on or before that date that are materially modified after that date. Under certain conditions, taxpayers may rely on the 2002 proposed regulations for split-dollar life insurance arrangements entered into on or before the date final regulations are published in the **Federal Register**.

In general, a split-dollar life insurance arrangement is an arrangement between two or more parties to allocate the policy benefits and, in some cases, the costs of a life insurance contract. Under a so-called equity split-dollar life insurance arrangement, one party to the arrangement typically receives an interest in the policy cash value (or equity) of the life insurance policy disproportionate to that party's share of policy premiums. That party also typically receives the benefit of current life insurance protection under the arrangement. Under a so-called non-equity split-dollar life insurance arrangement, one party typically provides the other party with current life insurance protection but not any interest in the policy cash value.

The 2002 proposed regulations provide two mutually exclusive regimes for taxation of split-dollar life insurance arrangements—a loan regime and an economic benefit regime. Under the loan regime (which is set forth in §1.7872–15 of the 2002 proposed regulations), the non-owner of the life insurance contract is treated as loaning the amount of its premium payments to the owner of the contract. The loan regime generally will govern the taxation of collateral assignment arrangements. Under the economic benefit regime (which is set forth in §1.61–22(d) through (g) of the 2002 proposed regulations), the owner of the life insurance contract is treated as providing economic benefits to the non-owner of the contract. The economic benefit regime generally will govern the taxation of endorsement arrangements.

The 2002 proposed regulations reserved on the rules for valuing economic benefits provided to the non-owner under an equity split-dollar life insurance arrangement governed by the economic benefit regime, pending receipt of comments from interested parties. The preamble to the 2002 proposed regulations notes that any proposal "for a specific methodology should be objective and administrable" and describes a potential approach under which the non-owner would include in income the difference between current premium payments and the net present value of the amount to be repaid to the owner in the future.

A public hearing on the 2002 proposed regulations was held on October 23, 2002. In addition, interested parties have submitted detailed comments on the 2002 proposed regulations, including comments on the valuation of economic benefits provided to a non-owner under an equity split-dollar life insurance arrangement governed by the economic benefit regime.

2. *Explanation of Provisions and Summary of Comments*

a. *Overview*

These proposed regulations, which supplement the 2002 proposed regulations, provide guidance on the valuation of economic benefits (including the valuation of an interest in policy cash value) under an equity split-dollar life insurance arrangement governed by the economic benefit regime. These proposed regulations apply for purposes of federal income, employment, and gift taxes.

These proposed regulations address only those comments received by the IRS and the Treasury Department on the valuation of economic benefits under an equity split-dollar life insurance arrangement governed by the economic benefit regime. Comments received on other issues regarding the 2002 proposed regulations and comments on these proposed regulations will be addressed when both sets of proposed regulations are finalized.

These proposed regulations provide that in the case of an equity split-dollar life insurance arrangement, the value of the economic benefits provided to the non-owner under the arrangement for a taxable year equals the cost of any current life insurance protection provided to the non-owner, the amount of policy cash value to which the non-owner has current access (to the extent that such amount was not actually taken into account for a prior taxable year), and the value of any other economic benefits provided to the non-owner (to the extent not actually taken into account for a prior taxable year). The terms *owner* and *non-owner* are defined in §1.61–22(c)(1) and (2) of the 2002 proposed regulations.

b. *Current access to policy cash value*

Generally, under an equity split-dollar life insurance arrangement governed by the economic benefit regime, the owner of the life insurance contract pays policy premiums, thereby establishing a pool of assets with respect to which the non-owner has certain rights under the arrangement (for example, rights of withdrawal, borrowing, surrender, or assignment). Additionally, the pool of assets is held by a third party, the life insurance company, effectively placing the cash value beyond the reach of the employer or the employer's general creditors in many cases. Thus, an equity split-dollar life insurance arrangement confers on the non-owner rights to direct or indirect economic enjoyment of policy cash value, making current taxation of the non-owner's interest in the cash value appropriate under the doctrines of constructive receipt, economic benefit, and cash equivalence.

These proposed regulations provide that the non-owner has current access to any portion of the policy cash value that is directly or indirectly accessible by the non-owner, inaccessible to the owner, or inaccessible to the owner's general creditors. For this purpose, "access" is to be construed broadly and includes any direct or indirect right under the arrangement of the non-owner to obtain, use, or realize potential economic value from the policy cash value. Thus, for example, a non-owner has current access to policy cash value if the non-owner can directly or indirectly make a withdrawal from the policy, borrow from the policy, or effect a total or partial surrender of the policy. Similarly, for example, the non-owner has current access if the non-owner can anticipate, assign (either at law or in equity), alienate, pledge, or encumber the policy cash value or if the policy cash value is available to the non-owner's creditors by attachment, garnishment, levy, execution, or other legal or equitable process. Policy cash value is inaccessible to the owner if the owner does not have the full rights to policy cash value normally held by an owner of a life insurance contract. Policy cash value is inaccessible to the owner's general creditors if, under the terms of the split-dollar life insurance arrangement or by operation of law or any contractual undertaking, the creditors cannot, for any reason, effectively reach the full policy cash value in the event of the owner's insolvency.

In a typical equity split-dollar life insurance arrangement, the non-owner has current access to all portions of the policy cash value in excess of the amount payable to the owner. In many arrangements, the non-owner may also have current access to the portion of the cash value payable to the owner if, for example, that portion of the policy cash value is for any reason not accessible to the owner or the owner's general creditors.

Under these proposed regulations, policy cash value is determined without regard to surrender charges or other similar charges or reductions. To provide uniformity, certainty, and administrative ease, policy cash value generally is determined on the last day of the non-owner's taxable year. In addition, solely for purposes of employment tax (as defined in §1.61–22(c)(5) of the 2002 proposed regulations) and the penalty for failure to pay estimated income taxes, the portion of the policy cash value that is treated as provided by the owner to the non-owner during the non-owner's taxable year is treated as so provided on the last day of that taxable year. The IRS and the Treasury Department request comments regarding circumstances in which it might be appropriate to use a different date for employment tax withholding purposes.

Several commentators on the 2002 proposed regulations asserted that those regulations were contrary to the intention, announced by the IRS and the Treasury Department in Notice 2002–8, 2002–1 C.B. 398, to publish proposed regulations that will not treat an owner as having made a transfer of a portion of the cash surrender value of a life insurance contract to a non-owner for purposes of section 83 solely because interest or other earnings credited to the cash surrender value of the contract cause the cash surrender value to exceed the portion thereof payable to the owner. The valuation methodology described in these proposed regulations, however, does not treat an owner as having made a transfer under section 83 solely because of growth in policy cash value. Rather, this approach, consistent with the doctrines of constructive receipt, economic benefit, and cash equivalence, treats the non-owner as having a taxable interest in policy cash value only to the extent that the non-owner has current access to the policy cash value.

Several commentators stated that a non-owner who includes in income a portion of the policy cash value should be credited with "inside build-up" on that portion of the policy cash value. This result might be appropriate if there were actual transfers of ownership of the underlying life insurance contract (or a portion thereof) from the owner to the non-owner. Here, by contrast to transfers described in §1.61–22(g) of the 2002 proposed regulations, no part of the life insurance contract is actually transferred from the owner to the non-owner by reason of the non-owner's taking policy cash value into account.

In addition, some commentators expressed the view that, under the economic benefit regime, if the policy cash value in one year is less than the policy cash value in a prior year, the non-owner should be allowed a loss to the extent this difference was included in income in the prior year. Consistent with the underlying doctrines of constructive receipt, economic benefit, and cash equivalence, a loss should not be allowed in this situation. Note, however, that under §1.61–22(g)(4)(ii)(A) of the 2002 proposed regulations, if a life insurance contract is transferred from an owner to a non-owner (the transferee), the transferee's investment in the contract under section 72(e) will include the amount of economic benefits previously taken into account by the transferee prior to the transfer.

c. *Current term life insurance protection*

These proposed regulations provide that, in the case of an equity split-dollar life insurance arrangement governed by the economic benefit regime, the value of the economic benefits provided to a non-owner for a taxable year also includes the cost of current life insurance protection provided to the non-owner. The cost of current life insurance protection provided to the non-owner in any year equals the amount of the current life insurance protection provided to the non-owner multiplied by the life insurance premium factor designated or permitted in guidance published in the Internal Revenue Bulletin. The amount of the current life insurance protection (including paid-up additions thereto) provided to the non-owner for a taxable year equals the excess of the average death benefit of the life insurance contract over the sum of the total amount payable to the owner (including any outstanding policy loans that offset amounts otherwise payable to the owner) under the split-dollar life insurance arrangement and the portion of the policy cash value actually taken into account for the current taxable year or for any prior taxable year. This subtraction of the portion of the policy cash value actually taken into account by the non-owner prevents the non-owner from being taxed twice on the same amount, once as part of the policy cash value to which the non-owner has current access and again as an amount provided to the non-owner in the form of death benefit protection.

d. *Other economic benefits*

These proposed regulations provide that, in the case of an equity split-dollar life insurance arrangement governed by the economic benefit regime, the value of all other economic benefits provided to the non-owner must be taken into account (to the extent not actually taken into account for a prior taxable year). For this purpose, the term "other economic benefits" should be construed broadly to include any benefit, right, or feature of the life insurance contract (other than current life insurance protection and policy cash value) provided to the non-owner under the arrangement.

Proposed Effective Date

These proposed regulations will have the same applicability date as that set forth in §1.61–22(j) of the 2002 proposed regulations. Thus, these proposed regulations will apply to split-dollar life insurance arrangements entered into after the date final regulations are published in the **Federal Register** and to arrangements entered into on or before that date that are materially modified after that date.

In addition, taxpayers may rely on these proposed regulations for equity split-dollar life insurance arrangements entered into on or before the date final regulations are published in the **Federal Register** if the conditions in §1.61–22(j)(2)(i) of the 2002 proposed regulations are met. For taxable years beginning after December 31, 2002, however, parties to an equity split-dollar life insurance arrangement may rely on these proposed regulations only if the value of all economic benefits taken into account by the parties is determined in accordance with these proposed regulations. These proposed regulations also conform the early reliance rules in §1.83–6(a)(5)(ii)(B) and §1.301–1(q)(4)(ii) of the 2002 proposed regulations to that set forth in the preceding sentence.

Special Analyses

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

Comments and Public Hearing

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

A public hearing has been scheduled for July 29, 2003, beginning at 10 a.m. in the IRS Auditorium in the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Thus, the public hearing concerning these proposed regulations will be held on a date sooner than the usual 120 days after the date of publication of proposed regulations in the **Federal Register**. The IRS and the Treasury Department believe that this shorter period is sufficient for taxpayers to comment on these proposed regulations because the issue addressed by these proposed regulations is narrowly focused and taxpayers have already submitted comments on this issue in connection with the 2002 proposed regulations.

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 and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by July 8, 2003. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the schedule of speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is Elizabeth Kaye of the Office of Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and Treasury Department participated in their development.

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Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.61–22, as proposed on July 9, 2002, at 67 FR 45423, is amended as follows:

1. The text of paragraph (d)(3)(ii) is added.

2. Paragraph (j)(2)(iii) is added.

The additions read as follows:

§1.61–22 Taxation of split-dollar life insurance arrangements.

* * * * *

(d) * * *

(3) * * *

(ii) *Valuation of economic benefits*—(A) *In general*. In the case of a split-dollar life insurance arrangement described in paragraph (d)(3)(i) of this section, the value of the economic benefits provided to a non-owner for a taxable year under the arrangement equals—

(*1*) The cost of current life insurance protection provided to the non-owner as determined under paragraph (d)(3)(ii)(B) of this section;

(*2*) The amount of policy cash value to which the non-owner has current access within the meaning of paragraph (d)(3)(ii)(C) of this section (to the extent that such amount was not actually taken into account for a prior taxable year); and

(*3*) The value of any economic benefits not described in paragraph (d)(3)(ii)(A)(*1*) or (*2*) of this section provided to the non-owner (to the extent not actually taken into account for a prior taxable year).

(B) *Valuation of current term life insurance protection*. In the case of a split-dollar life insurance arrangement described in paragraph (d)(3)(i) of this section, the amount of the current life insurance protection (including paid-up additions thereto) provided to the non-owner for a taxable year equals the excess of the average death benefit of the life insurance contract over the sum of the total amount payable to the owner under the split-dollar life insurance arrangement and the portion of the policy cash value actually taken into account for the current taxable year or for any prior taxable year. The total amount payable to the owner is increased by the amount of any outstanding policy loan. The cost of current life insurance protection provided to the non-owner in any year equals the amount of the current life insurance protection provided to the non-owner multiplied by the life insurance premium factor designated or permitted in guidance published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii) of this chapter).

(C) *Current access*. For purposes of this paragraph (d)(3), a non-owner has current access to that portion of the policy cash value that is directly or indirectly accessible by the non-owner, inaccessible to the owner, or inaccessible to the owner's general creditors.

(D) *Valuation date*—(*1*) *General rules*. For purposes of paragraph (d)(3)(ii)(A) of this section, the policy cash value is determined on the last day of the taxable year of the non-owner. Notwithstanding the previous sentence, if the split-dollar life insurance arrangement terminates during the taxable year of the non-owner, the policy cash value is determined on the day that the arrangement terminates.

(*2*) *Artifice or device*. Notwithstanding paragraph (d)(3)(ii)(D)(*1*) of this section, if any artifice or device is used to understate the amount of policy cash value to which the non-owner has current access on the valuation date in paragraph (d)(3)(ii)(D)(*1*) of this section, then, for purposes of paragraph (d)(3)(ii)(A) of this section, the date on which the amount of policy cash value is determined is the date on which the amount of policy cash value is greatest during that taxable year.

(E) *Policy cash value*. For purposes of this paragraph (d)(3), policy cash value is determined without regard to surrender charges or other similar charges or reductions.

(F) *Special rule for certain taxes*. For purposes of employment tax (as defined in paragraph (c)(5) of this section), and sections 6654 and 6655 (relating to the failure to pay estimated income tax), that portion of the policy cash value (as determined under paragraph (d)(3)(ii)(A)(*2*) of this section) that is treated as provided by the owner to the non-owner under paragraph (d)(1) of this section shall be treated as so provided on the last day of the taxable year of the non-owner. Notwithstanding the previous sentence, if the split-dollar life insurance arrangement terminates during the taxable year of the non-owner, such portion of the policy cash value shall be treated as so provided on the day that the arrangement terminates.

(G) *Examples*. The following examples illustrate the rules of this paragraph (d)(3)(ii). Except as otherwise provided, both examples assume the following facts: employer (R) is the owner (as defined in paragraph (c)(1) of this section) and employee (E) is the non-owner (as defined in paragraph (c)(2) of this section) of a life insurance contract that is part of an equity split-dollar life insurance arrangement that is subject to the provisions of paragraphs (d) through (g) of this section; the contract is a life insurance contract as defined in section 7702 and not a modified endowment contract as defined in section 7702A; R does not withdraw or obtain a loan of any portion of the policy cash value and does not surrender any portion of the life insurance contract; the compensation paid to E is reasonable; E is not provided any economic benefits described in paragraph (d)(3)(ii)(A)(*3*) of this section; E does not make any premium payments; E's taxable year is the calendar year; and E reports on E's federal income tax return for each year that the equity split-dollar life insurance arrangement is in effect the amount of income required to be reported under paragraph (d) of this section. The examples are as follows:

Example 1. (i) *Facts*. In year 1, R and E enter into the equity split-dollar life insurance arrangement. Under the arrangement R pays all of the premiums on the life insurance contract until the termination of the arrangement or E's death. The arrangement also provides that upon termination of the arrangement or E's death, R is entitled to receive the lesser of the aggregate premiums paid or the policy cash value of the contract and E is entitled to receive any remaining amounts. Under the terms of the arrangement and applicable state law, the policy cash value is fully accessible by R and R's creditors but E has the right to borrow or withdraw the portion of the policy cash value exceeding the amount payable to R upon termination of the arrangement or E's death. To fund the arrangement, R purchases a life insurance contract with constant death benefit protection equal to $1,500,000. As of December 31 of year 1, the policy cash value equals $55,000 and R has paid $60,000 of premiums on the life insurance contract. As of December 31 of year 2, the policy cash value equals $140,000 and R has paid aggregate premiums of $120,000 on the life insurance contract. As of December 31 of year 3, the policy cash value equals $240,000 and R has paid $180,000 of premiums on the life insurance contract.

(ii) *Analysis*. Under the terms of the equity split-dollar life insurance arrangement, E has the right for year 1 and all subsequent years to borrow or withdraw the portion of the policy cash value exceeding the amount payable to R. Thus, under paragraph (d)(3)(ii)(C) of this section, E has current access to such portion of the policy cash value for each year that the arrangement is in effect. In addition, because R pays all of the premiums on the life insurance contract, R provides to E all of the economic benefits that E receives under the arrangement. Therefore, under paragraph (d)(1) of this section, E includes in gross income the value of all economic benefits described in paragraphs (d)(3)(ii)(A)(*1*) and (*2*) of this section provided to E under the arrangement.

(iii) *Results for year 1*. For year 1, E is provided, under paragraph (d)(3)(ii)(A)(*2*) of this section, $0 of policy cash value (excess of $55,000 policy cash value determined as of December 31 of year 1 over $55,000 payable to R). For year 1, E is also provided, under paragraph (d)(3)(ii)(A)(*1*) of this section, current life insurance protection of $1,445,000 ($1,500,000 minus $55,000 payable to R). Thus, E includes in gross income for year 1 the cost of $1,445,000 of current life insurance protection.

(iv) *Results for year 2*. For year 2, E is provided, under paragraph (d)(3)(ii)(A)(*2*) of this section, $20,000 of policy cash value ($140,000 policy cash value determined as of December 31 of year 2 minus $120,000 payable to R). For year 2, E is also provided, under paragraph (d)(3)(ii)(A)(*1*) of this section, current life insurance protection of $1,360,000 ($1,500,000 minus the sum of $120,000 payable to R and the aggregate of $20,000 of policy cash value that E actually includes in income on E's year 1 and year 2 income tax returns). Thus, E includes in gross income for year 2 the sum of $20,000 of policy cash value and the cost of $1,360,000 of current life insurance protection.

(v) *Results for year 3*. For year 3, E is provided, under paragraph (d)(3)(ii)(A)(*2*) of this section, $40,000 of policy cash value ($240,000 policy cash value determined as of December 31 of year 3 minus the sum of $180,000 payable to R and $20,000 of aggregate policy cash value that E actually included in gross income on E's year 1 and year 2 federal income tax returns). For year 3, E is also provided, under paragraph (d)(3)(ii)(A)(*1*) of this section, current life insurance protection of $1,260,000 ($1,500,000 minus the sum of $180,000 payable to R and $60,000 of aggregate policy cash value that E actually includes in gross income on E's year 1, year 2, and year 3 federal income tax returns). Thus, E includes in gross income for year 3 the sum of $40,000 of policy cash value and the cost of $1,260,000 of current life insurance protection.

Example 2. (i) *Facts*. The facts are the same as in *Example 1* except that E cannot directly or indirectly access any portion of the policy cash value, but the terms of the equity split-dollar life insurance arrangement or applicable state law provide that the policy cash value in excess of the amount payable to R upon termination of the arrangement or E's death is inaccessible to R's general creditors.

(ii) *Analysis*. Under the terms of the equity split-dollar life insurance arrangement or applicable state law, the portion of the policy cash value exceeding the amount payable to R is inaccessible to R's general creditors. Thus, under paragraph (d)(3)(ii)(C) of this section, E has current access to such portion of the policy cash value for each year that the arrangement is in effect. In addition, because R pays all of the premiums on the life insurance contract, R provides to E all of the economic benefits that E receives under the arrangement. Therefore, under paragraph (d)(1) of this section, E includes in gross income the value of all economic benefits described in paragraphs (d)(3)(ii)(A)(*1*) and (*2*) of this section provided to E under the arrangement.

(iii) *Results for years 1, 2, and 3*. The results for this example are the same as the results in *Example 1*.

* * * * *

(j) * * *

(2) * * *

(iii) *Valuation of economic benefits*. Notwithstanding paragraph (j)(2)(ii) of this section, for taxable years beginning after December 31, 2002, parties to an arrangement described in paragraph (d)(3) of this section may rely on this section only if the value of all economic benefits taken into account by the parties is determined in accordance with paragraph (d)(3)(ii) of this section.

* * * * *

Par. 3. Section 1.83–6, as proposed on July 9, 2002, at 67 FR 45428, is amended by adding paragraph (a)(5)(ii)(B)(*3*) to read as follows:

§1.83–6 Deduction by employer.

(a) * * *

(5) * * *

(ii) * * *

(B) * * *

(*3*) *Valuation of economic benefits*. Notwithstanding paragraph (a)(5)(ii)(B)(*2*) of this section, for taxable years beginning after December 31, 2002, parties to an arrangement described in §1.61–22(d)(3) may rely on this section only if the value of all economic benefits taken into account by the parties is determined in accordance with §1.61–22(d)(3)(ii).

* * * * *

Par. 4. Section 1.301–1, as proposed on July 9, 2002, at 67 FR 45428, is amended by adding paragraph (q)(4)(ii)(C) to read as follows:

§1.301–1 Rules applicable with respect to distributions of money and other property.

* * * * *

(q) * * *

(4) * * *

(ii) * * *

(C) *Valuation of economic benefits*. Notwithstanding paragraph (q)(4)(ii)(B) of this section, for taxable years beginning after December 31, 2002, parties to an arrangement described in §1.61–22(d)(3) may rely on this section only if the value of all economic benefits taken into account by the parties is determined in accordance with §1.61–22(d)(3)(ii).

* * * * *

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

(Filed by the Office of the Federal Register on May 8, 2003, 8:45 a.m., and published in the issue of the Federal Register for May 9, 2003, 68 F.R. 24898)

Notice of Proposed Rulemaking by Cross-Reference to Temporary Regulations and Notice of Public Hearing

Guidance Under Section 1502; Amendment of Waiver of Loss Carryovers from Separate Return Limitation Years

REG–152524–02

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations and notice of public hearing.

SUMMARY: In this issue of the Bulletin, the IRS is issuing temporary regulations (T.D. 9057) under section 1502 that permit the amendment of certain elections to waive the loss carryovers of an acquired subsidiary. The text of the temporary regulations published in this issue of the Bulletin also serves as the text of these proposed regulations. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by August 5, 2003. Outlines of topics to be discussed at the public hearing scheduled for August 6, 2003, at 10 a.m., must be received by July 16, 2003.

ADDRESSES: Send submissions to: CC:ITA:RU (REG–152524–02), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to CC:ITA:RU (REG–

152524–02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20044. Alternatively, taxpayers may submit comments electronically directly to the IRS Internet site at *www.irs.gov/regs*. The public hearing will be held in room 6718, Internal Revenue Service Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Alison G. Burns or Jeffrey B. Fienberg, (202) 622–7930; concerning submission of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Sonya Cruse, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the **Office of Management and Budget** for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by July 7, 2003. Comments are specifically requested concerning:

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

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

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

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

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

The collection of information in this proposed regulation was previously approved and reviewed by the **Office of Management and Budget** under control number 1545–1774. The collection of information is required to allow the taxpayer to make certain elections to determine the amount of allowable loss under §1.337(d)–2T, §1.1502–20 as currently in effect, or under §1.1502–20 modified so that the amount of allowable loss determined pursuant to §1.1502–20(c)(1) is computed by taking into account only the amounts computed under §1.1502–20(c)(1)(i) and (ii); to allow the taxpayer to reapportion a section 382 limitation in certain cases; to allow the taxpayer to waive certain loss carryovers; and to ensure that loss is not disallowed under §1.337–2T and basis is not reduced under §1.337(d)–2T to the extent that the taxpayer establishes that the loss or basis is not attributable to the recognition of built-in gain on the disposition of an asset.

This collection of information is modified with respect to §§1.1502–20T and 1.1502–32T. Regarding §1.1502–20T, the collection of information also is necessary to allow the common parent of the selling group to reapportion a separate, subgroup or consolidated section 382 limitation when the acquiring group amends its §1.1502–32(b)(4) election. With respect to §1.1502–32T, the collection of information also is necessary to allow the acquiring group to amend its previous §1.1502–32(b)(4) election, so that it may use previously waived losses of its subsidiary.

The collection of information is required to obtain a benefit. The likely respondents are corporations that file consolidated income tax returns.

Estimated total annual reporting and/or recordkeeping burden: 30,400 hours.

Estimated average annual burden per respondent: 2 hours.

Estimated number of respondents: 15,200.

Estimated annual frequency of responses: once.

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

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

Background and Explanation of Provisions

Temporary regulations (T.D. 9057) on page 964 of this issue of the Bulletin amend the Income Tax Regulations (26 CFR part 1) relating to section 1502. The text of those regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations contains a full explanation of the reasons underlying the issues of the proposed regulations.

Proposed Effective Date

These proposed regulations will be effective on the date they are published as final regulations in the **Federal Register**.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations do not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations primarily will affect affiliated groups of corporations that have elected to file consolidated returns, which tend to be larger businesses, and, moreover, that any burden on taxpayers is minimal. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to §7805(f) of the Internal Revenue Code, these regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS.

All comments will be available for public inspection and copying.

A public hearing has been scheduled for August 6, 2003, beginning at 10 a.m. in room 6718, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" portion of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments must submit written or electronic comments and an outline of the topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by July 16, 2003. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

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

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Proposed Amendments to the Regulations

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

PART 1 — INCOME TAXES

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

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

Par. 2. Section 1.1502–20 is amended by redesignating paragraph (i)(5) as (i)(6) and by adding paragraphs (i)(3)(viii) and (i)(5) to read as follows:

§1.1502–20 — Disposition or deconsolidation of subsidiary stock.

[The text of this proposed section is the same as the text of §1.1502–20T(i)(3)(viii) and (i)(5) published elsewhere in this issue of the Bulletin].

Par. 3. Section 1.1502–32 is amended by adding paragraph (b)(4)(vii) to read as follows:

§1.1502–32 — Investment adjustments.

[The text of this proposed section is the same as the text of §1.1502–32T(b)(4)(vii) published elsewhere in this issue of the Bulletin].

* * * * *

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

(Filed by the Office of the Federal Register on May 6, 2003, 8:45 a.m., and published in the issue of the Federal Register for May 7, 2003, 68 F.R. 24404)

Definition of Terms

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

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

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

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

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

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

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

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

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

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

Abbreviations

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

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

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

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