Internal Revenue
bulletin

Bulletin No. 2010-24
June 14, 2010

# 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

### Notice 2010–46, page 757.

This notice addresses the U.S. tax imposed on substitute dividend payments received by foreign taxpayers that lend U.S. dividend paying securities in securities lending transactions. The notice announces the upcoming withdrawal of Notice 97–66, outlines a proposed regulatory framework to address potential over-withholding that may occur as a result of the HIRE Act, and provides transaction relief with respect to substitute dividend payments made between the effective date of the HIRE Act and the issuance of regulations. Notice 97–66 modified.

## EMPLOYEE PLANS

### T.D. 9484, page 748.

Final regulations under section 401(a)(35) of the Code relate to diversification requirements for certain defined contribution plans holding publicly traded employer securities. The regulations will affect administrators of, employers maintaining, participants in, and beneficiaries of defined contribution plans that are invested in employer securities. The regulations apply for plan years beginning on or after January 1, 2011.

## EXEMPT ORGANIZATIONS

### Notice 2010–39, page 756.

This notice solicits comments regarding the application of certain requirements imposed by new section 501(r), added to the Code by section 9007(a) of the Patient Protection and Affordable Care Act (Affordable Care Act). Comments should be submitted by July 22, 2010.

## ADMINISTRATIVE

### Rev. Proc. 2010–23, page 762.

**Qualified mortgage bonds; mortgage credit certificates; national median gross income.** Guidance is provided concerning the use of the national and area median gross income figures by issuers of qualified mortgage bonds and mortgage credit certificates in determining the housing cost/income ratio described in section 143(f) of the Code. Rev. Proc. 2009–27 obsoleted in part.

**Finding Lists begin on page ii.**

Department of the Treasury
Internal Revenue Service

# The IRS Mission

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

# Introduction

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

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

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

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

The Bulletin is divided into four parts as follows:

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

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

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

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

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



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

## Section 401.—Qualified Pension, Profit-Sharing, and Stock Bonus Plans

*26 CFR 1.401(a)(35)–1: Diversification requirements for certain defined contribution plans.*

## T.D. 9484

## DEPARTMENT OF THE TREASURY
## Internal Revenue Service
## 26 CFR Part 1

## Diversification Requirements for Certain Defined Contribution Plans

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations under section 401(a)(35) of the Internal Revenue Code (Code) relating to diversification requirements for certain defined contribution plans holding publicly traded employer securities. These regulations will affect administrators of, employers maintaining, participants in, and beneficiaries of defined contribution plans that are invested in employer securities.

DATES: *Effective date:* These regulations are effective on May 19, 2010.

*Applicability Date:* These regulations apply for plan years beginning on or after January 1, 2011.

FOR FURTHER INFORMATION CONTACT: R. Lisa Mojiri-Azad or Jamie Dvoretzky at (202) 622–6060 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

**Background**

This document contains final regulations under section 401(a)(35) of the Code, which was added by section 901 of the Pension Protection Act of 2006, Public Law 109–280 (120 Stat. 780 (2006)) (PPA '06).[1]

Section 401(a)(35)(A) provides that a trust which is part of an applicable defined contribution plan is not a qualified trust under section 401(a) unless the plan satisfies the diversification requirements of section 401(a)(35)(B), (C), and (D). Under section 401(a)(35)(B), each individual must have the right to direct the plan to divest employer securities allocated to the individual's account that are attributable to employee contributions or elective deferrals and to reinvest an equivalent amount in other investment options meeting the requirements of section 401(a)(35)(D).[2]

Under section 401(a)(35)(C), each individual who is a participant who has completed at least three years of service, a beneficiary of a participant who has completed at least three years of service, or a beneficiary of a deceased participant must be permitted to elect to direct the plan to divest employer securities allocated to the individual's account and to reinvest an equivalent amount in other investment options meeting the requirements of section 401(a)(35)(D).

Section 401(a)(35)(D)(i) requires an applicable defined contribution plan to offer individuals not less than three investment options, other than employer securities, to which the individuals may direct the proceeds from the divestment of employer securities, each of which is diversified and has materially different risk and return characteristics.

Under section 401(a)(35)(D)(ii)(I), a plan does not fail to meet the requirements of section 401(a)(35)(D) if it allows individuals to divest employer securities and reinvest the proceeds at periodic, reasonable opportunities occurring no less frequently than quarterly.

Under section 401(a)(35)(D)(ii)(II), a plan is not permitted to impose restrictions or conditions with respect to the investment of employer securities that are not imposed on the investment of other assets of the plan. However, this rule does not apply to restrictions or conditions imposed to comply with securities laws. The Secretary is authorized to issue regulations providing additional exceptions to the requirements of section 401(a)(35)(D)(ii)(II).

An applicable defined contribution plan under section 401(a)(35) is a defined contribution plan that holds any publicly traded employer securities. A publicly traded employer security is defined as an employer security under section 407(d)(1) of the Employee Retirement Income Security Act of 1974, Public Law 93–406 (88 Stat. 829 (1974)) (ERISA) which is readily tradable on an established securities market. Section 401(a)(35)(F)(i) provides that a plan that holds employer securities that are not publicly traded employer securities is nevertheless treated as holding publicly traded employer securities if any employer corporation or any member of a controlled group of corporations which includes the employer (determined by applying section 1563(a), except substituting 50 percent for 80 percent) has issued a class of stock that is a publicly traded employer security. However, section 401(a)(35)(F) does not apply to a plan if no employer corporation, or parent corporation (as defined in section 424(e)) of an employer corporation, has issued any publicly traded employer security and no employer or parent corporation has issued any special class of stock which grants particular rights to, or bears particular risks for, the holder or issuer with respect to any corporation described in section 401(a)(35)(F)(i) which has issued any publicly traded employer security.

[1] Section 901 of PPA '06 also added a parallel provision to section 401(a)(35) at section 204(j) of the Employee Retirement Income Security Act of 1974, Public Law 93–406 (88 Stat. 829 (1974)) (ERISA). Under section 101 of Reorganization Plan No. 4 of 1978 (43 FR 47713), the Secretary of Treasury has interpretative jurisdiction over the subject matter addressed in these final regulations for purposes of section 204(j) of ERISA. Thus, the guidance provided in these final regulations with respect to section 401(a)(35) of the Code also applies for purposes of section 204(j) of ERISA.

[2] Section 401(a)(28)(B) provides certain diversification rights to participants in an employee stock ownership plan within the meaning of section 4975(e)(7) (ESOP). Section 401(a)(28)(B)(v), as added by section 901(a)(2)(A) of PPA '06, provides that section 401(a)(28)(B) does not to apply to a plan to which section 401(a)(35) applies.

Section 401(a)(35)(E) provides that section 401(a)(35) does not apply to an employee stock ownership plan within the meaning of section 4975(e)(7) (ESOP) that holds no contributions (or earnings thereunder) that are subject to section 401(k) or (m) (generally relating to elective deferrals and matching and employee after-tax contributions) and the ESOP is a separate plan for purposes of section 414(l) with respect to any other defined benefit plan or defined contribution plan maintained by the same employer or employers. Section 401(a)(35)(E) further provides that section 401(a)(35) does not apply to one-participant retirement plans (within the meaning of section 401(a)(35)(E)(iv)).

Section 401(a)(35) is generally effective for plan years beginning after December 31, 2006. Section 401(a)(35)(H) generally provides a three year phase-in rule with respect to an individual's right to direct the divestment of employer securities attributable to employer contributions, except with respect to certain participants who have attained age 55. Section 901(c)(2) of PPA '06 includes a special rule for a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers that was ratified on or before August 17, 2006. Under this rule, section 401(a)(35) is not effective until plan years beginning after the earlier of (1) the later of (a) December 31, 2007 or (b) the date on which the last of such collective bargaining agreements terminates (determined without regard to any extension thereof after August 17, 2006) or (2) December 31, 2008.

Section 101(m) of ERISA as amended by section 507 of PPA '06 requires the plan administrator to furnish a notice to individuals not later than 30 days before the first date on which an individual is eligible to exercise his or her right to divest employer securities with respect to any type of contribution. The notice must set forth the diversification rights under section 204(j) of ERISA (which is the parallel provision in ERISA to section 401(a)(35)) and describe the importance of diversifying the investment of retirement account assets.

Notice 2006–107, 2006–2 C.B. 1114 (December 18, 2006)), (see §601.601(d)(2)(ii)(*b*)) includes guidance and transitional rules with respect to the diversification requirements of section 401(a)(35). Notice 2006–107 also includes guidance regarding the related notice requirements of section 101(m) of ERISA, including a model notice. Notice 2008–7, 2008–1 C.B. 276 (January 22, 2008)), (see §601.601(d)(2)(ii)(*b*)) extends the transitional guidance and transitional relief that was included in Notice 2006–107 until the final regulations become effective.

Notice 2009–97, 2009–52 I.R.B. 972 (December 28, 2009)), (see §601.601(d)(2)(ii)(*b*)) extends the deadline for adopting an interim or discretionary plan amendment under certain provisions of PPA '06, including section 401(a)(35), to the last day of the first plan year that begins on or after January 1, 2010.

On January 3, 2008, proposed regulations (REG–136701–07, 2008–1 C.B. 616) under section 401(a)(35) of the Code were published in the **Federal Register** (73 FR 421). No public hearing was requested. Written comments responding to the notice of proposed rulemaking were received. After consideration of all the comments, the proposed regulations are adopted, as amended by this Treasury decision. The most significant revisions are discussed in the Summary of Comments and Explanation of Revisions.

**Summary of Comments and Explanation of Revisions**

*Certain defined contribution plans or investment funds not treated as holding employer securities*

The proposed regulations provided that certain investment funds that include employer securities as part of a broader fund were treated as not holding employer securities. This exception was limited to the extent the employer securities were held indirectly through an investment company registered under the Investment Company Act of 1940; a common or collective trust fund or pooled investment fund maintained by a bank or trust company supervised by a State or a Federal agency; a pooled investment fund of an insurance company that is qualified to do business in a State; or any other investment fund designated by the Commissioner in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin. The proposed regulations also provided that this exception was limited to funds where the investment is independent of the employer and where the employer securities do not exceed 10 percent of the fund.

Commentators requested that this exception be broadened to include funds that are managed by an investment manager within the meaning of section 3(38) of ERISA. The final regulations do not provide for this expansion because such a fund would not necessarily be holding employer securities only as an indirect result of its investment policy. However, the final regulations provide that, in the case of a multiemployer plan, an investment option will not be treated as holding employer securities to the extent the employer securities are held indirectly through an investment fund managed by an investment manager if the investment is independent of the employer and the percentage limitation rule is satisfied.

The final regulations replace the reference to a fund that is an investment company registered under the Investment Company Act of 1940 with a regulated investment company as described in Code section 851(a). This change extends the types of investment companies to include exchange traded funds, which are unit investment trusts if they satisfy section 851(a). The final regulations also retain the rule from the proposed regulations that allows the Commissioner to designate additional types of funds as eligible for this exception.

Commentators requested that the percentage limitation rule be eliminated. They argued that it would be difficult and costly to monitor the investment fund to ensure that the aggregate value of the employer securities held in such fund was not in excess of 10 percent of the total assets of all the fund's investments. In response to these comments, the final regulations provide that the determination of whether the value of employer securities exceeds 10 percent of the total value of the fund's investments is made for the plan year as of the end of the preceding plan year. The determination can be based on the information in the latest disclosure of the fund's portfolio holdings (for example, Form N-CSR, *"Certified Shareholder Report of Registered Management Investment Companies"*) that was filed with the

Securities and Exchange Commission in that preceding plan year.

The final regulations also provide that in a case where a fund that indirectly holds employer securities fails to meet the requirement that the investment be independent of the employer (including the situation where the fund no longer meets the percentage limitation rule), the plan does not fail to satisfy the diversification requirements under section 401(a)(35) merely because it does not offer those rights for up to 90 days after the investment fund is treated as holding employer securities.

*Prohibition on restrictions or conditions*

Section 401(a)(35)(D)(ii)(II) provides that a plan is not permitted to impose restrictions or conditions with respect to the investment of employer securities that are not imposed on the investment of other assets of the plan. Like the proposed regulations, the final regulations provide that the prohibition on restrictions or conditions with respect to the investment of employer securities applies to any direct or indirect restriction on an individual's right to divest an investment in employer securities that is not imposed on an investment that is not employer securities, as well as a direct or indirect benefit that is conditioned on investment in employer securities.

The proposed regulations provided for a number of permitted restrictions and conditions. The proposed regulations would have permitted a plan to impose a restriction or condition either directly or indirectly because of applicable securities laws or because the plan becomes an applicable defined contribution plan, limits investments in employer securities, limits trading frequency, does not permit investment in a frozen fund, imposes a fee on other investment options that is not imposed on the investment in employer securities or imposes a reasonable fee on the divestment of employer securities, or allows investments to be made in a stable value or similar fund more frequently than other investment funds.

A commentator requested clarification with respect to the exception for frozen funds. The commentator requested that a frozen fund include a plan that reinvests employer security dividends in additional employer securities as long as the plan does not permit any further investment in employer securities. The final regulations clarify that the plan is permitted to allow reinvestment of dividends paid on employer securities. The final regulations also clarify that the frozen fund exception is only available for a plan that does not have another employer securities fund.

Commentators requested that the list for permitted indirect restrictions or conditions be expanded to include certain defined contribution plans that make matching contributions in employer securities and allow participants to divest employer securities attributable to such contributions, but do not permit participants to later elect to reinvest any portion of their account balances in employer stock. The final regulations do not adopt this suggestion. The IRS and the Treasury Department (Treasury) have concluded that the inability to reinvest in employer securities generally acts as a material deterrent to an individual who might otherwise have elected to diversify his or her account balance of employer securities. However, the final regulations provide a transitional rule for certain leveraged ESOPs. An employer stock fund does not fail to be a frozen fund merely because of the allocation of employer securities that are released as matching contributions from the plan's suspense account that holds employer securities acquired with an exempt loan under section 4975(d)(3). This transitional rule only applies to employer securities that were acquired in a plan year beginning before January 1, 2007, with the proceeds of an exempt loan within the meaning of section 4975(d)(3) which is not refinanced after the end of the last plan year beginning before January 1, 2007. This transitional rule was added because these leveraged ESOPs cannot cease allocations of employer securities acquired with an exempt loan that are held in a suspense account without significant effect on the company's debt arrangements.

Commentators suggested that the special rule for a stable value or similar fund be expanded to allow transfers out of a stable value fund or similar fund more frequently than other funds. In response to comments, the final regulations provide that a plan is generally permitted to allow transfers to be made into or out of a stable value fund more frequently than a fund invested in employer securities. Thus, a plan that includes a broad range of investment alternatives as described in section 401(a)(35)(D)(i), including a stable value or similar fund, does not impose an impermissible restriction merely because it permits transfers into and out of the stable value or similar fund more frequently than the other funds (taking into account any restrictions or conditions imposed with respect to the other investment options under the plan).

Commentators requested clarification as to the meaning of a stable value or similar fund. The final regulations provide that a stable value or similar fund means an investment product or fund designed to preserve or guarantee principal and provide a reasonable rate of return, while providing liquidity for benefit distributions or transfers to other investment alternatives (such as a product or fund described in Department of Labor Regulation section 2550.404c–5(e)(4)(iv)(A) or (v)(A)).

One commentator noted that the Department of Labor regulations for qualified default investment alternatives (QDIAs) require QDIAs to be restriction-free for 90 days. The commentator requested clarification that the restriction-free 90-day period does not cause a plan to violate the prohibition on imposing a restriction or condition with respect to employer securities that is not imposed on other investments. However, the commentator further stated that service providers will have difficulty administering restrictions only after 90 days and therefore requested that the final regulations permit restriction-free transfers for QDIAs permanently. The final regulations expand the list of permitted indirect restrictions to provide that a plan may provide for transfers out of a QDIA (within the meaning of Department of Labor Regulation section 2550.404c–5(e)) more frequently than a fund invested in employer securities.

A commentator requested clarification concerning plans being permitted to restrict reinvestments in only one employer stock fund when the plan allows investment in another employer stock fund, provided that the stock contained in each fund has the same characteristics except for differences in the tax cost basis of the trust. The final regulations provide that any applicable tax consequences are disregarded in determining whether a plan imposes an indirect restriction or condition on an individual's right to divest an investment in employer securities. Accordingly, a plan is permitted to provide that an individual may not reinvest divested amounts in the same employer securities account but is permitted to invest such divested amounts in another employer securities account where the only relevant difference between the separate accounts is the section 402(e)(4) cost (or other basis) of the trust in the shares held in each account.

Several commentators requested clarification regarding the 7-day rule in the proposed regulations. The preamble to the proposed regulations explained that the 7-day rule was an example and not the exclusive method to limit trading frequency. The permitted restriction for trading frequency provides that a plan is permitted to impose reasonable restrictions that are designed to limit short-term trading in employer securities. Thus, the 7-day rule, which was mentioned in the preamble to the proposed regulations, is an example and other short-term trading restrictions (such as a restriction based on multiple trades within a specified period) are allowable if they meet the reasonably designed standard.

*Miscellaneous*

Commentators requested clarification with respect to an ESOP that has been satisfying the diversification requirements under section 401(a)(28) by distributing the portion of the participant's account covered by an election within 90 days after the period during which the election may be made, but which is now subject to the diversification requirements under section 401(a)(35). Such a distribution option does not satisfy the diversification requirements under section 401(a)(35). These commentators were concerned that an amendment which eliminates this distribution option would be a violation of the anti-cutback rules under section 411(d)(6). Section 1107 of PPA '06 provides that any amendment which is made pursuant to a provision of PPA '06 will not fail to meet the requirements of section 411(d)(6) unless otherwise provided by the Secretary of the Treasury.[3] Thus, an amendment to an ESOP which is now subject to the diversification requirements under section 401(a)(35) that eliminates the distribution option available for ESOPs subject to the diversification requirements under section 401(a)(28), as permitted under section 1107 of PPA '06, would not violate the anti-cutback rules under section 411(d)(6).

In addition, it is expected that guidance will be issued in the near future exercising the authority under §1.411(d)–4, A–2(d)(4), to permit elimination of such a distribution option with respect to an ESOP that is subject to section 401(a)(35) after the end of the limited period to which section 1107 of PPA '06 applies. The guidance will permit elimination of such a distribution option during the extended remedial amendment period permitted with respect to section 401(a)(35) under Notice 2009–97, that is, to the last day of the first plan year that begins on or after January 1, 2010.

**Effective/Applicability Date**

The final regulations are effective and applicable for plan years beginning on or after January 1, 2011.

For the period after the statutory effective date and before the regulatory effective date set forth in the preceding sentence, a plan must comply with section 401(a)(35). During this period, a plan is permitted to rely on Notice 2006–107, the proposed regulations, or these final regulations for purposes of satisfying the requirements of section 401(a)(35).

**Special Analyses**

It has been determined that these final regulations are 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 §1.401(a)(35)–1 would 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 preceding this regulation was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comments on its impact on small business.

**Drafting Information**

The principal authors of these regulations are Dana A. Barry, formerly of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities), and R. Lisa Mojiri-Azad, Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and the Treasury Department participated in the development of these regulations.

* * * * *

**Adoption of Amendments to the Regulations**

Accordingly, 26 CFR part 1 is amended as follows:

Part 1—INCOME TAXES

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

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

Section 1.401(a)(35)–1 is also issued under 26 U.S.C. 401(a)(35). * * *

Par. 2. Section 1.401(a)(35)–1 is added to read as follows:

*§1.401(a)(35)–1 Diversification Requirements for Certain Defined Contribution Plans.*

(a) *General rule*—(1) *Diversification requirements*. Section 401(a)(35) imposes diversification requirements on applicable defined contribution plans. A trust that is part of an applicable defined contribution plan is not a qualified trust under section 401(a) unless the plan—

(i) Satisfies the diversification election requirements for elective deferrals and employee contributions set forth in paragraph (b) of this section;

(ii) Satisfies the diversification election requirements for employer nonelective contributions set forth in paragraph (c) of this section;

(iii) Satisfies the investment option requirement set forth in paragraph (d) of this section; and

[3] See also section 411(d)(6)(C)(ii).

(iv) Does not apply any restrictions or conditions on investments in employer securities that violate the requirements of paragraph (e) of this section.

(2) *Definitions, effective dates, and transition rules*. The definitions of applicable defined contribution plan, employer security, parent corporation, and publicly traded are set forth in paragraph (f) of this section. Applicability dates and transition rules are set forth in paragraph (g) of this section.

(b) *Diversification requirements for elective deferrals and employee contributions invested in employer securities*—(1) *General rule*. With respect to any individual described in paragraph (b)(2) of this section, if any portion of the individual's account under an applicable defined contribution plan attributable to elective deferrals (as described in section 402(g)(3)(A)), employee contributions, or rollover contributions is invested in employer securities, then the plan satisfies the requirements of this paragraph (b) if the individual may elect to divest those employer securities and reinvest an equivalent amount in other investment options. The plan may limit the time for divestment and reinvestment to periodic, reasonable opportunities occurring no less frequently than quarterly.

(2) *Applicable individual with respect to elective deferrals and employee contributions*. An individual is described in this paragraph (b)(2) if the individual is—

(i) A participant;

(ii) An alternate payee who has an account under the plan; or

(iii) A beneficiary of a deceased participant.

(c) *Diversification requirements for employer nonelective contributions invested in employer securities*—(1) *General rule*. With respect to any individual described in paragraph (c)(2) of this section, if a portion of the individual's account under an applicable defined contribution plan attributable to employer nonelective contributions is invested in employer securities, then the plan satisfies the requirements of this paragraph (c) if the individual may elect to divest those employer securities and reinvest an equivalent amount in other investment options. The plan may limit the time for divestment and reinvestment to periodic, reasonable opportunities occurring no less frequently than quarterly.

(2) *Applicable individual with respect to employer nonelective contributions*. An individual is described in this paragraph (c)(2) if the individual is—

(i) A participant who has completed at least three years of service;

(ii) An alternate payee who has an account under the plan with respect to a participant who has completed at least three years of service; or

(iii) A beneficiary of a deceased participant.

(3) *Completion of three years of service*. For purposes of paragraph (c)(2) of this section, a participant completes three years of service on the last day of the vesting computation period provided for under the plan that constitutes the completion of the third year of service under section 411(a)(5). However, for a plan that uses the elapsed time method of crediting service for vesting purposes (or a plan that provides for immediate vesting without using a vesting computation period or the elapsed time method of determining vesting), a participant completes three years of service on the day immediately preceding the third anniversary of the participant's date of hire.

(d) *Investment options*. An applicable defined contribution plan must offer not less than three investment options, other than employer securities, to which an individual who has the right to divest under paragraph (b)(1) or (c)(1) of this section may direct the proceeds from the divestment of employer securities. Each of the three investment options must be diversified and have materially different risk and return characteristics. For this purpose, investment options that constitute a broad range of investment alternatives within the meaning of Department of Labor Regulation section 2550.404c–1(b)(3) are treated as being diversified and having materially different risk and return characteristics.

(e) *Restrictions or conditions on investments in employer securities*—(1) *Impermissible restrictions or conditions*—(i) *General rule*. Except as provided in paragraph (e)(2) of this section, an applicable defined contribution plan violates the requirements of this paragraph (e) if the plan imposes restrictions or conditions with respect to the investment of employer securities that are not imposed on the investment of other assets of the plan. A restriction or condition with respect to employer securities means—

(A) A restriction on an individual's right to divest an investment in employer securities that is not imposed on an investment that is not employer securities; or

(B) A benefit that is conditioned on investment in employer securities.

(ii) *Indirect restrictions or conditions*—(A) Except as provided in paragraph (e)(3) of this section, a plan violates the requirements of this paragraph (e) if the plan imposes a restriction or condition described in paragraph (e)(1)(i)(A) or (B) of this section either directly or indirectly.

(B) A plan imposes an indirect restriction on an individual's right to divest an investment in employer securities if, for example, the plan provides that a participant who divests his or her account balance with respect to the investment in employer securities is not permitted for a period of time thereafter to reinvest in employer securities.

(C) A plan does not impose an indirect restriction or condition merely because there are tax consequences that result from an individual's divestment of an investment in employer securities. Thus, the loss of the special treatment for net unrealized appreciation provided under section 402(e)(4) with respect to employer securities is disregarded. Similarly, a plan does not impose an impermissible restriction or condition merely because it provides that an individual may not reinvest divested amounts in the same employer securities account but is permitted to invest such divested amounts in another employer securities account where the only relevant difference between the separate accounts is the section 402(e)(4) cost (or other basis) of the trust in the shares held in each account. (See §1.402(a)–1(b) for rules regarding section 402(e)(4).)

(2) *Permitted restrictions or conditions*—(i) *In general*. An applicable defined contribution plan does not violate the requirements of this paragraph (e) merely because it imposes a restriction or a condition set forth in paragraph (e)(2)(ii) or (e)(2)(iii) of this section.

(ii) *Securities laws*. A plan is permitted to impose a restriction or condition on the divestiture of employer securities that is either required in order to ensure compliance with applicable securities laws or is reasonably designed to ensure compliance with applicable securities laws. For example, it is permissible for a plan to limit divestiture rights for participants who are subject to section 16(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78f) to a reasonable period (such as 3 to 12 days) following publication of the employer's quarterly earnings statements because it is reasonably designed to ensure compliance with Rule 10b–5 of the Securities and Exchange Commission.

(iii) *Deferred application of the diversification requirements*—(A) *Becoming an applicable defined contribution plan*. An applicable defined contribution plan is permitted to restrict the application of the diversification requirements of section 401(a)(35) and this section for up to 90 days after the plan becomes an applicable defined contribution plan (for example, a plan becoming an applicable defined contribution plan because the employer securities held under the plan become publicly traded).

(B) *Loss of exception for indirect investments*. In the case where an investment fund described in paragraph (f)(3)(ii)(A) of this section no longer meets the requirement in paragraph (f)(3)(ii)(B) of this section that the investment must be independent of the employer (including the situation where the fund no longer meets the percentage limitation rule in paragraph (f)(3)(ii)(C) of this section), the plan does not fail to satisfy the diversification requirements of section 401(a)(35) and this section merely because it does not offer those rights with respect to that investment fund for up to 90 days after the investment fund ceases to meet those requirements.

(3) *Permitted indirect restrictions or conditions*—(i) *In general*. An applicable defined contribution plan does not violate the requirements of this paragraph (e) merely because it imposes an indirect restriction or condition set forth in this paragraph (e)(3).

(ii) *Limitation on investment in employer securities*. A plan is permitted to limit the extent to which an individual's account balance can be invested in employer securities, provided the limitation applies without regard to a prior exercise of rights to divest employer securities. For example, a plan does not impose a restriction that violates this paragraph (e) merely because the plan prohibits a participant from investing additional amounts in employer securities if more than 10 percent of that participant's account balance is invested in employer securities.

(iii) *Trading frequency*. A plan is permitted to impose reasonable restrictions on the timing and number of investment elections that an individual can make to invest in employer securities, provided that the restrictions are designed to limit short-term trading in the employer securities. For example, a plan could provide that a participant may not elect to invest in employer securities if the employee has elected to divest employer securities within a short period of time, such as seven days, prior to the election to invest in employer securities.

(iv) *Fees*. The plan has not provided an indirect benefit that is conditioned on investment in employer securities merely because the plan imposes fees on other investment options that are not imposed on the investment in employer securities. In addition, the plan has not provided a restriction on the right to divest an investment in employer securities merely because the plan imposes a reasonable fee for the divestment of employer securities.

(v) *Stable value or similar fund*. A plan is permitted to allow transfers to be made into or out of a stable value or similar fund more frequently than a fund invested in employer securities for purposes of paragraph (e)(1)(ii) of this section. Thus, a plan that includes a broad range of investment alternatives as described in paragraph (d) of this section, including a stable value or similar fund, does not impose an impermissible restriction under paragraph (e)(1)(ii) of this section merely because it permits transfers into or out of that fund more frequently than other funds under the plan, provided that the plan would otherwise satisfy this paragraph (e) (taking into account any restrictions or conditions imposed with respect to the other investment options under the plan). For purposes of this section, a stable value fund or similar fund means an investment product or fund designed to preserve or guarantee principal and provide a reasonable rate of return, while providing liquidity for benefit distributions or transfers to other investment alternatives (such as a product or fund described in Department of Labor Regulation section 2550.404c–5(e)(4)(iv)(A) or (v)(A)).

(vi) *Transfers out of a qualified default investment alternative (QDIA)*. A plan is permitted to provide for transfers out of a QDIA within the meaning of Department of Labor Regulation section 2550.404c–5(e) more frequently than a fund invested in employer securities.

(vii) *Frozen funds*—(A) *General rule*. A plan is permitted to prohibit any further investment in employer securities. Thus, a plan is not treated as imposing an indirect restriction merely because it provides that an employee that divests an investment in employer securities is not permitted to reinvest in employer securities, but only if the plan does not permit additional contributions or other investments to be invested in employer securities. For this purpose, a plan does not provide for further investment in employer securities merely because dividends paid on employer securities under the plan are reinvested in employer securities.

(B) *Transitional relief for certain leveraged employee stock ownership plans (ESOPs)*. An employer stock fund does not fail to be a frozen fund under this paragraph (e)(3)(vii) merely because of the allocation of employer securities that are released as matching contributions from the plan's suspense account that holds employer securities acquired with an exempt loan under section 4975(d)(3). This paragraph (e)(3)(vii)(B) only applies to employer securities that were acquired in a plan year beginning before January 1, 2007, with the proceeds of an exempt loan within the meaning of section 4975(d)(3) which is not refinanced after the end of the last plan year beginning before January 1, 2007.

(4) *Delegation of authority to Commissioner*. The Commissioner may provide for additional permitted restrictions or conditions or permitted indirect restrictions or conditions in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin.

(f) *Definitions*—(1) *Application of definitions*. This paragraph (f) contains definitions that are applicable for purposes of this section.

(2) *Applicable defined contribution plan*—(i) *General rule*. Except as provided in this paragraph (f)(2), an applicable defined contribution plan means any defined contribution plan which holds employer securities that are publicly traded.

See paragraph (f)(2)(iv) of this section for a special rule that treats certain plans that hold employer securities that are not publicly traded as applicable defined contribution plans and paragraph (f)(3)(ii) of this section for a special rule that treats certain plans as not holding publicly traded employer securities for purposes of this section.

(ii) *Exception for certain ESOPs*. An employee stock ownership plan (ESOP), as defined in section 4975(e)(7), is not an applicable defined contribution plan if the plan is a separate plan for purposes of section 414(l) with respect to any other defined benefit plan or defined contribution plan maintained by the same employer or employers and holds no contributions (or earnings thereunder) that are (or were ever) subject to section 401(k) or 401(m). Thus, an ESOP is an applicable defined contribution plan if the ESOP is a portion of a larger plan (whether or not that larger plan includes contributions that are subject to section 401(k) or 401(m)). For purposes of this paragraph (f)(2)(ii), a plan is not considered to hold amounts ever subject to section 401(k) or 401(m) merely because the plan holds amounts attributable to rollover amounts in a separate account that were previously subject to section 401(k) or 401(m).

(iii) *Exception for one-participant plans*. A one-participant plan, as defined in section 401(a)(35)(E)(iv), is not an applicable defined contribution plan.

(iv) *Certain defined contribution plans treated as holding publicly traded employer securities*—(A) *General rule*. A defined contribution plan holding employer securities that are not publicly traded is treated as an applicable defined contribution plan if any employer maintaining the plan or any member of a controlled group of corporations that includes such employer has issued a class of stock which is publicly traded. For purposes of this paragraph (f)(2)(iv), a controlled group of corporations has the meaning given such term by section 1563(a), except that "50 percent" is substituted for "80 percent" each place it appears.

(B) *Exception for certain plans*. Paragraph (f)(2)(iv)(A) of this section does not apply to a plan if—

(*1*) No employer maintaining the plan (or a parent corporation with respect to such employer) has issued stock that is publicly traded; and

(*2*) No employer maintaining the plan (or parent corporation with respect to such employer) has issued any special class of stock which grants to the holder or issuer particular rights, or bears particular risks for the holder or issuer, with respect to any employer maintaining the plan (or any member of a controlled group of corporations that includes such employer) which has issued any stock that is publicly traded.

(3) *Employer security*—(i) *General rule*. Employer security has the meaning given such term by section 407(d)(1) of the Employee Retirement Income Security Act of 1974, as amended (ERISA).

(ii) *Certain defined contribution plans or investment funds not treated as holding employer securities*—(A) *Exception for certain indirect investments*. Subject to paragraphs (f)(3)(ii)(B) and (C) of this section, a plan (and an investment option described in paragraph (d) of this section) is not treated as holding employer securities for purposes of this section to the extent the employer securities are held indirectly as part of a broader fund that is—

(*1*) A regulated investment company described in section 851(a);

(*2*) A common or collective trust fund or pooled investment fund maintained by a bank or trust company supervised by a State or a Federal agency;

(*3*) A pooled investment fund of an insurance company that is qualified to do business in a State;

(*4*) An investment fund managed by an investment manager within the meaning of section 3(38) of ERISA for a multiemployer plan; or

(*5*) Any other investment fund designated by the Commissioner in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin.

(B) *Investment must be independent*. The exception set forth in paragraph (f)(3)(ii)(A) of this section applies only if the investment in the employer securities is held in a fund under which—

(*1*) There are stated investment objectives of the fund; and

(*2*) The investment is independent of the employer (or employers) and any affiliate thereof.

(C) *Percentage limitation rule*. For purposes of paragraph (f)(3)(ii)(B)(*2*) of this section, an investment in employer securities in a fund is not considered to be independent of the employer (or employers) and any affiliate thereof if the aggregate value of the employer securities held in the fund is in excess of 10 percent of the total value of all of the fund's investments for the plan year. The determination of whether the value of employer securities exceeds 10 percent of the total value of the fund's investments for the plan year is made as of the end of the preceding plan year. The determination can be based on the information in the latest disclosure of the fund's portfolio holdings that was filed with the Securities and Exchange Commission (SEC) in that preceding plan year.

(4) *Parent corporation*. Parent corporation has the meaning given such term by section 424(e).

(5) *Publicly traded*—(i) *In general*. A security is publicly traded if it is readily tradable on an established securities market.

(ii) *Readily tradable on an established securities market*. For purposes of this paragraph (f)(5), except as provided by the Commissioner in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin, a security is readily tradable on an established securities market if—

(A) The security is traded on a national securities exchange that is registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f); or

(B) The security is traded on a foreign national securities exchange that is officially recognized, sanctioned, or supervised by a governmental authority and the security is deemed by the SEC as having a "ready market" under SEC Rule 15c3–1 (17 CFR 240.15c3–1).

(g) *Applicability date and transition rules*—(1) *Statutory effective date*—(i) *General rule*. Except as otherwise provided in this paragraph (g) and section 901(c)(3)(A) and (B) of the Pension Protection Act of 2006, Public Law 109–280 (120 Stat. 780 (2006)) (PPA '06), section 401(a)(35) is effective for plan years beginning after December 31, 2006.

(ii) *Collectively bargained plans*—(A) *Delayed statutory effective date*. In the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified on or before August 17, 2006, section 401(a)(35) is effective for plan years beginning after the earlier of—

(*1*) The later of—

(*i*) December 31, 2007; or

(*ii*) The date on which the last such collective bargaining agreement terminates (determined without regard to any extension thereof); or

(*2*) December 31, 2008.

(B) *Treatment of plans with both collectively bargained and non-collectively bargained employees*. If a collective bargaining agreement applies to some, but not all, of the plan participants, the definition of whether the plan is considered a collectively bargained plan for purposes of this paragraph (g)(1)(ii) is made in the same manner as the definition of whether a plan is collectively bargained under section 436(f)(3).

(2) *Regulatory effective/applicability date*. This section is effective and applicable for plan years beginning on or after January 1, 2011.

(3) *Statutory transition rules*—(i) *General rule*. Pursuant to section 401(a)(35)(H), in the case of the portion of an account to which paragraph (c) of this section applies and that consists of employer securities acquired in a plan year beginning before January 1, 2007, the requirements of paragraph (c) of this section only apply to the applicable percentage of such securities.

(ii) *Applicable percentage*—(A) *Phase-in percentage*. For purposes of this paragraph (g)(3), the applicable percentage is determined as follows—

| Plan year to which paragraph (c) of this section applies: | The applicable percentage is: |
|---|---|
| 1st | 33 |
| 2nd | 66 |
| 3rd and following | 100 |

(B) *Special rule*. For a plan for which the special effective date under section 901(c)(3) of PPA '06 applies, the applicable percentage under this paragraph (g)(3)(ii) is determined without regard to the delayed effective date in section 901(c)(3)(A) and (B) of PPA '06.

(iii) *Nonapplication for participants age 55 with three years of service*. Paragraph (g)(3)(i) of this section does not apply to an individual who is a participant who attained age 55 and had completed at least three years of service (as defined in paragraph (c)(3) of this section) before the first day of the first plan year beginning after December 31, 2005.

(iv) *Separate application by class of securities*. This paragraph (g)(3) applies separately with respect to each class of securities.

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

Approved May 5, 2010.

Michael F. Mundaca,
*Assistant Secretary of the Treasury (Tax Policy).*

(Filed by the Office of the Federal Register on May 18, 2010, 8:45 a.m., and published in the issue of the Federal Register for May 19, 2010, 75 F.R. 27927)

# Part III. Administrative, Procedural, and Miscellaneous

## Request for Comments Regarding Additional Requirements for Tax-Exempt Hospitals

## Notice 2010–39

Section 1. PURPOSE AND BACKGROUND

This notice solicits comments regarding the application of certain requirements imposed by new section 501(r), added to the Internal Revenue Code (Code) by section 9007(a) of the Patient Protection and Affordable Care Act (Affordable Care Act), enacted March 23, 2010, Pub. L. No. 111-148.[1] Section 501(r) affects hospital organizations that are currently described in section 501(c)(3) of the Code as exempt from Federal income taxation.

New section 501(r)(1) imposes four additional requirements, described in Sections 2, 3, 4, and 5 of this notice, that organizations described in section 501(r)(2) ("hospital organizations") must satisfy to be described in section 501(c)(3). The Affordable Care Act did not otherwise affect the substantive standards for tax exemption that hospitals are required to meet under section 501(c)(3).

Section 501(r)(2) provides that the additional requirements of section 501(r) apply to: (1) an organization that operates a facility required by a State to be licensed, registered, or similarly recognized as a hospital; and (2) any other organization that the Secretary determines has the provision of hospital care as its principal function or purpose constituting the basis for its exemption under section 501(c)(3). Section 501(r) applies to hospital organizations on a facility-by-facility basis. Accordingly, if a hospital organization operates more than one hospital facility, the organization is required to meet the additional requirements of section 501(r) separately with respect to each facility.

The Affordable Care Act also added new section 4959, which imposes an excise tax for failures to meet certain of the new section 501(r) requirements, and added reporting requirements under section 6033(b) related to sections 501(r) and 4959.

Section 2. COMMUNITY HEALTH NEEDS ASSESSMENT

Section 501(r)(3) requires a hospital organization to conduct a community health needs assessment (CHNA) every three years and adopt an implementation strategy to meet the community health needs identified through such assessment. The CHNA must (1) take into account input from persons who represent the broad interests of the community served by the hospital facility, including those with special knowledge of or expertise in public health and (2) be made widely available to the public. Section 501(r)(3)(B).

The Joint Committee on Taxation's Technical Explanation of the Affordable Care Act (Technical Explanation) states that the CHNA "may be based on current information collected by a public health agency or non-profit organizations and may be conducted together with one or more organizations, including related organizations." Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as amended, in combination with the "Patient Protection and Affordable Care Act"* (JCX–18–10), at 81, March 21, 2010.

Section 6033(b)(15)(A) requires hospital organizations to include in their annual information return (*i.e.*, Form 990) a description of how the organization is addressing the needs identified in each CHNA conducted under section 501(r)(3) and a description of any needs that are not being addressed, along with the reasons why the needs are not being addressed.

Section 4959 imposes a $50,000 excise tax on a hospital organization that fails to meet the CHNA requirements of section 501(r)(3). Section 6033(b)(10), as amended, requires hospital organizations to report the amount of the excise tax imposed on the organization under section 4959.

Section 3. FINANCIAL ASSISTANCE POLICY

Section 501(r)(4) requires a hospital organization to establish a financial assistance policy and a policy relating to emergency medical care.

Specifically, section 501(r)(4)(A) requires a hospital organization to have a written financial assistance policy that includes the following:

i. eligibility criteria for financial assistance, and whether such assistance includes free or discounted care;
ii. the basis for calculating amounts charged to patients;
iii. the method for applying for financial assistance;
iv. in the case of an organization which does not have a separate billing and collections policy, the actions the organization may take in the event of nonpayment, including collections action and reporting to credit agencies; and
v. measures to widely publicize the policy within the community to be served by the organization.

Section 501(r)(4)(B) requires a hospital organization to have a written policy requiring the organization to provide, without discrimination, care for emergency medical conditions (within the meaning of section 1867 of the Social Security Act (42 U.S.C. 1395dd)) to individuals regardless of their eligibility under the financial assistance policy described in section 501(r)(4)(A). The Technical Explanation states that "[t]he policy must prevent discrimination in the provision of emergency medical treatment, including denial of service, against those eligible for financial assistance under the facility's financial assistance policy or those eligible for government assistance." Technical Explanation at 82.

Section 4. LIMITATION ON CHARGES

Section 501(r)(5) requires a hospital organization to limit amounts charged for emergency or other medically necessary

[1] A related bill, the Health Care Education Affordability Reconciliation Act of 2010 (H.R. 4872) (the "Reconciliation Act"), was signed into law on March 30, 2010 (Pub. L. No. 111–152). The Reconciliation Act amends the Affordable Care Act and related laws.

care that is provided to individuals eligible for assistance under the organization's financial assistance policy to not more than the amounts generally billed to individuals who have insurance covering such care. Section 501(r)(5) also prohibits the use of gross charges.

The Technical Explanation states that "[i]t is intended that amounts billed to those who qualify for financial assistance may be based on either the best, or an average of the three best, negotiated commercial rates, or Medicare rates." Technical Explanation at 82.

Section 5. BILLING AND COLLECTION

Section 501(r)(6) requires a hospital organization to forego extraordinary collection actions against an individual before the organization has made reasonable efforts to determine whether the individual is eligible for assistance under the hospital organization's financial assistance policy.

The Technical Explanation states that "extraordinary collections include lawsuits, liens on residences, arrests, body attachments, or other similar collection processes." Technical Explanation at 82. The Technical Explanation also states that "[i]t is intended that for this purpose, 'reasonable efforts' includes notification by the hospital of its financial assistance policy upon admission and in written and oral communications with the patient regarding the patient's bill, including invoices and telephone calls, before collection action or reporting to credit agencies is initiated." Technical Explanation at 82.

Section 6. EFFECTIVE DATES

Section 501(r) (except for section 501(r)(3)), section 6033(b)(10), and section 6033(b)(15) apply to taxable years beginning after March 23, 2010, the date of enactment of the Affordable Care Act. The CHNA requirements of section 501(r)(3) are effective for taxable years beginning after March 23, 2012. The section 4959 excise tax for failure to satisfy section 501(r)(3) is effective for failures occurring after the date of enactment.

Section 7. REQUEST FOR COMMENTS

The IRS and the Department of Treasury request comments regarding the requirements for hospital organizations described in this notice, including in particular the need, if any, for guidance regarding such requirements. Comments are specifically requested regarding appropriate requirements for a CHNA, and what constitutes "reasonable efforts" to determine eligibility for assistance under a financial assistance policy for purposes of the billing and collection requirements under section 501(r)(6). In addition, comments are requested regarding section 501(r)(2)(B)(ii), which provides that an organization that operates more than one hospital facility "shall not be treated as described in [section 501(c)(3)] with respect to any such facility for which such requirements are not separately met," including the tax consequences of a failure with respect to some, but not all, facilities and the proper tax treatment in future periods in such a case.

Comments should refer to Notice 2010–39 and be submitted by July 22, 2010, to:

Internal Revenue Service
CC:PA:LPD:PR (Notice 2010–39)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to:

Courier's Desk
Internal Revenue Service
1111 Constitution Ave., N.W.
Washington, DC 20224
Attn: CC:PA:LPD:PR
(Notice 2010–39)

Alternatively, taxpayers may submit comments electronically to *notice.comments@irscounsel.treas.gov*. Please include "Notice 2010–39" in the subject line of any electronic communications.

All comments will be available for public inspection and copying.

Section 8. DRAFTING INFORMATION

The principal author of this notice is Garrett Gluth of the Exempt Organizations, Tax Exempt and Government Entities Division. For further information regarding this notice, contact Mr. Gluth at (202) 283–9485 (not a toll-free call).

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# Prevention of Over-Withholding and U.S. Tax Avoidance With Respect to Certain Substitute Dividend Payments

# Notice 2010–46

I. SUMMARY AND MODIFICATION AND WITHDRAWAL OF NOTICE 97–66

*A. Background*

On October 14, 1997, final regulations were published in the Federal Register (T.D. 8735, 1997–2 C.B. 72, 62 FR 53498 (1997)) (the "final regulations") that source substitute interest and substitute dividend payments made pursuant to a securities lending transaction described in § 1058 of the Internal Revenue Code ("Code") or a substantially similar transaction or a sale-repurchase transaction (a "Securities Lending Transaction") by reference to the income that would be earned with respect to the underlying transferred debt security or stock. The final regulations also provide that substitute interest and dividend payments that are from sources within the United States under the regulations are characterized as interest and dividends for purposes of determining the fixed or determinable annual or periodical income of nonresident alien individuals and foreign corporations subject to tax under §§ 871(a), 881, 4948(a) and Chapter 3 of the Code and for purposes of granting tax treaty benefits with respect to interest and dividends. As promulgated, the final regulations were made applicable in all respects for substitute interest payments (as defined in § 1.861–2(a)(7)) and substitute dividend payments (as defined in § 1.861–3(a)(6)) made after November 13, 1997.

Some taxpayers expressed concern that the total U.S. gross-basis tax paid with respect to a series of Securities Lending Transactions (that is, a chain of related Securities Lending Transactions with respect to identical securities) could be excessive under the final regulations. For example, a series of Securities Lending Transactions could give rise to multiple substitute payments, each of which would be treated as equivalent to a dividend under the final regulations. If a dividend distribution on the transferred security were U.S.-source income, each substitute dividend payment in the series would be treated as U.S.-source income and potentially subject to gross-basis taxation under §§ 871 and 881 and withholding of tax under §§ 1441 and 1442. Thus, a series of Securities Lending Transactions could result in "cascading" taxation that might, in the aggregate, exceed 30 percent of the amount of the dividend distribution on the underlying transferred security.

To allow relief for taxpayers unable to structure transactions to avoid excessive or cascading taxation, the Treasury Department and the Service issued Notice 97–66, 1997–2 C.B. 328 (1997), on November 12, 1997. Notice 97–66 provides guidance that generally limits the aggregate U.S. gross-basis tax on a series of Securities Lending Transactions to no more than 30 percent of the amount equivalent to the dividend distribution on the underlying transferred security. To implement this limitation, Notice 97–66 provides a formulary method to calculate the amount of U.S. tax to be imposed on a foreign-to-foreign substitute dividend payment. Under this method,

> the amount of U.S. withholding tax to be imposed under §§ 1.871–7(b)(2) and 1.881–2(b)(2) with respect to a foreign-to-foreign payment will be the amount of the underlying dividend multiplied by a rate equal to the excess of the rate of U.S. withholding tax that would be applicable to U.S. source dividends paid by a U.S. person directly to the recipient of the substitute payment over the rate of U.S. withholding tax that would be applicable to U.S. source dividends paid by a U.S. person directly to the payor of the substitute payment.

The following example demonstrates the operation of this rule. If a borrower that is eligible under an income tax treaty for a reduced rate of tax equal to 15 percent on U.S.-source dividends makes a substitute dividend payment to a lender that is resident in a non-treaty jurisdiction subject to a tax of 30 percent on U.S.-source dividends, the amount of tax imposed on the substitute dividend payment under §§ 1.871–7(b)(2) and 1.881–2(b)(2) generally would be limited to 15 percent (*i.e.*, the payee's tax rate of 30 percent less the payor's rate of 15 percent). Notice 97–66 also provides in an example that if the securities lender's tax liability has already been reflected in prior withholding within a series of Securities Lending Transactions, the borrower, as a withholding agent, is permitted to reduce the lender's liability by such amount.

It has been widely reported that some taxpayers have relied on Notice 97–66 to avoid U.S. gross-basis taxation of foreign lenders of U.S. dividend-paying stocks in transactions undertaken primarily to enhance the after-tax yield of U.S. dividend-paying stocks held by foreign persons.[1]

On March 18, 2010, the Hiring Incentives to Restore Employment Act, Pub. L. No. 111–147, 124 Stat. 71 (2010) ("HIRE Act") was enacted. Section 541 of the HIRE Act added new § 871(l) to the Code, which provides that certain dividend equivalent payments are treated as U.S.-source dividends, effective for payments made on or after the date that is 180 days after the date of enactment. The term "dividend equivalent" is defined for this purpose to include "any substitute dividend made pursuant to a securities lending or sale-repurchase transaction that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States." § 871(l)(2)(A). Section 871(l)(6) authorizes the Secretary to reduce tax with respect to a chain of dividend equivalents "but only to the extent that the taxpayer can establish that such tax has been paid with respect to another dividend equivalent in such chain, or is not otherwise due, or as the Secretary determines is appropriate to address the role of financial intermediaries in such chain."

*B. Modification and Withdrawal of Notice 97–66*

Notice 97–66 is withdrawn effective for payments made on or after September 14, 2010 (the effective date of § 871(l)). Prior to September 14, 2010, taxpayers may continue to rely on Notice 97–66, except that Notice 97–66 is modified as follows: a withholding agent or foreign lender may not rely on Notice 97–66 when the withholding agent or foreign lender knows or has reason to know that a Securities Lending Transaction, or series of such transactions, has a principal purpose of reducing or eliminating the amount of gross-basis tax that would have been due in the absence of such transaction or transactions. For example, a person may not rely on Notice 97–66 to reduce or eliminate the amount of U.S. tax on the substitute dividend it is obligated to pay the foreign lender when it structures or participates in an arrangement whereby it: (1) borrows shares of a domestic corporation from a foreign person in a transaction described in § 1058 after a dividend declaration; (2) sells that stock to a related U.S. person before the ex-dividend date; and (3) enters into a total return swap agreement with that related person in order to hedge its risk. No inference is intended as to whether any transaction entered into prior to May 20, 2010, is eligible for the relief described in Notice 97–66, and the Service may challenge transactions under existing law, including by applying existing judicial doctrines, as appropriate.

## II. PROPOSED WITHHOLDING AND REPORTING FRAMEWORK

The Treasury Department and the Service intend to issue regulations exercising the authority described in § 871(l)(6). These regulations will coordinate the tax imposed on substitute payments under § 871(l) and §§ 1.871–7(b)(2) and 1.881–2(b)(2) with the withholding and reporting requirements under §§ 1441, 1442 and 1461 and the regulations thereunder to ensure that the appropriate amount of tax is paid and reported. Generally, the regulations, as described below, are expected to replace the formulary approach previously adopted by Notice 97–66 with a documentation-based system under which withholding agents will be able to reduce withholding to the extent that withholding is shown to have been made on another substitute payment or dividend with respect to identical securities. Additionally,

[1] *See* STAFF OF S. PERMANENT SUBCOMM. ON INVESTIGATIONS, 110TH CONG., REPORT ON DIVIDEND TAX ABUSE: HOW OFFSHORE ENTITIES DODGE TAXES ON U.S. STOCK DIVIDENDS (COMM. PRINT 2008).

to reduce instances of potential excessive or cascading taxation and to properly account for the role of financial intermediaries in Securities Lending Transactions, this proposed system is expected to exempt certain financial institutions from being subject to withholding at source on receipt of substitute dividend payments provided that they assume responsibility and liability for properly withholding, reporting, depositing, and paying U.S. tax with respect to substitute dividend payments. This system will also permit the Service to administer compliance by market participants more effectively by disqualifying noncompliant taxpayers from eligibility for the relief provided in this notice in appropriate cases.

*A. Substitute Dividend Payments to a "Qualified Securities Lender"*

*Treatment of Withholding Agent.* The regulations are expected to provide that a withholding agent making a substitute dividend payment to a financial institution that meets the regulatory definition of a Qualified Securities Lender will not be required to withhold U.S. tax with respect to such payment. Part 2.A.ii describes the certifications required to be made by a Qualified Securities Lender to a withholding agent in order to relieve a withholding agent of its obligation to withhold on a substitute dividend.

*Treatment of Qualified Securities Lender.* The regulations will coordinate the obligation of a Qualified Securities Lender to withhold on substitute dividend payments that it makes, pay and deposit tax on substitute dividends it receives, and report on substitute dividends it makes (on behalf of itself or any other person). The regulations are expected to define these obligations in terms of two distinct categories of substitute dividends that Qualified Securities Lenders pay or receive.

In circumstances where a Qualified Securities Lender receives a substitute dividend payment (the "first substitute dividend payment") and is obligated to make an offsetting substitute dividend payment with respect to identical securities (the "second substitute dividend payment"), the regulations are expected to provide that a Qualified Securities Lender: (A) will not be liable for U.S. gross-basis tax on the first substitute dividend payment under § 871(a) or 881(a); and (B) must properly withhold under §§ 1441 and 1442 and report with respect to the second substitute dividend payment.

In circumstances where a Qualified Securities Lender receives a substitute dividend payment for which it has no obligation to make an offsetting substitute dividend payment with respect to identical securities, the Qualified Securities Lender remains liable for tax under § 871(a) or 881(a) by virtue of the receipt of such substitute dividend payment.

The Service intends to monitor Qualified Securities Lenders for compliance with all applicable rules described in this notice and may revoke an institution's status as a Qualified Securities Lender for noncompliance. Such noncompliance may include, for example, circumstances in which an institution structures or participates in arrangements designed to facilitate the avoidance of U.S. gross-basis taxation by foreign persons that hold or held U.S. equities, as well as circumstances in which an institution does not withhold and deposit tax at the proper rate when it acts as a custodian on behalf of both a borrower and lender in the same Securities Lending Transaction.

*i. Definition of Qualified Securities Lender*

For purposes of the relief described above, the regulations are expected to provide that a foreign financial institution is a Qualified Securities Lender only if it satisfies all of the following conditions:

- it is a bank, custodian, broker-dealer, or clearing organization that is subject to regulatory supervision by a governmental authority in the jurisdiction in which it was created or organized, and is regularly engaged in a trade or business that includes the borrowing of securities of domestic corporations (as defined in § 7701(a)(4)) from, and lending of securities of domestic corporations to, its unrelated customers;
- it is subject to audit by the Service under § 7602 or, in the case of a Qualified Intermediary (QI) that appropriately amends its QI agreement with the Service, by an external auditor. Further guidance will specify the requirements of such an amendment to the QI agreement. In general, however, the amendment will require the QI to report, withhold, deposit, and pay U.S. tax as described in Parts II.A and D of this notice; and
- it files an annual statement on a form prescribed by the Service certifying that it satisfies the conditions necessary to be a Qualified Securities Lender.

ii. *Certifications by a Qualified Securities Lender*

As noted above, the regulations are expected to relieve a withholding agent of its liability to withhold U.S. tax with respect to any substitute dividend paid to a Qualified Securities Lender only if the withholding agent receives a written certification from the Qualified Securities Lender, either on a form prescribed by the Service or as otherwise provided by regulation. This certification must include a statement that the recipient of a substitute dividend is a Qualified Securities Lender and that, with respect to any substitute dividend it receives from the withholding agent, it will withhold and remit or pay the proper amount of U.S. gross-basis tax with respect to substitute dividend payments that it receives or makes.

*B. Credit Forward of Prior Withholding*

The Treasury Department and the Service believe that the vast majority of instances of excessive or cascading taxation will be relieved through the Qualified Securities Lender rules described above. To address remaining instances of excessive or cascading taxation not addressed by the Qualified Securities Lender rules, the regulations are expected to provide a credit forward system, as described below.

i. *Availability of credit for prior withholding*

The regulations are expected to provide that withholding agents may limit the aggregate U.S. gross-basis tax within a series of Securities Lending Transactions to the amount of U.S. gross-basis tax, if any, applicable to the foreign taxpayer (other than in the case of a Qualified Securities Lender that is obligated to make an offsetting substitute dividend payment) bearing the highest rate of U.S. gross-basis tax on either a substitute or actual dividend with respect to the underlying security transferred in the series. As a result, the aggregate taxes paid in such transactions should not exceed the 30 percent statutory rate applicable to U.S.-source dividends paid to foreign persons. The regulations are expected to provide that withholding agents may relieve excessive tax on substitute dividends by reducing withholding on a substitute dividend payment that the withholding agent is obligated to make by an amount not to exceed the amount that has been previously withheld within the same series of Securities Lending Transactions, but only to the extent that there is sufficient evidence that tax was actually withheld on a prior dividend and/or substitute dividend paid to the withholding agent or a prior withholding agent within the same such series. No payee in a series of Securities Lending Transactions may claim a refund (or claim a credit against any other liability) solely because a prior payee in the same series was subjected to a higher rate of gross-basis U.S. tax. Moreover, no taxpayer or withholding agent in a series of Securities Lending Transactions may credit any tax withheld with respect to a substitute dividend payment in such series against any tax imposed with respect to a substitute dividend payment in a different series of Securities Lending Transactions.

*ii. Substantiation of Prior Withholding*

The regulations are expected to provide that sufficient evidence of prior withholding will be deemed to exist where there is written documentation that identifies amounts previously withheld by another withholding agent with respect to actual dividend distributions or substitute dividends in the same series of Securities Lending Transactions or as otherwise prescribed by the Service in future guidance. For example, the regulations are expected to provide that a withholding agent may presume that tax has been withheld by a prior withholding agent in a series of Securities Lending Transactions if that agent: (1) receives a substitute dividend net of U.S. withholding taxes; (2) receives a written statement from the immediately prior withholding agent setting out the amount of such taxes; (3) identifies the person who withheld such tax and the recipient of the payment against which such tax was withheld; and (4) does not know or have reason to know that the written statement is unreliable. For these determinations, a withholding agent may not rely upon evidence of a sale of the underlying security as a basis to determine that tax has been paid or withheld.

*C. Anti-Abuse*

Finally, the regulations are expected to provide that a withholding agent or a Qualified Securities Lender may not rely on any of the foregoing rules (including any certifications provided by a Qualified Securities Lender) when the withholding agent or Qualified Securities Lender knows or has reason to know that a Securities Lending Transaction, or series of such transactions, has a principal purpose of reducing or eliminating the amount of U.S. gross-basis tax that would have been due in the absence of such transaction or transactions. In such a case, a withholding agent or Qualified Securities Lender must withhold, and the recipient of such payment is subject to U.S. gross-basis tax, at 30 percent (subject to reduction under an applicable income tax treaty) on each substitute dividend payment with respect to such transaction.

*D. Other Considerations—Information Reporting of Substitute Payments*

In cases in which a withholding agent (including a Qualified Securities Lender) makes a substitute dividend payment and, in reliance on the regulations, (1) reduces the withholding or (2) is exempted from withholding, the withholding agent should include on Form 1042 and Form 1042–S: (a) the gross amount of the substitute dividend to which the recipient would have otherwise been entitled before consideration of any withholding tax obligations; and (b) the amount of tax withheld by the withholding agent and shown to have been withheld by other withholding agents in the series of Securities Lending Transactions based on the documentation and information as described above. In addition, a withholding agent (including a Qualified Securities Lender) that makes a substitute dividend payment to a United States person as defined in § 7701(a)(30) will be required to report and withhold to the extent required under Chapter 61 and § 3406.

## III. TRANSITION RULE

### A. *Summary and General Transition Rule*

The Treasury Department and the Service anticipate that the regulatory framework outlined in Part II of this notice will be effective for transactions entered into on or after January 1, 2012. Until such regulations are issued, and after September 14, 2010 (the "transition period"), § 871(l) will apply with the potential for U.S. tax due on a series of Securities Lending Transactions that exceeds 30 percent in the aggregate. In order to avoid excessive or cascading tax in these situations, withholding agents may rely on the transition rules described in this Part.

Generally, the transition rules described in this Part III provide that the maximum aggregate U.S. gross-basis tax due, if any, with respect to a series of Securities Lending Transactions and any related dividend payment is the amount determined by the tax rate paid by the foreign taxpayer (other than in the case of a Qualified Securities Lender that is obligated to make an offsetting substitute dividend payment) bearing the highest rate of U.S. gross-basis tax in the series. Accordingly, the aggregate U.S. gross-basis taxes paid in such transactions generally should not exceed the 30 percent statutory rate applicable to U.S.-source dividends paid to foreign persons.

### B. *Receipt of Net Payments*

A withholding agent that is obligated to make a substitute dividend payment pursuant to a Securities Lending Transaction may presume that U.S. tax has been paid in an amount equal to the amount implied by the net payment if all of the following are satisfied:

- The withholding agent receives a substitute dividend or dividend payment with respect to identical securities that reflects a reduction for withholding of U.S. gross-basis tax;
- The withholding agent does not know or have reason to know that tax was not withheld and deposited or paid. For this purpose, a withholding agent has a reason to know that tax was not withheld if, for example, the amount of any lending fee or similar fee is increased directly or indirectly, in whole

or in part, by the difference between the gross amount of the substitute dividend and the net amount received; and

- The withholding agent is a person subject to audit under § 7602, or in the case of a QI, by an external auditor.

No payee in a series of Securities Lending Transactions may claim a refund (or claim a credit against any other liability) solely because a prior payee in the same series was subjected to a higher rate of gross-basis U.S. tax. Moreover, no taxpayer or withholding agent in a series of Securities Lending Transactions may credit any tax withheld with respect to a substitute dividend payment in such series against any tax imposed with respect to a substitute dividend payment in a different series of Securities Lending Transactions.

C. *Application of Qualified Securities Lender Rules*

During the transition period, withholding agents may adopt a system that reasonably implements the principles of the Qualified Securities Lender system described in Part II of this notice. In particular, during the transition period, a withholding agent is not required to withhold on a substitute dividend payment made to a Qualified Securities Lender if the withholding agent receives, at least annually, a statement from its counterparty that substantially complies with the certification requirement described in Part II.A.ii of this notice. A financial institution may make such a certification only if it reasonably determines that it meets the requirements to qualify as a Qualified Securities Lender described in Part II.A.i of this notice (without regard to the requirement that a Qualified Securities Lender file an annual statement with the Service). It is anticipated that future guidance will provide that all Qualified Securities Lenders taking advantage of the transition relief described in this Part may be required to identify themselves to the Service (in a manner to be specified) before the end of calendar year 2010. A QI that provides such a certification will be deemed to have agreed to amend its QI agreement for these purposes as necessary to report, withhold, deposit, and pay U.S. tax as described in Part II.A of this notice.

D. *Anti-Abuse*

Withholding agents may not rely on the transition relief described in Part III of this notice with respect to a Securities Lending Transaction or series of such transactions that are entered into with a principal purpose of reducing or eliminating the aggregate amount of U.S. tax that would have been due in the absence of such transaction or series of transactions. A financial institution that is determined to have structured or engaged in one or more transactions described in the preceding sentence on or after May 20, 2010, will not qualify as a Qualified Securities Lender for a period of 5 years from the date of such determination.

E. *Other Considerations*

A Qualified Securities Lender may use any reasonable method, consistently applied, to determine which securities within a pool of fungible securities available to borrow have actually been borrowed and lent.

Withholding agents will be required to perform information reporting as specified in Part II.D above.

F. *Extensions*

The Treasury Department and the Service believe that administrative relief is appropriate to ensure that withholding agents have sufficient time to make the operational changes necessary to comply with § 541 of the HIRE Act and the provisions of this notice. Therefore, to the extent that § 871(l) applies to any substitute dividend payments in respect of any transaction described in § 871(l)(2)(A), withholding agents are hereby granted an automatic six-month extension of time to file information returns pursuant to § 1.1461–1(c) with respect to the calendar year 2010. However, the time for filing information returns pursuant to § 1.1461–1(c) shall not be extended beyond the date on which the withholding agent provides a copy of the return to the recipient. In addition, withholding agents are hereby granted an automatic extension for making deposits of withheld tax from such substitute dividend payments until January 31, 2011, for the calendar year 2010. The Treasury Department and the Service believe that the administrative relief provided by this notice is in the best interests of sound tax administration.

IV. EFFECTIVE DATES

The modification of Notice 97–66 described in Part I is effective for amounts paid on or after May 20, 2010 and before September 14, 2010. The transition rules described in Part III are effective for amounts paid on or after September 14, 2010.

V. PAPERWORK REDUCTION ACT

The collections of information contained in this notice 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 1545–1566.

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 collection of information contained in this notice is in Part III. The information is required to prevent excessive taxation under §871(l) during the transition period. The information will be used for the same purpose described in the preceding sentence. The collections of information are required to obtain a benefit. The likely respondents are businesses or other for-profit institutions.

The estimated total annual reporting and/or recordkeeping burden is 1,000 hours.

The estimated annual burden per respondent/recordkeeper varies from 1 minute to 15 minutes, depending on individual circumstances, with an estimated average of 10 minutes. The estimated number of respondents and/or recordkeepers is 6,000.

The estimated frequency of responses (used for reporting requirements only) is once.

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.

## VI. EFFECT ON OTHER DOCUMENTS

Notice 97–66 is modified as provided in Part I.

## VII. REQUEST FOR COMMENTS

The Treasury Department and the Service invite comments on the guidance described in this notice. In particular, comments are requested on the following issues.

1. The definition of a Qualified Securities Lender.
2. The treatment of substitute dividends paid to a Qualified Securities Lender where that entity holds the relevant position in a proprietary account.
3. Whether additional rules are required to address abusive Securities Lending Transactions that avoid U.S. tax in addition to the anti-abuse regulation described above.
4. The treatment of substitute dividends paid with respect to securities transferred from a commingled account containing securities held by a Qualified Securities Lender in its proprietary capacity and other securities held in connection with transactions for customers.
5. Whether a Qualified Intermediary with Qualified Securities Lender status (a "Lender QI") should be required to provide the withholding rate pool information of its customers to another Qualified Intermediary (a "Borrower QI") that has borrowed securities in a Securities Lending Transaction. Whether a Borrower QI should be required to withhold and carry out information reporting on a substitute dividend payment made to a Lender QI based upon the withholding information provided by a Lender QI with respect to its customers.
6. The definition of a series of Securities Lending Transactions, and how related securities loans in a series should be identified, including appropriate methods pursuant to which a Qualified Securities Lender may determine which securities within a pool of fungible securities are attributable to particular Securities Lending Transactions.

The principal authors of this notice are Peter Merkel and John Sweeney of the Office of Associate Chief Counsel (International). For further information regarding this notice, contact Peter Merkel or John Sweeney at (202) 622–3870 (not a toll-free call).

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*26 CFR 601.601: Rules and regulations.*
*(Also Part I, §§ 25, 103, 143; 1.25–4T, 1.103–1, 6a.103A–2.)*

# Rev. Proc. 2010–23

## SECTION 1. PURPOSE

This revenue procedure provides guidance with respect to the United States and area median gross income figures that are to be used by issuers of qualified mortgage bonds, as defined in § 143(a) of the Internal Revenue Code, and issuers of mortgage credit certificates, as defined in § 25(c), in computing the housing cost/income ratio described in § 143(f)(5).

## SECTION 2. BACKGROUND

.01 Section 103(a) provides that, except as provided in § 103(b), gross income does not include interest on any state or local bond. Section 103(b)(1) provides that § 103(a) shall not apply to any private activity bond that is not a qualified bond (within the meaning of § 141). Section 141(e) provides that the term "qualified bond" includes any private activity bond that (1) is a qualified mortgage bond, (2) meets the applicable volume cap requirements under § 146, and (3) meets the applicable requirements under § 147.

.02 Section 143(a)(1) provides that the term "qualified mortgage bond" means a bond that is issued as part of a "qualified mortgage issue". Section 143(a)(2)(A) provides that the term "qualified mortgage issue" means an issue of one or more bonds by a state or political subdivision thereof, but only if (i) all proceeds of the issue (exclusive of issuance costs and a reasonably required reserve) are to be used to finance owner-occupied residences; (ii) the issue meets the requirements of subsections (c), (d), (e), (f), (g), (h), (i), and (m)(7) of § 143; (iii) the issue does not meet the private business tests of paragraphs (1) and (2) of § 141(b); and (iv) with respect to amounts received more than 10 years after the date of issuance, repayments of $250,000 or more of principal on financing provided by the issue are used not later than the close of the first semi-annual period beginning after the date the prepayment (or complete repayment) is received to redeem bonds that are part of the issue.

.03 Section 143(f) imposes eligibility requirements concerning the maximum income of mortgagors for whom financing may be provided by qualified mortgage bonds. Section 25(c)(2)(A)(iii)(IV) provides that recipients of mortgage credit certificates must meet the income requirements of § 143(f). Generally, under §§ 143(f)(1) and 25(c)(2)(A)(iii)(IV), these income requirements are met only if all owner-financing under a qualified mortgage bond and all certified indebtedness amounts under a mortgage credit certificate program are provided to mortgagors whose family income is 115 percent or less of the applicable median family income. Under § 143(f)(6), the income limitation is reduced to 100 percent of the applicable median family income if there are fewer than three individuals in the family of the mortgagor.

.04 Section 143(f)(4) provides that the term "applicable median family income" means the greater of (A) the area median gross income for the area in which the residence is located, or (B) the statewide median gross income for the state in which the residence is located.

.05 Section 143(f)(5) provides for an upward adjustment of the income limitations in certain high housing cost areas. Under § 143(f)(5)(C), a high housing cost area is a statistical area for which the housing cost/income ratio is greater than 1.2. The housing cost/income ratio is determined under § 143(f)(5)(D) by dividing (a) the applicable housing price ratio by (b) the ratio that the area median gross income bears to the median gross income for the United States. The applicable housing price ratio is the new housing price ratio (new housing average purchase price for the area divided by the new housing average purchase price for the United States) or the existing housing price ratio (existing housing average area purchase price divided by the existing housing average purchase price for the United States), whichever results in the housing cost/income ratio being closer to 1. This income adjustment applies only to bonds issued, and nonissued bond amounts elected, after December 31, 1988. *See* § 4005(h) of the Technical and Miscellaneous Revenue Act of 1988, 1988–3 C.B. 1, 311 (1988).

.06 The Department of Housing and Urban Development (HUD) has computed the median gross income for the United States, the states, and statistical areas within the states. The income information was released to the HUD regional offices on May 14, 2010, and may be obtained by calling the HUD reference service at 1–800–245–2691. The income information is also available at HUD's World Wide Web site, *http:huduser.org/datasets/il.html*, which provides a menu from which you may select the year and type of data of interest. The Internal Revenue Service annually publishes the median gross income for the United States.

.07 The most recent nationwide average purchase prices and average area purchase price safe harbor limitations were published on March 16, 2009, in Rev. Proc. 2009–18, 2009–11 I.R.B. 686.

SECTION 3. APPLICATION

.01 When computing the income requirements of § 143(f), issuers of qualified mortgage bonds and mortgage credit certificates must use either (1) the median gross income for the United States, the states, and statistical areas within the states, as released to the HUD regional offices on March 19, 2009, or (2) the median gross income for the United States, the states, and statistical areas within the states, as released to the HUD regional offices on May 14, 2010.

.02 If an issuer uses the median gross income for the United States, the states, and statistical areas within the states, as released to the HUD regional offices on March 19, 2009, to compute the housing cost/income ratio under § 143(f)(5), the issuer must use the median gross income for the United States, the states, and statistical areas within the states, as released to the HUD regional offices on March 19, 2009, for all purposes under § 143(f). Likewise, if an issuer uses the median gross income for the United States, the states, and statistical areas within the states, as released to the HUD regional offices on May 14, 2010, to compute the housing cost/income ratio under § 143(f)(5), the issuer must use the median gross income for the United States, the states, and statistical areas within the states, as released to the HUD regional offices on May 14, 2010, for all purposes under § 143(f).

SECTION 4. EFFECT ON OTHER REVENUE PROCEDURES

.01 Rev. Proc. 2009–27, 2009–19 I.R.B. 938, is obsolete except as provided in §§ 3.01, 3.02, or 5.01 of this revenue procedure.

.02 This revenue procedure does not affect the effective date provisions of Rev. Rul. 86–124, 1986–2 C.B. 27. Those effective date provisions will remain operative at least until the Service publishes a new revenue ruling that conforms the approach to effective dates set forth in Rev. Rul. 86–124 to the general approach taken in this revenue procedure.

SECTION 5. EFFECTIVE DATES

.01 Issuers must use the United States and area median gross income figures specified in § 3.01 of this revenue procedure for commitments to provide financing that are made, or (if the purchase precedes the financing commitment) for residences that are purchased, in the period that begins on May 14, 2010, and ends on the date when these United States and area median gross income figures are rendered obsolete by a new revenue procedure.

DRAFTING INFORMATION

The principal authors of this revenue procedure are David White and Timothy Jones of the Office of Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue procedure, contact Mr. White or Mr. Jones at (202) 622–3980 (not a toll-free call).

# Definition of Terms

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

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

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

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

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

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

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

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

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

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

# Abbreviations

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

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

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