Bulletin No. 1997–9
March 3, 1997

HIGHLIGHTS OF THIS ISSUE

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

INCOME TAX

Rev. Rul. 97–9, page 4.
Medical and dental expenses. Amounts paid to obtain a controlled substance (such as marijuana), in violation of federal law, are not deductible expenses for medical care under section 213 of the Code.

T.D. 8709, page 5.
REG–242996–96, page 18.
Final, temporary, and proposed regulations under section 1275 of the Code relate to the federal income tax treatment of inflation-indexed debt instruments. A public hearing will be held on the proposed regulations on April 30, 1997.

REG–252233–96, page 19.
Proposed regulations under section 368 of the Code provide certain reorganizations, transfers by the acquiring corporation of target assets or stock to certain controlled corporations, and transfers of target assets to partnerships, will not disqualify the transaction from satisfying the continuity of interest and business enterprise requirements. A public hearing will be held on May 7, 1997.

EMPLOYEE PLANS

Notice 97–16, page 15.
Weighted average interest rate update. Guidelines are set forth for determining for February 1997, the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for purposes of the full funding limitation of section 412(c)(7) of the Code as amended by the Omnibus Budget Reconciliation Act of 1987 and by the Uruguay Round Agreements Act (GATT).

EXEMPT ORGANIZATIONS

Announcement 97–17, page 23.
A list is given of organizations now classified as private foundations.

EMPLOYMENT TAX

T.D. 8706, page 11.
Final regulations under section 3402 of the Code relate to Form W–4, Employee's Withholding Allowance Certificate.

Page 17.
Social security domestic employee coverage threshold. The Commissioner of the Social Security Administration has determined the domestic employee coverage threshold amount for 1997.

ADMINISTRATIVE

Rev. Proc. 97–17, page 15.
Mortgage revenue bonds; mortgage credit certificates; average annual mortgage originations. A list is set forth of the average annual aggregate principal amount of mortgages executed during the years 1992, 1993, and 1994 for each state, the District of Columbia, Guam, Puerto Rico, and the Virgin Islands to assist issuers of mortgage revenue bonds and mortgage credit certificates in determining whether the required portion of loans are made available in targeted areas as described in section 143(h) of the Code. Rev. Proc. 95–14 is obsolete, except as provided in section 5.02 of this procedure.

Announcement 97–15, page 23.
Rev. Proc. 97–10, 1997–2 I.R.B. 59, relating to the change in computing depreciation for retail motor fuels outlets, is corrected.

Announcement 97–16, page 23.
Notice 97–9, 1997–2 I.R.B. 35, regarding adoption assistance, is corrected.

Finding Lists begin on page 26.
Monthly Index for February on page 28.

Mission of the Service

The purpose of the Internal Revenue Service is to collect the proper amount of tax revenue at the least cost; serve the public by continually improving the quality of our products and services; and perform in a manner warranting the highest degree of public confidence in our integrity, efficiency and fairness.

Statement of Principles of Internal Revenue Tax Administration

The function of the Internal Revenue Service is to administer the Internal Revenue Code. Tax policy for raising revenue is determined by Congress.

With this in mind, it is the duty of the Service to carry out that policy by correctly applying the laws enacted by Congress; to determine the reasonable meaning of various Code provisions in light of the Congressional purpose in enacting them; and to perform this work in a fair and impartial manner, with neither a government nor a taxpayer point of view.

At the heart of administration is interpretation of the Code. It is the responsibility of each person in the Service, charged with the duty of interpreting the law, to try to find the true meaning of the statutory provision and not to adopt a strained construction in the belief that he or she is ''protecting the revenue.'' The revenue is properly protected only when we ascertain and apply the true meaning of the statute.

The Service also has the responsibility of applying and administering the law in a reasonable, practical manner. Issues should only be raised by examining officers when they have merit, never arbitrarily or for trading purposes. At the same time, the examining officer should never hesitate to raise a meritorious issue. It is also important that care be exercised not to raise an issue or to ask a court to adopt a position inconsistent with an established Service position.

Administration should be both reasonable and vigorous. It should be conducted with as little delay as possible and with great courtesy and considerateness. It should never try to overreach, and should be reasonable within the bounds of law and sound administration. It should, however, be vigorous in requiring compliance with law and it should be relentless in its attack on unreal tax devices and fraud.

Introduction

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

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

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

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

The Bulletin is divided into four parts as follows:

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

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

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

Part IV.—Items of General Interest.
With the exception of the Notice of Proposed Rulemaking and the disbarment and suspension list included in this part, none of these announcements are consolidated in the Cumulative Bulletins.

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

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

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

Section 25.—Interest on Certain Home Mortgages

26 CFR 1.25–4T: Qualified mortgage credit certificate program (temporary).

The average annual aggregate principal amount of mortgages executed during 1992, 1993, 1994 are set forth for use by issuers of mortgage credit certificates in determining if the required portion of loans under sections 25(c)(2)(A)(iii)(V) and 143(h) of the Code are made available in targeted areas. See Rev. Proc. 97–17, page 15.

Section 103.—State and Local Bonds

26 CFR 1.103–1: Interest upon obligations of a State, Territory, etc.

The average annual aggregate principal amount of mortgages executed during 1992, 1993, 1994 are set forth for use by issuers of qualified mortgage bonds in determining if the required portion of loans are made available in targeted areas under section 143(h) of the Code. See Rev. Proc. 97–17, page 15.

Section 143.—Mortgage Revenue Bonds: Qualified Mortgage Bond and Qualified Veterans' Mortgage Bond

26 CFR 6a.103A–2: Qualified mortgage bond.

The average annual aggregate principal amount of mortgages executed during 1992, 1993, 1994 are set forth for use by issuers of qualified mortgage bonds and mortgage credit certificates in determining if the required portion of loans are made available in targeted areas under section 143(h) of the Code. See Rev. Proc. 97–17, page 15.

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

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

Medical and dental expenses. Amounts paid to obtain a controlled substance (such as marijuana), in violation of federal law, are not deductible expenses for medical care under section 213 of the Code.

Rev. Rul. 97–9

ISSUE

Is an amount paid to obtain a controlled substance (such as marijuana) for medical purposes, in violation of federal law, a deductible expense for medical care under § 213 of the Internal Revenue Code?

FACTS

Based on the recommendation of a physician, *A* purchased marijuana and used it to treat *A*'s disease in a state whose laws permit such purchase and use.

LAW AND ANALYSIS

Section 213(a) allows a deduction for uncompensated expenses of an individual for medical care to the extent such expenses exceed 7.5 percent of adjusted gross income. Section 213(d)(1) provides, in part, that "medical care" means amounts paid for the cure, mitigation, and treatment of disease. However, under § 213(b) an amount paid for medicine or a drug is an expense for medical care under § 213(a) only if the medicine or drug is a prescribed drug or insulin. Section 213(d)(3) provides that a "prescribed drug" is a drug or biological that requires a prescription of a physician for its use by an individual.

Section 1.213–1(e)(2) of the Income Tax Regulations provides, in part, that the term "medicine and drugs" includes only items that are "legally procured." Section 1.213–1(e)(1)(ii) provides that amounts expended for illegal operations or treatments are not deductible.

Rev. Rul. 78–325, 1978–2 C.B. 124, holds that amounts paid by a taxpayer for laetrile, prescribed by a physician for the medical treatment of the taxpayer's illness, are expenses for medicine and drugs that are deductible under § 213. The revenue ruling states that the laetrile was purchased and used in a locality where its sale and use were legal.

Rev. Rul. 73–201, 1973–1 C.B. 140, holds that amounts paid for a vasectomy and an abortion are expenses for medical care that are deductible under § 213. The revenue ruling states that neither procedure was illegal under state law.

A's purchase and use of marijuana were permitted under the laws of *A*'s state. However, marijuana is listed as a controlled substance on Schedule I of the Controlled Substances Act (CSA), 21 U.S.C. §§ 801–971. 21 U.S.C. § 812(c). Except as authorized by the CSA, it is unlawful for any person to manufacture, distribute, or dispense, or possess with intent to manufacture, distribute, or dispense, a controlled substance. 21 U.S.C. § 841(a). Further, it is unlawful for any person knowingly or intentionally to possess a controlled substance except as authorized by the CSA. 21 U.S.C. 844(a). Generally, the CSA does not permit the possession of controlled substances listed on Schedule I, even for medical purposes, and even with a physician's prescription.

Notwithstanding state law, a controlled substance (such as marijuana), obtained in violation of the CSA, is not "legally procured" within the meaning of § 1.213–1(e)(2). Further, an amount expended to obtain a controlled substance (such as marijuana) in violation of the CSA is an amount expended for an illegal treatment within the meaning of § 1.213–1(e)(1)(ii). Accordingly, *A* may not deduct under § 213 the amount *A* paid to purchase marijuana.

HOLDING

An amount paid to obtain a controlled substance (such as marijuana) for medical purposes, in violation of federal law, is not a deductible expense for medical care under § 213. This holding applies even if the state law requires a prescription of a physician to obtain and use the controlled substance and the taxpayer obtains a prescription.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 78–325 is obsoleted. Subsequent to the issuance of Rev. Rul. 78–325, the courts have upheld the Food and Drug Administration determination that generally prohibits interstate commerce in laetrile under the Food, Drug, and Cosmetic Act, 21 U.S.C. §§ 331 and 355(a). *See United States v. Rutherford*, 442 U.S. 544 (1979); *Rutherford v. United States*, 806 F.2d 1455 (10th Cir. 1986). Thus, notwithstanding state and local law, laetrile cannot be legally procured within the meaning of § 1.213–1(e)(2). Accordingly, amounts paid to obtain laetrile are not deductible under § 213.

Rev. Rul. 73–201 is clarified to reflect that the medical procedures at issue in that revenue ruling are not illegal under federal law.

DRAFTING INFORMATION

The principal authors of this revenue ruling are Donna M. Crisalli and Sharon Hester of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Ms. Crisalli or Ms. Hester on (202) 622–4920 (not a toll-free call).

Section 1275.—Other Definitions and Special Rules

26 CFR 1.1275–7T: Inflation-indexed debt instruments (temporary).

T.D. 8709

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Inflation-Indexed Debt Instruments

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary and final regulations.

SUMMARY: This document contains temporary regulations relating to the federal income tax treatment of inflation-indexed debt instruments, including Treasury Inflation-Indexed Securities. The text of the temporary regulations also serves as the text of REG–242996–96, page 18. This document also contains amendments to final regulations to reflect the addition of the temporary regulations. The regulations in this document provide needed guidance to holders and issuers of inflation-indexed debt instruments.

EFFECTIVE DATE: The regulations are effective January 6, 1997.

FOR FURTHER INFORMATION CONTACT: Jeffrey W. Maddrey, (202) 622–3940, or William E. Blanchard, (202) 622–3950 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

The Department of the Treasury published final rules describing the terms and conditions of new debt instruments that it plans to issue. The payments on these debt instruments (Treasury Inflation-Indexed Securities) will be indexed for inflation and deflation.

On June 14, 1996, the IRS published final regulations in the **Federal Register** relating to certain debt instruments that provide for contingent payments (61 FR 30133). The preamble to the final regulations indicates that the noncontingent bond method described in § 1.1275–4(b) might be inappropriate for the Treasury Inflation-Indexed Securities. On October 15, 1996, the IRS published Notice 96–51 (1996–42 I.R.B. 6), which announced the IRS's intention to issue temporary and proposed regulations that would provide guidance on the federal income tax treatment of the Treasury Inflation-Indexed Securities and other debt instruments with similar terms. This document contains the temporary regulations described in Notice 96–51. Explanation of provisions

A. In general

The temporary regulations provide rules for the treatment of certain debt instruments that are indexed for inflation and deflation, including Treasury Inflation-Indexed Securities. The temporary regulations generally require holders and issuers of inflation-indexed debt instruments to account for interest and original issue discount (OID) using constant yield principles. In addition, the temporary regulations generally require holders and issuers of inflation-indexed debt instruments to account for inflation and deflation by making current adjustments to their OID accruals.

B. Applicability

The temporary regulations apply to inflation-indexed debt instruments. In general, an inflation-indexed debt instrument is a debt instrument that (1) is issued for cash, (2) is indexed for inflation and deflation (as described below), and (3) is not otherwise a contingent payment debt instrument. The temporary regulations do not apply, however, to certain debt instruments, such as debt instruments issued by qualified state tuition programs.

C. Indexing methodology

A debt instrument is considered indexed for inflation and deflation if the payments on the instrument are indexed by reference to the change in value of a general price or wage index over the term of the instrument. Specifically, the amount of each payment on an inflation-indexed debt instrument must equal the product of (1) the amount of the payment that would be payable on the instrument (determined as if there were no inflation or deflation over the term of the instrument) and (2) the ratio of the value of the reference index for the payment date to the value of the reference index for the issue date.

The reference index for a debt instrument is the mechanism for measuring inflation and deflation over the term of the instrument. This mechanism associates the value of a single qualified inflation index for a particular month with a specified day of a succeeding month. For example, under the terms of the Treasury Inflation-Indexed Securities, the reference index for the first day of a month is the value of a qualified inflation index for the third preceding month. The reference index must be reset once a month to the current value of a qualified inflation index. Between reset dates, the value of the reference index is determined through straight-line interpolation.

A qualified inflation index is a general price or wage index that is updated and published at least monthly by an agency of the United States Government. A general price or wage index is an index that measures price or wage changes in the economy as a whole. An index is not general if it only measures price or wage changes in a particular segment of the economy. For example, the non-seasonally adjusted U.S. City Average All Items Consumer Price Index for All Urban Consumers (CPI-U), which is published by the Bureau of Labor Statistics of the Department of Labor, is a qualified inflation index because it measures general price changes in the economy. By contrast, the gasoline price component of the CPI-U is not a qualified inflation index because it only measures price changes in a particular segment of the economy.

D. Coupon bond method

The temporary regulations provide a simplified method of accounting for qualified stated interest and inflation adjustments on certain inflation-indexed debt instruments (the coupon bond method). To qualify for the coupon bond method, an inflation-indexed debt instrument must satisfy two conditions. First, there must be no more than a de minimis difference between the debt instrument's issue price and its principal amount for the issue date. Second, all stated interest on the debt instrument must be qualified stated interest. Because Treasury Inflation-Indexed Securities that are not stripped into principal and interest components satisfy both of these conditions, the coupon bond method applies to these securities.

If an inflation-indexed debt instrument qualifies for the coupon bond method, the stated interest payable on the debt instrument is taken into account under the taxpayer's regular method of accounting. Any increase in the inflation-adjusted principal amount is treated as OID for the period in which the increase occurs. Any decrease in the inflation-adjusted principal amount is taken into account under the rules for deflation adjustments described below.

For example, if a taxpayer holds a Treasury Inflation-Indexed Security for an entire calendar year and the taxpayer uses the cash receipts and disbursements method of accounting (cash method), the taxpayer generally includes in income the interest payments received on the security during the year. In addition, the taxpayer includes in income an amount of OID measured by subtracting the inflation-adjusted principal amount of the security at the beginning of the year from the inflation-adjusted principal amount of the security at the end of the year. If the taxpayer uses an accrual method of accounting rather than the cash method, the taxpayer includes in income the qualified stated interest that accrued on the debt instrument during the year and an amount of OID measured by subtracting the inflation-adjusted principal amount of the security at the beginning of the year from the inflation-adjusted principal amount of the security at the end of the year.

E. Discount bond method

If an inflation-indexed debt instrument does not qualify for the coupon bond method (for example, because it is issued at a discount), the instrument is subject to the discount bond method. In general, the discount bond method requires holders and issuers to make current adjustments to their OID accruals to account for inflation and deflation.

Under the discount bond method, a taxpayer determines the amount of OID allocable to an accrual period by using steps similar to those provided in § 1.1272–1(b)(1). First, the taxpayer determines the yield to maturity of the debt instrument as if there were no inflation or deflation over the term of the instrument. Second, the taxpayer determines the length of the accrual periods to be used to allocate OID over the term of the debt instrument, provided no accrual period is longer than one month. Third, the taxpayer determines the percentage change in the value of the reference index during the accrual period by comparing the value at the beginning of the period to the value at the end of the period. Fourth, the taxpayer determines the OID allocable to the accrual period by using a formula that takes into account both the yield of the debt instrument and the percentage change in the value of the reference index during the period. Fifth, the taxpayer allocates to each day in the accrual period a ratable portion of the OID for the accrual period (the daily portions). If the daily portions for an accrual period are positive amounts, these amounts are taken into account under section 163(e) by an issuer and under section 1272 by a holder. If the daily portions for an accrual period are negative amounts, these amounts are taken into account under the rules for deflation adjustments described below.

Under Notice 96–51, the discount bond method would have allowed qualified stated interest. The temporary regulations, however, provide that no interest payments on an inflation-indexed debt instrument subject to the discount bond method are qualified stated interest. The Treasury and the IRS believe that this change simplifies the taxation of an inflation-indexed debt instrument subject to the discount bond method.

F. Deflation adjustments

The temporary regulations treat deflation adjustments in a manner consistent with the treatment of net negative adjustments on contingent payment debt instruments under § 1.1275–4(b)(6)(iii). If a holder has a deflation adjustment for a taxable year, the deflation adjustment first reduces the amount of interest otherwise includible in income with respect to the debt instrument for the taxable year. If the amount of the deflation adjustment exceeds the interest otherwise includible in income for the taxable year, the holder treats the excess as an ordinary loss in the taxable year. However, the amount treated as an ordinary loss is limited to the amount by which the holder's total interest inclusions on the debt instrument in prior taxable years exceed the total amount treated by the holder as an ordinary loss on the debt instrument in prior taxable years. If the deflation adjustment exceeds the interest otherwise includible in income by the holder with respect to the debt instrument for the taxable year and the amount treated as an ordinary loss for the taxable year, the excess is carried forward to offset interest income on the debt instrument in subsequent taxable years. Similar rules apply to determine an issuer's interest deductions and income for the debt instrument.

G. Minimum guarantee

Certain inflation-indexed debt instruments may provide for an additional payment at maturity (a minimum guarantee payment) if the total amount of inflation-adjusted principal paid on the debt instrument is less than the instrument's stated principal amount. Under both the coupon bond method and the discount bond method, a minimum guarantee payment is ignored until the payment is made. If a minimum guarantee payment is made, the payment is treated as interest on the date it is paid.

In general, the temporary regulations only allow a debt instrument that is indexed by reference to the CPI–U to provide for a minimum guarantee payment. The Treasury and the IRS believe that there is only a small possibility that the total amount of principal paid on a debt instrument indexed to the CPI–U will be less than the instrument's stated principal amount. In this case, it is appropriate to ignore the minimum guarantee payment until it is paid.

H. Principal amount for the issue date

For purposes of the temporary regulations, if an inflation-indexed debt instrument is issued with pre-issuance accrued interest, the principal amount of the instrument for the issue date includes an adjustment for inflation or deflation. This adjustment is measured by the change in the value of the reference index between the date on which interest starts to accrue (the dated date in the case of a Treasury Inflation-Indexed Security) and the issue date. The stated principal amount of a debt instrument under the regulations, however, is not adjusted for inflation or deflation between the date on which interest starts to accrue and the issue date. Therefore, the stated principal amount of the debt instrument is the same regardless of whether interest accrues on the instrument from the issue date or from an earlier date. The stated principal amount of a Treasury Inflation-Indexed Security is the par amount of the security, as defined in the final rules published by the Treasury Department describing the terms and conditions of Treasury Inflation-Indexed Securities.

When there is a difference between the stated principal amount of an inflation-indexed debt instrument and its principal amount for the issue date, the instrument's principal amount for the issue date generally is used for purposes of applying the rules in the temporary regulations to the instrument. For example, the debt instrument's principal amount for the issue date is used to determine whether the instrument qualifies for the coupon bond method. The temporary regulations require the use of a debt instrument's stated principal amount rather than its principal amount for the issue date to measure the amount of a minimum guarantee payment.

I. Strips

Treasury Inflation-Indexed Securities are eligible for the Department of the Treasury's Separate Trading of Registered Interest and Principal of Securities (STRIPS) program. Under this program, the interest and principal components of a Treasury Inflation-Indexed Security may be transferred as separate instruments (stripped bonds and coupons). In general, section 1286 treats the holder of a stripped bond (or coupon) as if the holder purchased a newly issued debt instrument that has OID. The temporary regulations provide that the holder of a component of a Treasury Inflation-Indexed Security that is stripped under the Treasury STRIPS program must use the discount bond method to account for the OID on the component.

J. Information reporting

The temporary regulations do not provide any new information reporting rules for inflation-indexed debt instruments. The OID and any qualified stated interest on an inflation-indexed debt instrument should be reported on Form 1099–OID. The IRS plans to issue guidance for the reporting of OID on Treasury Inflation-Indexed Securities that are stripped under the STRIPS program.

K. Effective date

The temporary regulations apply to an inflation-indexed debt instrument issued on or after January 6, 1997.

Special Analyses

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

Drafting Information

The principal author of the regulations is Jeffrey W. Maddrey, Office of Assistant Chief Counsel (Financial Institutions and Products). However, other personnel from the IRS and Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

Part 1—INCOME TAXES

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

Authority: 26 U.S.C. 7805 * * *
Section 1.1275–7T also issued under 26 U.S.C. 1275(d). * * *
Section 1.1286–2T also issued under 26 U.S.C. 1286(f). * * *

Par. 2. Section 1.1271–0 is amended by—

1. Revising the second sentence of paragraph (a);
2. Revising the introductory text of paragraph (b); and
3. Adding entries for § 1.1275–7T in paragraph (b).

The revisions and additions read as follows:

§ 1.1271–0 Original issue discount; effective date; table of contents.

(a) * * * Taxpayers, however, may rely on these sections (as contained in 26 CFR part 1 revised April 1, 1996) for debt instruments issued after December 21, 1992, and before April 4, 1994.

(b) *Table of contents*. This section lists captioned paragraphs contained in §§ 1.1271–1 through 1.1275–7T.

* * * * *

§ 1.1275–7T Inflation-indexed debt instruments (temporary).

* * * * *

Par. 3. Section 1.1275–4 is amended by—

1. Removing the word ''or'' from the end of paragraph (a)(2)(vi);
2. Redesignating paragraph (a)(2)(vii) as paragraph (a)(2)(viii); and
3. Adding a new paragraph (a)(2)(vii).

The addition reads as follows:

§ 1.1275–4 Contingent payment debt instruments.

(a) * * *

(2) * * *

(vii) An inflation-indexed debt instrument (as defined in § 1.1275–7T); or

* * * * *

Par. 4. Section 1.1275–7T is added to read as follows:

§ 1.1275–7T Inflation-indexed debt instruments (temporary).

(a) *Overview.* This section provides rules for the federal income tax treatment of an inflation-indexed debt instrument. If a debt instrument is an inflation-indexed debt instrument, one of two methods will apply to the instrument: the coupon bond method (as described in paragraph (d) of this section) or the discount bond method (as described in paragraph (e) of this section). Both methods determine the amount of OID that is taken into account each year by a holder or an issuer of an inflation-indexed debt instrument.

(b) *Applicability*—(1) *In general*. Except as provided in paragraph (b)(2) of this section, this section applies to an inflation-indexed debt instrument as defined in paragraph (c)(1) of this section. For example, this section applies to Treasury Inflation-Indexed Securities.

(2) *Exceptions*. This section does not apply to an inflation-indexed debt instrument that is also—

(i) A debt instrument (other than a tax-exempt obligation) described in section 1272(a)(2) (for example, U.S. savings bonds, certain loans between natural persons, and short-term taxable obligations); or

(ii) A debt instrument subject to section 529 (certain debt instruments issued by qualified state tuition programs).

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

(1) *Inflation-indexed debt instrument*. An inflation-indexed debt instrument is a debt instrument that satisfies the following conditions:

(i) *Issued for cash*. The debt instrument is issued for U.S. dollars and all payments on the instrument are denominated in U.S. dollars.

(ii) *Indexed for inflation and deflation*. Except for a minimum guarantee payment (as defined in paragraph (c)(5) of this section), each payment on the debt instrument is indexed for inflation and deflation. A payment is indexed for inflation and deflation if the amount of the payment is equal to—

(A) The amount that would be payable if there were no inflation or deflation over the term of the debt instrument, multiplied by

(B) A ratio, the numerator of which is the value of the reference index for the date of the payment and the denominator of which is the value of the reference index for the issue date.

(iii) *No other contingencies*. No payment on the debt instrument is subject to a contingency other than the inflation contingency or the contingencies described in this paragraph (c)(1)(iii). A debt instrument may provide for—

(A) A minimum guarantee payment as defined in paragraph (c)(5) of this section; or

(B) Payments under one or more alternate payment schedules if the payments under each payment schedule are indexed for inflation and deflation and a payment schedule for the debt instrument can be determined under § 1.1272–1(c). (For purposes of this section, the rules of § 1.1272–1(c) are applied to the debt instrument by assuming that no inflation or deflation will occur over the term of the instrument.)

(2) *Reference index*. The reference index is an index used to measure inflation and deflation over the term of a debt instrument. To qualify as a reference index, an index must satisfy the following conditions:

(i) The value of the index is reset once a month to a current value of a single qualified inflation index (as defined in paragraph (c)(3) of this section). For this purpose, a value of a qualified inflation index is current if the value has been updated and published within the preceding six month period.

(ii) The reset occurs on the same day of each month (the reset date).

(iii) The value of the index for any date between reset dates is determined through straight-line interpolation.

(3) *Qualified inflation index*. A qualified inflation index is a general price or wage index that is updated and published at least monthly by an agency of the United States Government (for example, the non-seasonally adjusted U.S. City Average All Items Consumer Price Index for All Urban Consumers (CPI–U), which is published by the Bureau of Labor Statistics of the Department of Labor).

(4) *Inflation-adjusted principal amount*. For any date, the inflation-adjusted principal amount of an inflation-indexed debt instrument is an amount equal to—

(i) The outstanding principal amount of the debt instrument (determined as if there were no inflation or deflation over the term of the instrument), multiplied by

(ii) A ratio, the numerator of which is the value of the reference index for the date and the denominator of which is the value of the reference index for the issue date.

(5) *Minimum guarantee payment*. In general, a minimum guarantee payment is an additional payment made at maturity on a debt instrument if the total amount of inflation-adjusted principal paid on the instrument is less than the instrument's stated principal amount. The amount of the additional payment must be no more than the excess, if any, of the debt instrument's stated principal amount over the total amount of inflation-adjusted principal paid on the instrument. An additional payment is not a minimum guarantee payment unless the qualified inflation index used to determine the reference index is either the CPI–U or an index designated for this purpose by the Commissioner in the **Federal Register** or the Internal Revenue Bulletin (see § 601.601(d)(2)(ii) of this chapter). See paragraph (f)(4) of this section for the treatment of a minimum guarantee payment.

(d) *Coupon bond method*—(1) *In general*. This paragraph (d) describes the method (coupon bond method) to be used to account for qualified stated interest and inflation adjustments (OID) on an inflation-indexed debt instrument described in paragraph (d)(2) of this section.

(2) *Applicability*. The coupon bond method applies to an inflation-indexed debt instrument that satisfies the following conditions:

(i) *Issued at par*. The debt instrument is issued at par. A debt instrument is issued at par if the difference between its issue price and principal amount for the issue date is less than the de minimis amount. For this purpose, the de minimis amount is determined using the principles of § 1.1273–1(d).

(ii) *All stated interest is qualified stated interest*. All stated interest on the debt instrument is qualified stated interest. For purposes of this paragraph (d), stated interest is qualified stated interest if the interest is unconditionally payable in cash, or is constructively received under section 451, at least annually at a single fixed rate. Stated interest is payable at a single fixed rate if the amount of each interest payment is determined by multiplying the inflation adjusted principal amount for the payment date by the single fixed rate.

(3) *Qualified stated interest*. Under the coupon bond method, qualified stated interest is taken into account under the taxpayer's regular method of accounting. The amount of accrued but unpaid qualified stated interest as of any date is determined by using the principles of § 1.446–3(e)(2)(ii) (relating to notional principal contracts). For example, if the interval between interest payment dates spans two taxable years, a taxpayer using an accrual method of accounting determines the amount of accrued qualified stated interest for the first taxable year by reference to the inflation-adjusted principal amount at the end of the first taxable year.

(4) *Inflation adjustments*—(i) *Current accrual*. Under the coupon bond method, an inflation adjustment is taken into account for each taxable year in which the debt instrument is outstanding.

(ii) *Amount of inflation adjustment*. For any relevant period (such as the taxable year or the portion of the taxable year during which a taxpayer holds an inflation-indexed debt instrument), the amount of the inflation adjustment is equal to—

(A) The sum of the inflation-adjusted principal amount at the end of the period and the principal payments made during the period, minus

(B) The inflation-adjusted principal amount at the beginning of the period.

(iii) *Positive inflation adjustments*. A positive inflation adjustment is OID.

(iv) *Negative inflation adjustments*. A negative inflation adjustment is a deflation adjustment that is taken into account under the rules of paragraph (f)(1) of this section.

(5) *Example*. The following example illustrates the coupon bond method:

Example. (i) *Facts*. On October 15, 1997, X purchases at original issue, for $100,000, a debt instrument that is indexed for inflation and deflation. The debt instrument matures on October 15, 1999, has a stated principal amount of $100,000, and has a stated interest rate of 5 percent, compounded semiannually. The debt instrument provides that the principal amount is indexed to the CPI–U. Interest is payable on April 15 and October 15 of each year. The amount of each interest payment is determined by multiplying the inflation-adjusted principal amount for each interest payment date by the stated interest rate, adjusted for the length of the accrual period. The debt instrument provides for a single payment of the inflation-adjusted principal amount at maturity. In addition, the debt instrument provides for an additional payment at maturity equal to the excess, if any, of $100,000 over the inflation-adjusted principal amount at maturity. X uses the cash receipts and disbursements method of accounting and the calendar year as its taxable year.

(ii) *Indexing methodology*. The debt instrument provides that the inflation-adjusted principal amount for any day is determined by multiplying the principal amount of the instrument for the issue date by a ratio, the numerator of which is the value of the reference index for the day the inflation-adjusted principal amount is to be determined and the denominator of which is the value of the reference index for the issue date. The value of the reference index for the first day of a month is the value of the CPI–U for the third preceding month. The value of the reference index for any day other than the first day of a month is determined based on a straight-line interpolation between the value of the reference index for the first day of the month and the value of the reference index for the first day of the next month.

(iii) *Inflation-indexed debt instrument subject to the coupon bond method*. Under paragraph (c)(1) of this section, the debt instrument is an inflation-indexed debt instrument. Because there is no difference between the debt instrument's issue price ($100,000) and its principal amount for the issue date ($100,000) and because all stated interest is qualified stated interest, the coupon bond method applies to the instrument.

(iv) *Reference index values*. Assume the following table lists the relevant reference index values for 1997 through 1999:

Date	*Reference index value*
October 15, 1997	100
January 1, 1998	101
April 15, 1998	103
October 15, 1998	105
January 1, 1999	99

(v) *Treatment of X in 1997*. X does not receive any payments of interest on the debt instrument in 1997. Therefore, X has no qualified stated interest income for 1997. X, however, must take into account the inflation adjustment for 1997. The inflation-adjusted principal amount for January 1, 1998, is $101,000 ($100,000 x 101/100). Therefore, the inflation adjustment for 1997 is $1,000, the inflation-adjusted principal amount for January 1, 1998 ($101,000) minus the principal amount for the issue date ($100,000). X includes the $1,000 inflation adjustment in income as OID in 1997.

(vi) *Treatment of X in 1998*. In 1998, X receives two payments of interest: On April 15, 1998, X receives a payment of $2,575 ($100,000 x 103/100 x .05/2), and on October 15, 1998, X receives a payment of $2,625 ($100,000 x 105/100 x .05/2). Therefore, X's qualified stated interest income for 1998 is $5,200 ($2,575 + $2,625). X also must take into account the inflation adjustment for 1998. The inflation-adjusted principal amount for January 1, 1999, is $99,000 ($100,000 x 99/100). Therefore, the inflation adjustment for 1998 is negative $2,000, the inflation-adjusted principal amount for January 1, 1999 ($99,000) minus the inflation-adjusted principal amount for January 1, 1998 ($101,000). Because the amount of the inflation adjustment is negative, it is a deflation adjustment. Under paragraph (f)(1)(i) of this section, X uses this $2,000 deflation adjustment to reduce the interest otherwise includible in income by X with respect to the debt instrument in 1998. Therefore, X includes $3,200 in income for 1998, the qualified stated interest income for 1998 ($5,200) minus the deflation adjustment ($2,000).

(e) *Discount bond method*—(1) *In general*. This paragraph (e) describes the method (discount bond method) to be used to account for OID on an inflation-indexed debt instrument that does not qualify for the coupon bond method.

(2) *No qualified stated interest*. Under the discount bond method, no interest on an inflation-indexed debt instrument is qualified stated interest.

(3) *OID*. Under the discount bond method, the amount of OID that accrues on an inflation-indexed debt instrument is determined as follows:

(i) *Step one: Determine the debt instrument's yield to maturity*. The yield of the debt instrument is determined under the rules of § 1.1272–1(b)(1)(i). In calculating the yield under those rules for purposes of this paragraph (e)(3)(i), the payment schedule of the debt instrument is determined as if there were no inflation or deflation over the term of the instrument.

(ii) *Step two: Determine the accrual periods*. The accrual periods are determined under the rules of § 1.1272–1(b)(1)(ii). However, no accrual period can be longer than 1 month.

(iii) *Step three: Determine the percentage change in the reference index during the accrual period*. The percentage change in the reference index during the accrual period is equal to—

(A) The ratio of the value of the reference index at the end of the period to the value of the reference index at the beginning of the period,

(B) Minus one.

(iv) *Step four: Determine the OID allocable to each accrual period*. The OID allocable to an accrual period (n) is determined by using the following formula:

$OID_{(n)} = AIP_{(n)} \times [r + inf_{(n)} + (r \times inf_{(n)})]$ in which,

r = yield of the debt instrument as determined under paragraph (e)(3)(i) of this section (adjusted for the length of the accrual period);

$inf_{(n)}$ = percentage change in the value of the reference index for period (n) as determined under paragraph (e)(3)(iii) of this section; and

$AIP_{(n)}$ = adjusted issue price at the beginning of period (n).

(v) *Step five: Determine the daily portions of OID*. The daily portions of OID are determined and taken into account under the rules of § 1.1272–1(b)(1)(iv). If the daily portions determined under this paragraph (e)(3)(v) are negative amounts, however, these amounts (deflation adjustments) are taken into account under the rules for deflation adjustments described in paragraph (f)(1) of this section.

(4) *Example*. The following example illustrates the discount bond method:

Example. (i) *Facts*. On November 15, 1997, X purchases at original issue, for $91,403, a zero-coupon debt instrument that is indexed for inflation and deflation. The principal amount of the debt instrument for the issue date is $100,000. The debt instrument provides for a single payment on November 15, 2000. The amount of the payment will be determined by multiplying $100,000 by a fraction, the numerator of which is the CPI–U for September 2000, and the denominator of which is the CPI–U for September 1997. The debt instrument also provides that in no event will the payment on November 15, 2000, be less than $100,000. X uses the cash receipts and disbursements method of accounting and the calendar year as its taxable year.

(ii) *Inflation-indexed debt instrument.* Under paragraph (c)(1) of this section, the instrument is an inflation-indexed debt instrument. The debt instrument's principal amount for the issue date ($100,000) exceeds its issue price ($91,403) by $8,597, which is more than the de minimis amount for the debt instrument ($750). Therefore, the coupon bond method does not apply to the debt instrument. As a result, the discount bond method applies to the debt instrument.

(iii) *Yield and accrual period.* Assume X chooses monthly accrual periods ending on the 15th day of each month. The yield of the debt instrument is determined as if there were no inflation or deflation over the term of the instrument. Therefore, based on the issue price of $91,403 and an assumed payment at maturity of $100,000, the yield of the debt instrument is 3 percent, compounded monthly.

(iv) *Percentage change in reference index.* Assume that the CPI–U for September 1997 is 160; for October 1997 is 161.2; and for November 1997 is 161.7. The value of the reference index for November 15, 1997, is 160, the value of the CPI–U for September 1997. Similarly, the value of the reference index for December 15, 1997, is 161.2, and for January 15, 1998, is 161.7. The percentage change in the reference index from November 15, 1997, to December 15, 1997, (inf_1) is 0.0075 (161.2/160 − 1); the percentage change in the reference index from December 15, 1997, to January 15, 1998, (inf_2) is 0.0031 (161.7/161.2 − 1).

(v) *Treatment of X in 1997.* For the accrual period ending on December 15, 1997, r is .0025 (.03/12), inf_1 is .0075, and the product of r and inf_1 is .00001875. Under paragraph (e)(3) of this section, the amount of OID allocable to the accrual period ending on December 15, 1997, is $916. This amount is determined by multiplying the issue price of the debt instrument ($91,403) by .01001875 (the sum of r, inf_1, and the product of r and inf_1). The adjusted issue price of the debt instrument on December 15, 1997, is $92,319 ($91,403 + $916). For the accrual period ending on January 15, 1998, r is .0025 (.03/12), inf_2 is .0031, and the product of r and inf_2 is .00000775. Under paragraph (e)(3) of this section, the amount of OID allocable to the accrual period ending on January 15, 1998, is $518. This amount is determined by multiplying the adjusted issue price of the debt instrument ($92,319) by .00560775 (the sum of r, inf_2, and the product of r and inf_2). Because the accrual period ending on January 15, 1998, spans two taxable years, only $259 of this amount ($518/30 days x 15 days) is allocable to 1997. Therefore, X includes $1,175 of OID in income for 1997 ($916 + $259).

(f) *Special rules.* The following rules apply to an inflation-indexed debt instrument:

(1) *Deflation adjustments*—(i) *Holder*. A deflation adjustment reduces the amount of interest otherwise includible in income by a holder with respect to the debt instrument for the taxable year. For purposes of this paragraph (f)(1)(i), interest includes OID, qualified stated interest, and market discount. If the amount of the deflation adjustment exceeds the interest otherwise includible in income by the holder with respect to the debt instrument for the taxable year, the excess is treated as an ordinary loss by the holder for the taxable year. However, the amount treated as an ordinary loss is limited to the amount by which the holder's total interest inclusions on the debt instrument in prior taxable years exceed the total amount treated by the holder as an ordinary loss on the debt instrument in prior taxable years. If the deflation adjustment exceeds the interest otherwise includible in income by the holder with respect to the debt instrument for the taxable year and the amount treated as an ordinary loss for the taxable year, this excess is carried forward to reduce the amount of interest otherwise includible in income by the holder with respect to the debt instrument for subsequent taxable years.

(ii) *Issuer*. A deflation adjustment reduces the interest otherwise deductible by the issuer with respect to the debt instrument for the taxable year. For purposes of this paragraph (f)(1)(ii), interest includes OID and qualified stated interest. If the amount of the deflation adjustment exceeds the interest otherwise deductible by the issuer with respect to the debt instrument for the taxable year, the excess is treated as ordinary income by the issuer for the taxable year. However, the amount treated as ordinary income is limited to the amount by which the issuer's total interest deductions on the debt instrument in prior taxable years exceed the total amount treated by the issuer as ordinary income on the debt instrument in prior taxable years. If the deflation adjustment exceeds the interest otherwise deductible by the issuer with respect to the debt instrument for the taxable year and the amount treated as ordinary income for the taxable year, this excess is carried forward to reduce the interest otherwise deductible by the issuer with respect to the debt instrument for subsequent taxable years. If there is any excess remaining upon the retirement of the debt instrument, the issuer takes the excess amount into account as ordinary income.

(2) *Adjusted basis*. A holder's adjusted basis in an inflation-indexed debt instrument is determined under § 1.1272–1(g). However, a holder's adjusted basis in the debt instrument is decreased by the amount of any deflation adjustment the holder takes into account to reduce the amount of interest otherwise includible in income or treats as an ordinary loss with respect to the instrument during the taxable year. The decrease occurs when the deflation adjustment is taken into account under paragraph (f)(1) of this section.

(3) *Subsequent holders*. A holder determines the amount of acquisition premium or market discount on an inflation-indexed debt instrument by reference to the adjusted issue price of the instrument on the date the holder acquires the instrument. A holder determines the amount of bond premium on an inflation-indexed debt instrument by assuming that the amount payable at maturity on the instrument is equal to the instrument's inflation-adjusted principal amount for the day the holder acquires the instrument. Any premium or market discount is taken into account over the remaining term of the debt instrument as if there were no further inflation or deflation. See section 171 for additional rules relating to the amortization of bond premium and sections 1276 through 1278 for additional rules relating to market discount.

(4) *Minimum guarantee*. Under both the coupon bond method and the discount bond method, a minimum guarantee payment is ignored until the payment is made. If there is a minimum guarantee payment, the payment is treated as interest on the date it is paid.

(5) *Temporary unavailability of a qualified inflation index*. Notwithstanding any other rule of this section, an inflation-indexed debt instrument may provide for a substitute value of the qualified inflation index if and when the publication of the value of the qualified inflation index is temporarily delayed. The substitute value may be determined by the issuer under any reasonable method. For example, if the CPI–U is not reported for a particular month, the debt instrument may provide that a substitute value may be determined by increasing the last reported value by the average monthly percentage increase in the qualified inflation index over the preceding twelve months. The use of a substitute value does not result in a reissuance of the debt instrument.

(g) *Reopenings*. For purposes of § 1.1275–2(d)(2), a reopening of Treasury Inflation-Indexed Securities is a qualified reopening if—

(1) The terms of the securities issued in the reopening are the same as the terms of the original securities; and

(2) The reopening occurs not more than one year after the original securities were first issued to the public.

(h) *Effective date*. This section applies to an inflation-indexed debt instrument issued on or after January 6, 1997.

Par. 5. Section 1.1286–2T is added to read as follows:

§ 1.1286–2T Stripped inflation-indexed debt instruments (temporary).

Stripped inflation-indexed debt instruments. If a Treasury Inflation-Indexed Security is stripped under the Department of the Treasury's Separate Trading of Registered Interest and Principal of Securities (STRIPS) program, the holders of the principal and coupon components must use the discount bond method (as described in § 1.1275–7T(e)) to account for the original issue discount on the components.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved December 6, 1996.

Donald C. Lubick,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on December 31, 1996, and published in the issue of the Federal Register for January 6, 1997, 62 F.R. 615)

Section 3402.—Income Tax Collected at Source

26 CFR 31.3402(f)(5)–1: Form and contents of withholding exemption certificates.

T.D. 8706

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Parts 31 and 602

Electronic Filing of Form W–4

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to Form W–4, Employee's Withholding Allowance Certificate. The final regulations authorize employers to establish electronic systems for use by employees in filing their Forms W–4. The regulations provide employers and employees with guidance necessary to comply with the law. The regulations affect employers that establish electronic systems and their employees.

EFFECTIVE DATE: These final regulations are effective January 2, 1997.

FOR FURTHER INFORMATION CONTACT: Karin Loverud, (202) 622–6060 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1435. Responses to this collection of information are mandatory.

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 estimated annual burden per respondent is 20 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224, and to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

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

On April 15, 1994, a notice of proposed rulemaking [EE–45–93] containing proposed regulations relating to Form W–4, Employee's Withholding Allowance Certificate, was published in the Federal Register (59 FR 18057).

On December 21, 1994, temporary regulations (T.D. 8577) clarifying the existing proposed regulations were published in the **Federal Register** (59 FR 65712). A notice of proposed rulemaking (EE–45–93) cross-referencing the temporary regulations was published in the **Federal Register** for the same day (59 FR 65740).

Written comments responding to these notices were received. Public hearings were requested and were held on July 15, 1994, and November 7, 1995.

After consideration of all the comments, the proposed regulations under section 3402(f) are adopted as revised by this Treasury decision. The comments and revisions are discussed below.

Explanation of Revisions and Summary of Comments

1. Relationship between paper and electronic Forms W–4. A withholding exemption certificate (Form W–4) may be in either paper or electronic form. Therefore, an employee will furnish a Form W–4 to the employer either on paper or electronically. To clarify that an electronic Form W–4 has the same status as a paper Form W–4, the final regulations make minor revisions to § 31.3402(f)(5)–1, Form and contents of withholding exemption certificates. Further, the final regulations appear as § 31.3402(f)(5)–1(c), rather than in a separate regulations section limited to electronic forms.

2. Electronic filing by all employees. The existing proposed and temporary regulations require employers that establish electronic systems to provide employees with the option of filing paper or electronic Forms W–4. Several commentators requested that employers be allowed to adopt systems under which all employees file Forms W–4 electronically. These commentators stated that a system under which all employees file electronically would reduce employer burden in terms of costs and time (for example, eliminate maintenance of duplicative paper and electronic systems). Similarly, it would reduce employee burden in terms of time and choosing a filing option.

The IRS and Treasury want to assist in reducing burdens on both employers and employees and to make it as easy as possible for employers to adopt less burdensome systems. The final regulations permit an employer to adopt a system under which all employees file Forms W–4 electronically. The IRS and Treasury expect, however, that an employer will make a paper option reasonably available upon request to any employee who has a serious objection to using the electronic system or whose access to, or ability to use, the system may be limited (for example, as a result of a disability). The paper option would be satisfied, for example, if the employer informs employees how they can obtain a paper Form W–4 and where they should submit the completed paper Form W–4. The IRS and Treasury also expect that employers will comply with all applicable law governing the workplace and terms and conditions of employment, such as the Americans with

Disabilities Act (42 U.S.C. 12112(a)). Compliance with these regulations does not guarantee that a system for filing Forms W–4 electronically is in compliance with those applicable laws.

3. Electronic Forms W–4. Several commentators recommended that electronic systems be allowed for all Forms W–4 without exception. The prior proposed and temporary regulations specifically exclude (1) Forms W–4 required upon commencement of employment (initial Form W–4), and (2) Forms W–4 required to be furnished to the IRS by employers because more than 10 withholding exemptions are claimed or, if the employee is expected to earn more than $200 per week, exemption from withholding is claimed.

Initial Form W–4. Section 3402(f)(2)(A) of the Internal Revenue Code (Code) requires a new employee to furnish the employer with a signed withholding exemption certificate. Section 6061 requires all Forms W–4 to be signed. See discussion below under ''5. Signature under penalties of perjury'' and § 301.6061–1(b), which states that the Secretary may prescribe in forms, instructions, or other appropriate guidance the method of signing any return, statement, or other document required to be made under any provision of the internal revenue laws or regulations. The final regulations permit electronic systems to include Forms W–4 required upon commencement of employment.

Forms W–4 claiming more than 10 exemptions or exemption from withholding. Section 31.3402(f)(2)–1(g) requires employers to submit to the IRS copies of certain Forms W–4 furnished to them by their employees. The Forms W–4 required to be submitted are those on which the employee claims either (1) more than 10 withholding exemptions, or (2) exemption from withholding (and the employee is expected to earn more than $200 per week).

Under § 31.3402(f)(2)–1(g)(5), if the IRS determines that a Form W–4, a copy of which was submitted to the IRS, is defective, the IRS will notify in writing both the employer and the employee. (The notice is referred to as a ''lock-in letter.'') A Form W–4 is defective if (1) the IRS determines that the Form W–4 contains a materially incorrect statement, or (2) following communication with the employee, the IRS lacks sufficient information to determine whether the certificate is correct. The lock-in letter issued by the IRS advises the employer that the employee either is not entitled to claim exemption from withholding or is not entitled to claim more withholding exemptions than the number specified by the IRS in the notice, or both. If the employee subsequently files a new Form W–4, the employer may withhold on the basis of that new Form W–4 only if the new Form W–4 is consistent with the lock-in letter. The employer must continue to withhold on the basis of that advice until the IRS revokes in writing its lock-in letter.

The final regulations permit electronic systems to include Forms W–4 on which employees claim more than 10 withholding exemptions or exemption from withholding. However, the IRS and Treasury expect that electronic systems, alone or in conjunction with the rest of an employer's payroll system, will ensure compliance with the advice contained in a lock-in letter. For instance, an electronic system can ensure compliance with a lock-in letter by prohibiting an employee for whom a lock-in letter was issued from filing any electronic Form W–4 or prohibiting the employee from claiming more withholding exemptions than the number specified in the IRS notice. Additionally, an employer may choose to require any employee to file a paper Form W–4 if the employee wishes to claim more than 10 withholding exemptions or exemption from withholding.

4. Submission of certain Forms W–4 to IRS. Section 31.3402(f)(2)–1(g) requires employers to submit to the IRS copies of Forms W–4 on which the employee claims either more than 10 withholding exemptions or exemption from withholding (and the employee is expected to earn more than $200 per week). Generally, the copies are sent quarterly to the IRS along with the employer's Form 941, Employer's Quarterly Federal Tax Return. Copies can also be submitted earlier and more often to the employer's IRS service center.

Employers that establish electronic systems will satisfy the requirement of § 31.3402(f)(2)–1(g) if they furnish the Form W–4 information on magnetic media. Before using magnetic media, employers must submit Form 4419, Application for Filing Information Returns Magnetically/Electronically, to request authorization. Rev. Proc. 92–80 (1992–2 C.B. 465) contains specifications for filing Forms W–4 on magnetic tape and on 5¼- and 3½-inch magnetic diskettes. Electronic transmission of Form W–4 information to the IRS is not yet available.

5. Signature under penalties of perjury. Section 6061 of the Code requires that any return, statement, or other document required to be made under any provision of the Code or regulations be signed. Section 6065 requires that any such document contain or be verified by a written declaration that it is made under the penalties of perjury. These requirements apply to all Forms W–4, including those filed electronically, and are reflected in § 31.3402(f)(5)–1(c)(iii) of the final regulations.

Although sections 6061 and 6065 apply to all Forms W–4, the IRS and Treasury are concerned that some electronic systems established under the temporary regulations may not include a signature under penalties of perjury. The final regulations, therefore, include guidance on the perjury statement and the electronic signature.

For certain Forms W–4, the final regulations treat the signature-under-penalties-of-perjury-statement requirement as satisfied until January 1, 1999. This special rule applies only if the system precludes the electronic filing of Forms W–4 required upon commencement of employment and Forms W–4 claiming more than 10 withholding exemptions or exemption from withholding. Moreover, the special rule applies only to Forms W–4 filed electronically before the earlier of (1) January 1, 1999, or (2) the first date on which the employer's electronic system permits the filing of Forms W–4 required upon commencement of employment or Forms W–4 claiming more than 10 withholding exemptions or exemption from withholding.

The IRS and Treasury will consider written comments pertaining to the provisions relating to signatures under penalties of perjury. Submissions should be sent to: CC:DOM:CORP:R (T.D. 8706), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the ''Tax Regs'' option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R

(T.D. 8706), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC.

6. Employer retention of Forms W–4 and predecessor and successor employers. One commentator requested guidance concerning the period for which paper Forms W–4 are required to be retained under § 31.6001–1(e) after the employer establishes an electronic system and in predecessor-employer/successor-employer situations. Electronic Forms W–4 have the same status as paper Forms W–4. Therefore, guidance that applies to paper Forms W–4 also applies to electronic Forms W–4. For further information, see Rev. Proc. 91–59 (1991–2 C.B. 841) (information regarding the retention of records using a variety of automatic data processing systems); and section 5 of Rev. Proc. 96–60 (1996–53 I.R.B.) (predecessor/successor situations).

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because the notice of proposed rulemaking preceding the regulations was issued prior to March 29, 1996, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

Drafting Information

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

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 31 and 602 are amended as follows:

PART 31—EMPLOYMENT TAXES AND COLLECTION OF INCOME TAX AT SOURCE

Paragraph 1. The authority citation for part 31 is amended by adding an entry for Section 31.3402(f)(5)–1 to read as follows:

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

Section 31.3402(f)(5)–1 also issued under 26 U.S.C. 3402(i) and (m). * * *

Par. 2. Section 31.3402(f)(5)–1 is amended as follows:

1. Headings are added to paragraphs (a) and (b).
2. The fourth sentence of paragraph (a) is revised.
3. Paragraph (c) is added.
4. The authority citation which follows the end of the section is removed.

The revisions and additions read as follows:

§ 31.3402(f)(5)–1 Form and contents of withholding exemption certificates.

(a) *Form W–4*. * * * Blank copies of paper Forms W–4 will be supplied to employers upon request to the Internal Revenue Service. * * *

(b) Invalid Form W–4. * * *

(c) *Electronic Form W–4*—(1) *In general*. An employer may establish a system for its employees to file withholding exemption certificates electronically.

(2) *Requirements*—(i) *In general*. The electronic system must ensure that the information received is the information sent, and must document all occasions of employee access that result in the filing of a Form W–4. In addition, the design and operation of the electronic system, including access procedures, must make it reasonably certain that the person accessing the system and filing the Form W–4 is the employee identified in the form.

(ii) *Same information as paper Form W–4*. The electronic filing must provide the employer with exactly the same information as the paper Form W–4.

(iii) *Jurat and signature requirements*. The electronic filing must be signed by the employee under penalties of perjury.

(A) *Jurat*. The jurat (perjury statement) must contain the language that appears on the paper Form W–4. The electronic program must inform the employee that he or she must make the declaration contained in the jurat and that the declaration is made by signing the Form W–4. The instructions and the language of the jurat must immediately follow the employee's income tax withholding selections and immediately precede the employee's electronic signature.

(B) *Electronic signature*. The electronic signature must identify the employee filing the electronic Form W–4 and authenticate and verify the filing. For this purpose, the terms "authenticate" and "verify" have the same meanings as they do when applied to a written signature on a paper Form W–4. An electronic signature can be in any form that satisfies the foregoing requirements. The electronic signature must be the final entry in the employee's Form W–4 submission.

(iv) *Copies of electronic Forms W–4*. Upon request by the Internal Revenue Service, the employer must supply a hardcopy of the electronic Form W–4 and a statement that, to the best of the employer's knowledge, the electronic Form W–4 was filed by the named employee. The hardcopy of the electronic Form W–4 must provide exactly the same information as, but need not be a facsimile of, the paper Form W–4.

(3) *Effective date*—(i) *In general*. This paragraph applies to all withholding exemption certificates filed electronically by employees on or after January 2, 1997.

(ii) *Special rule for certain Forms W–4*. In the case of an electronic system that precludes the filing of Forms W–4 required on commencement of employment and Forms W–4 claiming more than 10 withholding exemptions or exemption from withholding, the requirements of paragraph (c)(2)(iii) of this section will be treated as satisfied if the Form W–4 is filed electronically before January 1, 1999.

§ 31.3402(f)(5)–2T [Removed]

Par. 3. Section 31.3402(f)(5)–2T is removed.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 4. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 5. In § 602.101, paragraph (c) is amended by:

1. Removing the entry for 31.3402(f)(5)–2T from the table.

§ 602.101 OMB Control numbers.

* * * * *

(c) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
31.3402(f)(5)–2T	1545–1435
* * * * *	

2. Revising the entry for 31.3402(f)(5)–1 to read as follows:

§ 602.101 OMB Control numbers.

* * * * *

(c) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
31.3402(f)(5)–1.	1545–0010 1545–1435
* * * * *	

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved December 12, 1996.

Donald C. Lubick,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on December 31, 1996, 8:45 a.m., and published in the issue of the Federal Register for January 2, 1997, 62 F.R. 22)

Part III. Administrative, Procedural, and Miscellaneous

Weighted Average Interest Rate Update

Notice 97–16

Notice 88–73 provides guidelines for determining the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of § 412(c)(7) of the Internal Revenue Code as amended by the Omnibus Budget Reconciliation Act of 1987 and as further amended by the Uruguay Round Agreements Act, Pub. L. 103–465 (GATT).

The average yield on the 30-year Treasury Constant Maturities for January 1997 is 6.83 percent.

The following rates were determined for the plan years beginning in the month shown below.

Month	Year	Weighted Average	90% to 107% Permissible Range	90% to 110% Permissible Range
February	1997	6.88	6.19 to 7.36	6.19 to 7.57

Drafting Information

The principal author of this notice is Donna Prestia of the Employee Plans Division. For further information regarding this notice, call (202) 622–6076 between 2:30 and 4:00 p.m. Eastern time (not a toll-free number). Ms. Prestia's number is (202) 622–7377 (also not a toll-free number).

26 CFR 601.201: Rulings and determination letters.
(Also Part I, Sections 25, 103, 143; 1.25–4T, 1.103–1, 6a.103A–2.)

Rev. Proc. 97–17

SECTION 1. PURPOSE

This revenue procedure provides 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), with a list of the average annual aggregate principal amount of mortgages executed during the calendar years 1992, 1993, and 1994 for each state, the District of Columbia, Guam, Puerto Rico, and the Virgin Islands.

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. Under § 141(e) the term ''qualified bond'' includes any private activity bond that (1) is a qualified mortgage bond, (2) meets the volume cap requirements under § 146, and (3) meets the applicable requirements under § 147.

.02 Section 143(a)(1)(A) 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 semiannual period beginning after the date the prepayment (or complete repayment) is received to redeem bonds that are part of the issue.

.03 An issue of bonds meets the requirements of subsection (h) of § 143 only if a sufficient portion of the bond proceeds is made available (with reasonable diligence) for owner-financing of targeted area residences for at least one year after the date on which owner-financing is first made available with respect to targeted area residences. The applicable portion of bond proceeds to be made available must be equal to or greater than an amount that is the lesser of (1) 20 percent of the proceeds of the issue that are devoted to providing owner-financing, or (2) 40 percent of the average annual aggregate principal amount of mortgages executed during the immediately preceding 3 calendar years for single-family, owner-occupied residences in targeted areas within the jurisdiction of the issuing authority.

.04 A targeted area residence, defined in § 143(j), is a residence in either a qualified census tract or an area of chronic economic distress. A ''qualified census tract'' means a census tract in which 70 percent or more of the families have income which is 80 percent or less of the statewide median family income, based on the most recent decennial census for which data are available. See Rev. Proc. 93–38, 1993–2 C.B. 483, for the most recent list of qualified census tracts for each state and the District of Columbia; that list is based on data from the 1990 census. Section 143(j)(3) defines an ''area of chronic economic distress'' (''ACED'') as an area (i) designated by the state as meeting the standards established by the state for purposes of § 143(j), and (ii) the designation of which has been approved by the Secretary of Treasury and the Secretary of Housing and Urban Development in accordance with criteria set forth in § 143(j)(3)(B). See Rev. Proc. 88–31, 1988–1 C.B. 832, for the procedures to obtain an ACED designation.

.05 When determining the portion of the proceeds that must be made available for owner-financing of targeted area residences under the 40 percent limitation in § 143(h)(2), issuers of mortgage revenue bonds may rely upon the amount produced by the following safe harbor formula described in § 6a.103A–2(h)(3) of the temporary Income Tax Regulations (issued under former § 103A(h) of the 1954 Code):

$$P = \frac{.2\ (X \times Z)}{Y} \quad \text{where}$$

P = Required portion to be made available to targeted areas,

X = Average annual aggregate principal amount of mortgages executed during the immediately preceding 3 calendar years for single-family owner-occupied residences within

P = Required portion to be made available to targeted areas,
the state in which the issuing jurisdiction is located,

Y = The total population within the state, based on the most recent decennial census for which data are available, and

Z = The total population in the targeted areas located within the issuer's jurisdiction, based on the most recent decennial census for which data are available.

An issuing jurisdiction may use estimates of X published by the Treasury Department when computing the safe harbor formula. The specified portion required to be made available in targeted areas is a minimum amount so that more than the minimum amount may be (but need not be) made available in targeted areas. See § 6a.103A–2(h)(4).

.06 Section 25(c)(2)(A)(ii) provides that a state or a political subdivision thereof may elect to exchange all or part of its qualified mortgage bond authority for authority to issue the mortgage credit certificates described in § 25(c). The election must be in accordance with § 1.25–4T(c).

.07 Section 25(a) provides, in general, that the recipient of a mortgage credit certificate (MCC) may claim a credit against income tax equal to the product of the certificate credit rate and the interest paid or accrued by the taxpayer during the taxable year on the remaining principal of the certified indebtedness amount.

.08 Section 25(b)(2) defines the certified indebtedness amount as the amount of indebtedness that is incurred by the taxpayer to acquire the taxpayer's principal residence, as a qualified home improvement loan, or as a qualified rehabilitation loan, and is specified in the MCC.

.09 Section 25(c)(2)(A)(iii)(V) provides that the indebtedness certified by MCCs must meet the requirements of § 143(h) concerning the portion of loans to be placed in targeted areas. See also § 1.25–4T(g) of the temporary regulations.

.10 The average annual mortgage originations for 1990, 1991, and 1992 were published in Rev. Proc. 95–14, 1995–1 C.B. 520. Section 5.01 of Rev. Proc. 95–14 provides that issuers may continue to rely on the average annual mortgage originations in Rev. Proc. 95–14 until those averages are rendered obsolete by a new revenue procedure, such as this one.

.11 The average annual mortgage originations are developed by the Department of Housing and Urban Development (HUD) for publication by the Service. The mortgage originations are based on data and procedures that are employed in the HUD-coordinated surveys of mortgage lending activity for 1- to 4-family dwellings. The estimates of mortgage volume for 1- to 4-family dwellings in each state are adjusted from a special tabulation of the HUD-sponsored Annual Housing Survey to reflect only the amount of mortgages originated that were secured by owner-occupied residences.

SECTION 3. APPLICATION

The average annual mortgage originations, based on mortgage loan originations secured by owner-occupied residences during 1992, 1993, and 1994, for each state, the District of Columbia, Guam, Puerto Rico, and the Virgin Islands are listed below (dollars in millions).

	Gross Mortgage Originations for Owner-Occupied Homes			Three-Year	Average Annual
State	1992	1993	1994	Total	Mortgage Originations
Alabama	9,292	10,688	7,835	27,815	9,272
Alaska	2,678	3,581	2,393	8,652	2,884
Arizona	13,811	22,004	15,478	51,293	17,098
Arkansas	5,110	5,746	4,303	15,159	5,053
California	110,252	119,554	105,353	335,159	111,720
Colorado	21,599	27,361	16,865	65,825	21,942
Connecticut	9,139	13,117	8,487	30,743	10,248
Delaware	2,042	1,735	1,402	5,179	1,726
District of Columbia	978	1,931	1,191	4,100	1,367
Florida	42,634	49,952	41,612	134,198	44,733
Georgia	21,522	26,963	18,487	66,972	22,324
Hawaii	5,068	5,118	3,649	13,835	4,612
Idaho	3,502	3,757	2,963	10,222	3,407
Illinois	33,894	34,271	27,148	95,313	31,771
Indiana	16,693	20,016	14,648	51,357	17,119
Iowa	4,662	4,204	3,056	11,922	3,974
Kansas	6,986	7,096	4,676	18,758	6,253
Kentucky	8,656	9,125	7,098	24,879	8,293
Louisiana	6,033	7,169	6,091	19,293	6,431
Maine	2,304	2,914	2,360	7,578	2,526
Maryland	23,366	28,045	32,406	83,817	27,939
Massachusetts	14,513	19,401	11,760	45,674	15,225
Michigan	21,014	22,918	15,466	59,398	19,799
Minnesota	26,875	29,609	15,632	72,116	24,039
Mississippi	4,122	4,716	3,218	12,056	4,019
Missouri	14,251	15,995	11,266	41,512	13,837
Montana	2,589	2,912	1,777	7,278	2,426

State	Gross Mortgage Originations for Owner-Occupied Homes 1992	1993	1994	Three-Year Total	Average Annual Mortgage Originations
Nebraska	4,242	5,070	2,188	11,500	3,833
Nevada	5,960	7,282	7,568	20,810	6,937
New Hampshire	2,415	3,156	2,461	8,032	2,677
New Jersey	22,194	19,736	11,805	53,735	17,912
New Mexico	4,078	4,656	3,634	12,368	4,123
New York	36,824	36,750	33,956	107,530	35,843
North Carolina	21,943	23,303	16,221	61,467	20,489
North Dakota	2,801	3,626	2,090	8,517	2,839
Ohio	25,532	29,422	21,376	76,330	25,443
Oklahoma	6,481	7,387	5,474	19,342	6,447
Oregon	5,925	6,559	5,267	17,751	5,917
Pennsylvania	27,263	33,214	20,361	80,838	26,946
Rhode Island	2,071	3,301	1,720	7,092	2,364
South Carolina	8,019	8,470	6,447	22,936	7,645
South Dakota	1,579	1,565	922	4,066	1,355
Tennessee	14,029	18,395	13,458	45,882	15,294
Texas	41,049	49,761	41,681	132,491	44,164
Utah	9,138	11,988	7,381	28,507	9,502
Vermont	992	1,260	891	3,143	1,048
Virginia	32,722	42,008	29,670	104,400	34,800
Washington	18,779	22,076	18,063	58,918	19,639
West Virginia	2,417	2,658	2,039	7,114	2,371
Wisconsin	13,244	12,833	8,664	34,741	11,580
Wyoming	1,527	1,490	1,834	4,851	1,617
Guam	99	94	88	281	94
Puerto Rico	5,008	7,354	7,990	20,352	6,784
Virgin Islands	104	66	74	244	81

SECTION 4. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 95–14 is obsolete except as provided in section 5.02 of this revenue procedure.

SECTION 5. EFFECTIVE DATES

.01 Issuers of qualified mortgage bonds or mortgage credit certificates may rely on this revenue procedure during the period beginning March 3, 1997, the date of publication of this revenue procedure in the Internal Revenue Bulletin, and ending on the date as of which this revenue procedure is rendered obsolete by a new revenue procedure.

.02 With respect to qualified mortgage bonds sold, and bond authority elected to be exchanged for authority to issue mortgage credit certificates, before April 2, 1997, 30 days after the publication of this Rev. Proc. 97–17 in the Internal Revenue Bulletin, issuers may continue to rely on the list of average annual mortgage originations that is contained in Rev. Proc. 95–14.

Drafting Information

The principal author of this revenue procedure is Patricia M. Monahan of the Office of Assistant Chief Counsel (Financial Institutions and Products). For further information regarding this revenue procedure contact Ms. Monahan on (202) 622–4122 (not a toll-free call).

Social Security

Domestic Employee Coverage Threshold

General. Section 2 of the ''Social Security Domestic Employment Reform Act of 1994'' (Pub. L. 103–387) increased the threshold for coverage of a domestic employee's wages paid per employer from $50 per calendar quarter to $1,000 in calendar year 1994. The statute holds the coverage threshold at the $1,000 level for 1995 and then increases the threshold in $100 increments for years after 1995. The formula for increasing the threshold is provided in section 3121(x) of the Internal Revenue Code.

Computation. Under the new formula, the domestic employee coverage threshold amount for 1997 shall be equal to the 1995 amount of $1,000 multiplied by the ratio of the national average wage index for 1995 to that for 1993. The national average wage index for 1993 was previously determined to be $23,132.67. The national average wage index for 1995 is $24,705.66 as determined above. If the amount so determined is not a multiple of $100, it shall be rounded to the next lower multiple of $100.

Domestic Employee Coverage Threshold Amount. The ratio of the national average wage index for 1995, $24,705.66, compared to that for 1993, $23,132.67, is 1.0679986. Multiplying the 1995 domestic employee coverage threshold amount of $1,000 by the ratio of 1.0679986 produces the amount of $1,068.00, which must then be rounded to $1,000. Accordingly, the domestic employee coverage threshold amount is determined to be $1,000 for 1997.

Part IV. Items of General Interest

Notice of Proposed Rulemaking Inflation-Indexed Debt Instruments

REG–242996–96

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: In T.D. 8709, page 5, the IRS is issuing temporary regulations relating to the federal income tax treatment of inflation-indexed debt instruments, including Treasury Inflation-Indexed Securities. The text of the temporary regulations also serves as the text of the proposed regulations. This document also provides notice of a public hearing on the proposed regulations.

DATES: Comments must be received by April 7, 1997. Requests to appear and outlines of topics to be discussed at the public hearing scheduled for April 30, 1997, at 10 a.m. must be received by April 9, 1997.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–242996–96), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG–242996–96), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the internet by selecting the "Tax Regs" option of the IRS Home Page or by submitting comments directly to the IRS internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. A public hearing will be held in the NYU Classroom, room 2615, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, William E. Blanchard, (202) 622–3950, or Jeffrey W. Maddrey, (202) 622–3940; concerning submissions and the hearing, Mike Slaughter, (202) 622–7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

T.D. 8709 amends the Income Tax Regulations (26 CFR part 1) relating to sections 1275 and 1286 of the Internal Revenue Code. The temporary regulations provide rules relating to inflation-indexed debt instruments, including Treasury Inflation-Indexed Securities.

The text of the temporary regulations also serves as the text of the proposed regulations. The preamble to the temporary regulations explains the temporary regulations.

Special Analyses

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

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely (in the manner described in the ADDRESSES portion of this preamble) to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for April 30, 1997, at 10 a.m. in the NYU Classroom, room 2615, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC. Because of access restrictions, visitors will not be admitted beyond the building lobby more than 15 minutes before the hearing starts.

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

Persons who wish to present oral comments at the hearing must submit comments by April 7, 1997, and submit an outline of the topics to be discussed and the time to be devoted to each topic by April 9, 1997.

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

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

Drafting Information

The principal author of these regulations is William E. Blanchard, Office of Assistant Chief Counsel (Financial Institutions and Products). However, other personnel from the IRS and the Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

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

Part 1—INCOME TAXES

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

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

Section 1.1275–7 also issued under 26 U.S.C. 1275(d). ***

Section 1.1286–2 also issued under 26 U.S.C. 1286(f). ***

Par. 2. Section 1.1275–7 is added to read as follows:

§ 1.1275–7 Inflation-indexed debt instruments.

[The text of this proposed section is the same as the text of § 1.1275–7T published in T.D. 8709, page 5.]

Par. 3. Section 1.1286–2 is added to read as follows:

§ 1.1286–2 Inflation-indexed debt instruments.

[The text of this proposed section is the same as the text of § 1.1286–2T published in T.D. 8709, page 5.]

Margaret Milner Richardson,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on December 31, 1996, and published in the issue of the Federal Register for January 6, 1997, 62 F.R. 694)

Notice of Proposed Rulemaking and Notice of Public Hearing

Continuity of Interest and Business Enterprise

REG–252233–96

AGENCY: Internal Revenue Service (IRS), Treasury

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

SUMMARY: This document proposes rules providing that for certain reorganizations, transfers by the acquiring corporation of target assets or stock to certain controlled corporations, and under prescribed conditions, transfers of target assets to partnerships, will not disqualify the transaction from satisfying the continuity of interest and continuity of business enterprise requirements. This document also provides notice of a public hearing on these proposed regulations.

DATES: Comments must be received by April 3, 1997. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for Wednesday, May 7, 1997 must be received by Wednesday, April 16, 1997.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–252233–96), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (REG–252233–96), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the ''Tax Regs'' option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The public hearing will be held in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue NW, Washington DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Marlene Peake Oppenheim, (202) 622–7750; concerning submissions and the hearing, Christina Vasquez, (202) 622–6808 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) under section 368. The proposed regulations establish rules providing that for certain reorganizations transfers by the acquiring corporation of target corporation assets or stock to certain controlled corporations and under prescribed conditions transfers of target assets to partnerships, will not disqualify the transaction from satisfying the continuity of interest and continuity of business enterprise requirements.

Explanation of Proposed Regulations

A. Remote Continuity of interest

1. Overview

The Internal Revenue Code of 1986 (Code) provides general nonrecognition treatment for reorganizations specifically described in section 368 of the Code. Literal compliance with the statutory requirements is not sufficient, however, for nonrecognition treatment.

The Supreme Court, in *Groman v. Commissioner*, 302 U.S. 82 (1937), and *Helvering v. Bashford*, 302 U.S. 454 (1938), established the basis of what has become known as the ''remote continuity of interest doctrine.'' Under this doctrine, stock consideration received by the target corporation's (T) shareholders does not provide continuity unless the target assets or stock are ultimately held by the corporation that issued the stock. Thus, if T transfers its assets to an acquiring corporation (P), in exchange for stock of the corporation controlling P (see *Groman*), or if P acquires the T assets but pursuant to the plan of reorganization transfers them to a controlled subsidiary (S) (see *Bashford*), the continuity of interest requirement is not satisfied.

Congress has substantially limited the remote continuity of interest doctrine. In 1954, Congress enacted section 368(a)(2)(C) which provides that P's transfer of T assets acquired in a reorganization under section 368(a)(1)(A) (merger or consolidation) or section 368(a)(1)(C) (asset acquisition) to S does not disqualify the reorganization. Section 368(a)(1)(C) was also amended to provide that P can acquire T assets directly in exchange for voting stock of a corporation in control of P (a triangular C reorganization).

In the 1960's, the Treasury Department and IRS issued several revenue rulings attempting to clarify to what extent the remote continuity doctrine had remaining vitality. Where the guidance held that the remote continuity doctrine applied to disqualify the transaction from reorganization treatment, Congress at times responded by amending the relevant Code section and overturning the result. For example, Rev. Rul. 63–234 (1963–2 C.B. 148) held that remote continuity remained an issue for section 368(a)(1)(B) reorganizations. The following year Congress responded by amending section 368(a)(1)(B), permitting P to acquire T's stock in exchange for stock of the corporation controlling P (a triangular B reorganization). Congress also amended section 368(a)(2)(C) to provide that P can transfer T stock acquired in a reorganization under section 368(a)(1)(B) to S without disqualifying the reorganization.

Similarly, when Rev. Rul. 67–326 (1967–2 C.B. 143) held that a merger of T into S in exchange for stock of the corporation controlling S (a forward triangular merger) violated the continuity of interest doctrine, Congress responded in the following year by enacting section 368(a)(2)(D), which provides that a forward triangular merger qualifies as a section 368(a)(1)(A) reorganization.

In contrast, Rev. Rul. 64–73 (1964–1 C.B. 142) held that a transaction qualified as a section 368(a)(1)(C) reorganization where P and P's second tier subsidiary acquired all the T assets in exchange for P stock. The transaction was viewed as an acquisition of substantially all the T assets by P.

2. Transfers of T assets or stock to controlled corporations

The proposed regulations curtail the remote continuity of interest doctrine by providing that assets can be transferred among members of a ''qualified group.'' A qualified group consists of one or more chains of corporations connected through stock ownership with the ''issuing corporation,'' but only if the issuing corporation owns directly stock meeting the requirements of section 368(c) in at least one other corporation, and stock meeting the requirements of section 368(c) in each of the corporations (except the issuing corporation) is owned directly by one of the other corporations. The issuing corporation is the acquiring corporation (as that term is used in section 368(a)), except in transactions where use of stock of a corporation in control of the acquiring corporation is permitted. Where stock of the controlling corporation is used, the controlling corporation is the issuing corporation.

The proposed regulations generally permit transfers or successive transfers of assets or stock to members of the qualified group. Thus, continuity of interest is not violated where there are transfers or successive transfers of T stock (or transfers of the T assets after a T stock acquisition) or T assets (or transfers of the acquiring corporation's stock after a T asset acquisition) among members of the qualified group. The Treasury Department and IRS solicit comments on whether the qualified group should be defined other than by reference to section 368(c).

The proposed regulations are limited to asset or stock transfers following transactions that otherwise qualify as section 368(a)(1)(A), (B), (C), or (G) (meeting the requirements of sections 354(b)(1)(A) and (B)) reorganizations (covered reorganizations). Section 368(a)(2)(C) by its terms does not apply to acquisitive section 368(a)(1)(D) or section 368(a)(1)(F) reorganizations. The Treasury Department and IRS solicit comments as to whether the rules in the proposed regulations should be extended to these other reorganization provisions or to section 355 divisive transactions.

3. Transfer of T assets to a partnership

Whether the transfer of assets to a partnership (PRS) by the corporate transferor partner (PTR) disqualifies an otherwise qualifying covered reorganization depends in part on whether PRS is viewed as an aggregate of its partners or as an entity separate from the partners. The treatment of PRS as an aggregate or entity must be determined on the basis of the characterization most appropriate for the situation. H.R. Conf. Rep. No. 2543, 83d Cong., 2d Sess. 59 (1954). Cf. § 1.701–2(e)(1) of the Income Tax Regulations.

The Treasury Department and IRS believe it is appropriate to treat PRS as an aggregate of its partners in analyzing a transaction with respect to continuity of interest. Thus, the proposed regulations provide that PTR's transfer of T assets to PRS does not violate the continuity of interest requirement.

The proposed regulations do not permit the transfer of stock to PRS where the Code imposes a control requirement in section 368. See sections 368(a)(1)(B) and (C), sections 368(a)(2)(D) and (E), and section 368(a)(2)(C). In addition, the transfer of T assets to PRS may violate the continuity of business enterprise (COBE) requirement.

B. Continuity of business enterprise

1. Overview

Section 1.368–1(b) requires that reorganizations afford a continuity of business enterprise under modified corporate form. COBE requires that P either (i) continue T's historic business (business continuity) or (ii) use a significant portion of T's historic business assets in a business (asset continuity). § 1.368–1(d)(2). The proposed regulations provide a framework for applying the existing COBE regulations to situations where the T assets or stock are transferred to certain controlled corporations or assets are transferred to partnerships.

2. Transfer of T assets or stock to a controlled corporation

The proposed regulations provide that, under prescribed conditions, COBE is not violated by reason of the fact that part or all of the T assets or stock are transferred among members of a qualified group. Thus, the COBE requirement is not violated where there are transfers or successive transfers of T stock (or transfers of the T assets after a T stock acquisition) or T assets (or transfers of the acquiring corporation's stock after a T asset acquisition) among members of the qualified group.

3. Transfer of T assets to a partnership

The proposed regulations provide that, under prescribed conditions, COBE is not violated by reason of the fact that part or all of the T assets are transferred to PRS by PTR. The proposed regulations adopt an aggregate approach in determining whether COBE has been satisfied when T assets are transferred to PRS following a T asset or T stock acquisition. Thus, the proposed regulations provide that for purposes of the business continuity test, PTR will be treated as conducting a business of PRS if PTR has active and substantial management functions as a partner with regard to the business (cf. Rev. Rul. 92–17 (1992–1 C.B. 142)) or if PTR's partnership interest in PRS represents a significant interest in the PRS business. Furthermore, in determining whether PTR satisfies the asset continuity test (i) PTR will be treated as owning the assets of PRS in accordance with PTR's interest in PRS, and (ii) PTR will be treated as conducting a business of PRS under the rules applicable to business continuity.

COBE requires a facts and circumstances analysis. Thus, the proposed regulations also state that the fact that PTR meets the business continuity requirements of § 1.368–1(d)(2)(i) and 1(d)(3) through active and substantial management of a PRS business tends to establish COBE, but the fact that PTR conducts a PRS business is not alone sufficient.

C. Effect on other authorities

The proposed regulations apply only for the purpose of determining the effect that transfers of assets or stock following a reorganization have on the continuity of interest and COBE requirements. They do not address any other issues concerning the qualification of a transaction as a reorganization.

Thus, the proposed regulations do not expand the scope of triangular reorganizations. Under current law, a T asset or stock acquisition in exchange for stock of a grandparent (or higher tier) corporation does not qualify as a reorganization. See Rev. Rul. 74–564 (1974–2 C.B. 124) and Rev. Rul. 74–565 (1974–2 C.B. 125). The proposed regulations do not change this result.

The proposed regulations do not provide guidance on whether the "solely for voting stock" requirement is satisfied in a section 368(a)(1)(C) reorganization when a corporation other than the acquiring corporation assumes target liabilities. See generally Rev. Rul. 70–107 (1970–1 C.B. 78).

Furthermore, the proposed regulations do not modify the section 381 regulations which provide rules concerning which entity inherits the tax attributes of T in an asset acquisition.

The Treasury Department and IRS solicit comments on these issues.

Proposed Effective Date

The revisions and additions in the proposed regulations apply to transactions occurring after these regulations are published as final regulations in the **Federal Register**, except that they shall not apply to transactions occurring pursuant to a written agreement which is (subject to customary conditions) binding on or before these regulations are published as final regulations in the **Federal Register**.

Effect on Other Documents

The Treasury Department and IRS solicit comments on what IRS publications should be modified or obsoleted when the proposed regulations are published as final regulations.

Special Analyses

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

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight copies) that are submitted timely to the Internal Revenue Service. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the ''Tax Regs'' option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. All comments will be available for public inspection and copying.

A public hearing has been scheduled for Wednesday, May 7, 1997, beginning at 10 a.m., in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

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

Persons who wish to present oral comments at the hearing must request to speak, and submit an outline of topics to be discussed and the time to be devoted to each topic by Wednesday, April 16, 1997.

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

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

Drafting Information

The principal author of the proposed regulations is Marlene Peake Oppenheim of the Office of Assistant Chief Counsel (Corporate), IRS. However, other personnel from the Treasury and IRS participated in their development.

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.368–1 as proposed to be amended at 61 FR 67514 is amended by:

1. Adding two sentences after the sixth sentence of paragraph (b).
2. Redesignating paragraph (d)(5) as paragraph (d)(6).
3. Adding a new paragraph (d)(5).
4. Adding three sentences to the end of newly designated paragraph (d)(6) introductory text.
5. Adding *Example 6* through *Example 10* to newly designated paragraph (d)(6).
6. Adding paragraph (f).

The additions read as follows:

§ 1.368–1 Purpose and scope of exception of reorganization exchanges.

* * * * *

(b) * * * Rules concerning continuity of interest as applied to section 368(a)(1)(A), (B), (C), or (G) (meeting the requirements of sections 354(b)(1)(A) and (B)) are in paragraph (f) of this section. The preceding sentence applies to transactions occurring after these regulations are published as final regulations in the **Federal Register** except that it shall not apply to any transactions occurring pursuant to a written agreement which is (subject to customary conditions) binding on or before these regulations are published as final regulations in the **Federal Register**. * * *

* * * * *

(d) * * *

(5) *Transfers of assets or stock to controlled corporations and partnerships*—(i) *Scope*. The following rules of paragraphs (d)(5)(ii) through (vi) of this section apply in determining whether the continuity of business enterprise requirement of paragraph (d)(1) of this section is satisfied with respect to transactions otherwise qualifying as reorganizations under section 368(a)(1)(A), (B), (C), or (G) (meeting the requirements of sections 354(b)(1)(A) and (B)).

(ii) *Transfers to members of a qualified group*. Continuity of business enterprise continues to be satisfied where there are transfers or successive transfers of target (T) stock (or transfers of T assets after a stock acquisition) or T assets (or transfers of the acquiring corporation's stock after a T asset acquisition) among members of a qualified group as defined in paragraph (d)(5)(iii) of this section.

(iii) *Qualified group*. A qualified group is one or more chains of corporations connected through stock ownership with the issuing corporation as defined in paragraph (d)(5)(iv) of this section, but only if the issuing corporation owns directly stock meeting the requirements of section 368(c) in at least one other corporation, and stock meeting the requirements of section 368(c) in each of the corporations (except the issuing corporation) is owned directly by one of the other corporations.

(iv) *Issuing corporation*. The issuing corporation is the acquiring corporation (as that term is used in section 368(a)), except in transactions where the use of stock of a corporation in control of the acquiring corporation is permitted. Where stock of the controlling corporation is used, the controlling corporation is the issuing corporation.

(v) *Partnerships*—(A) For purposes of the business continuity test of paragraph (d)(3) of this section, the corporate transferor partner (PTR) will be treated as conducting a business of a partnership (PRS) where—

(*1*) PTR has active and substantial management functions as a partner with respect to the PRS business; or

(*2*) PTR's interest in PRS represents a significant interest in the PRS business.

(B) For purposes of the asset continuity test of paragraph (d)(4) of this section—

(*1*) PTR will be treated as owning the assets of PRS in accordance with PTR's interest in PRS; and

(*2*) PTR will be treated as conducting a PRS business if PTR meets the requirement of paragraph (d)(5)(v)(A)(*1*) or (*2*) of this section.

(C) The fact that PTR is treated as conducting a business of PRS under paragraph (d)(5)(v)(A) of this section tends to establish the requisite continuity, but is not alone sufficient.

(vi) This paragraph (d)(5) applies to transactions occurring after these regulations are published as final regulations in the **Federal Register** except that it shall not apply to any transactions occurring pursuant to a written agreement which is (subject to customary conditions) binding on or before these regulations are published as final regulations in the **Federal Register**.

(6) * * * All corporations have only one class of common stock outstanding. *Example 6* through *Example 10* of this paragraph (d)(6) apply to transactions occurring after these regulations are published as final regulations in the **Federal Register** except that they shall not apply to any transactions occurring pursuant to a written agreement which is (subject to customary conditions) binding on or before these regulations are published as final regulations in the **Federal Register**. The examples are as follows:

* * * * *

Example 6. Qualified group and business continuity. (a) Facts. T operates a bakery which makes and supplies delectable pastries and cookies to a few select locations. The acquiring corporate group consists of numerous corporations which produce a variety of baked goods for distribution around the world. Holding Company (HC) owns 80 percent of the stock of P. Pursuant to a plan, T transfers all of its assets to P solely in exchange for HC voting stock, which T distributes to its shareholders. P owns 80 percent of the stock of S1; S1 owns 80 percent of the stock of S2, which also makes and supplies pastries and cookies. To amalgamate the T business into HC's affiliated group, P would like to operate T's business in S2. Pursuant to the plan, P transfers the T assets to S1; S1 then transfers the T assets to S2.

(b) *Continuity of business enterprise*. HC, P, S1, and S2 are members of a qualified group as defined in paragraph (d)(5)(iii) of this section. Under paragraph (d)(5)(ii) of this section, continuity of business enterprise continues to be satisfied where T's historic business is transferred to a member of the qualified group. The same results would occur if T had been acquired by P for HC voting stock in a reorganization described in section 368(a)(1)(B) and the T stock had been transferred from P to S1 and from S1 to S2.

Example 7. Transfers of assets to multiple controlled corporations. (a) *Facts*. T operates an auto parts distributorship. Pursuant to a plan, T merges into P and the T shareholders receive solely P stock. P owns 80 percent of the stock of S1. S1 owns 80 percent of the stock of ten subsidiaries, S2 through S11. S2 through S11 each separately operate a full service gas station. As part of the plan, P transfers T's auto parts to S1, which in turn transfers some of the parts to each of its ten subsidiaries. No one subsidiary receives a significant portion of T's historic business assets. Each of S1's subsidiaries will use the T assets received in the operation of its full service gas station. No S1 subsidiary will be an auto parts distributor.

(b) *Continuity of business enterprise*. P, S1, and the respective subsidiaries are members of a qualified group as defined in paragraph (d)(5)(iii) of this section. Under paragraph (d)(5)(ii) of this section, continuity of business enterprise continues to be satisfied where all of T's historic business assets are transferred among members of the qualified group. Even though no one corporation is using a significant portion of T's historic business assets in a business, the continuity of business enterprise requirement is satisfied because the qualified group is using a significant portion of T's historic business assets in a business.

Example 8. Transfer of a historic T business to PRS — active and substantial management. (a) *Facts*. T manufactures custom ski boots. T transfers all of its assets to P solely in exchange for P voting stock, which T then distributes to its shareholders. P plans to continue manufacturing ski boots and to expand this operation. As part of the expansion, P and R (an unrelated party) form a new partnership (PRS). As part of the plan of reorganization, P (PTR) transfers T's ski boot business to PRS in exchange for a 20 percent interest in PRS. R transfers cash in exchange for its interest in PRS. PTR performs active and substantial management functions for PRS including the decision-making regarding significant business decisions of PRS and regular participation in the overall supervision, direction and control of the employees of PRS in operating the ski boot business.

(b) *Continuity of business enterprise*. Under paragraph (d)(5)(v)(A)(*1*) of this section, PTR is treated as conducting T's historic business because the officers of PTR perform active and substantial management functions for the ski boot business in PRS. Thus, the continuity of business enterprise requirement is satisfied because PTR is treated as continuing to conduct T's historic business.

(c) *Continuity of interest*. Under paragraph (f)(1)(ii) of this section, the continuity of interest requirement is satisfied even though the assets are transferred to PRS in exchange for an interest in PRS.

Example 9. Transfer of a historic T business to PRS — significant interest. (a) *Facts*. The facts are the same as in Example 8 except that PTR's officers do not operate the ski boot business, and PTR owns a 33 1/3 percent interest in PRS.

(b) *Continuity of business enterprise*. Under paragraph (d)(5)(v)(A)(2) of this section, PTR is treated as conducting T's historic ski boot business because PTR's 33 1/3 percent interest in PRS represents a significant interest in the PRS ski boot business.

(c) *Continuity of interest*. Under paragraph (f)(1)(ii) of this section, the continuity of interest requirement is satisfied even though the assets are transferred to PRS in exchange for an interest in PRS.

Example 10. Transfer of T's historic assets to PRS. (a) *Facts*. T manufactures silk. T transfers all of its assets to P solely in exchange for P voting stock, which T then distributes to its shareholders. P manufactures clothing and has been buying silk from T. P (PTR) and R (an unrelated party) own interests in a partnership (PRS) which owns and maintains warehouse facilities. As part of the plan of reorganization, PTR transfers the T assets to PRS, increasing PTR's percentage interest in PRS from 20 to 33 1/3 percent. PTR decides to buy its silk from a different manufacturer and converts T's plant facilities into warehouses.

(b) *Continuity of business enterprise*. Under paragraph (d)(5)(v)(A)(2), PTR is treated as being in the business of owning and maintaining warehouse space because of PTR's significant interest in PRS. Furthermore, under paragraph (d)(5)(v)(B) of this section, PTR is treated as owning the assets of PRS in accordance with its interest in the partnership. Thus, the continuity of business enterprise requirement is satisfied because PTR continues to use a significant portion of T's historic assets in a business.

(c) *Continuity of interest*. Under paragraph (f)(1)(ii) of this section, the continuity of interest requirement continues to be satisfied even though the assets are transferred to PRS in exchange for an interest in PRS.

* * * * *

(f) *Continuity of interest and asset or stock transfers*. (1) *Scope*. The following rules apply to transactions otherwise qualifying as a reorganization under section 368(a)(1)(A), (B), (C), or (G) (meeting the requirements of sections 354(b)(1)(A) and (B)):

(i) *Transfers to members of a qualified group*. Continuity of interest is satisfied where there are transfers or successive transfers of target (T) stock (or transfers of T assets after a stock acquisition) or T assets (or transfers of the acquiring corporation's stock after a T asset acquisition) among members of a qualified group as defined in paragraph (d)(5)(iii) of this section.

(ii) *Partnerships*. Continuity of interest is satisfied even where T assets (or transfers of T assets following a T stock acquisition) are transferred to a partnership in exchange for a partnership interest.

(2) *Example*. The rules of this paragraph (f) are illustrated by the following example. P represents the acquiring corporation and T represents the target corporation. Also see *Example 8* through *Example 10* in paragraph (d)(6) of this section. The example is as follows:

Example. Transfers to corporations in the qualified group. (a) *Facts*. T manufactures playground equipment, including launch ramps and half pipes for skateboarding, in-line skating, and bicycling. The P affiliated group is engaged in architectural design and construction. A holding company (HC) owns 80 percent of the stock of each of P and S1. S1 in turn, owns 80 percent of the stock of S2, and S2 owns 80 percent of the stock of S3. T transfers all of its assets to P in exchange for HC voting stock, which T distributes to its shareholders. HC transfers all of the P stock to S1. S1 in turn transfers all of the P stock to S2, and S2 transfers the P stock to S3.

(b) *Continuity of interest*. HC, P, S1, S2 and S3 are members of a qualified group as defined in paragraph (d)(5)(iii) of this section. Under paragraph (f)(1)(i) of this section, the successive transfers of the P stock to other members of the qualified group do not violate the continuity of interest requirement.

Par. 3. In § 1.368–2, paragraph (f) is amended by removing the second sentence and adding two new sentences in its place to read as follows:

§ 1.368–2 Definition of terms.

* * * * *

(f) * * * A corporation remains a party to the reorganization even though assets are transferred among members of a qualified group as defined in § 1.368–1(d)(5)(iii). The preceding sentence applies to transactions occurring after these regulations are published as final regulations in the **Federal Register** except that it shall not apply to any transactions occurring pursuant to a written agreement which is (subject to customary conditions) binding on or before these regulations are published as final regulations in the Federal Register. * * *

* * * * *

Margaret Milner Richardson,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on January 2, 1997, 8:45 a.m., and published in the issue of the Federal Register for January 3, 1997, 62 F.R. 361)

Rev. Proc. 97–10; Correction

Announcement 97–15

This announcement is a correction to Rev. Proc. 97–10, 1997–2 I.R.B. 59, which provides the exclusive procedure for making the election under § 1120 of the Small Business Job Protection Act of 1996 to treat a retail motor fuels outlet placed in service before August 20, 1996, as 15-year property under § 168 of the Code. As the result of a printing error, two dates were omitted from the revenue procedure. The date ''July 14, 1997,'' should be inserted in section 5.04(1) of the revenue procedure. The date ''January 13, 1997,'' should be inserted in section 5.06(2) of the revenue procedure.

The principal author of this announcement is Mark Pitzer of the Office of Assistant Chief Counsel (Passthroughs and Special Industries). For further information regarding this announcement, contact Mark Pitzer at (202) 622–3110 (not a toll-free call).

Announcement 97–16

The following correction should be made to Notice 97–9, Adoption Assistance, 1997–2 I.R.B. 35.

The second sentence of the first paragraph of Section VI. ''Comments on Future Guidance Invited'' should be corrected to read: ''The Service requests that written comments be submitted by April 14, 1997.'' It currently says ''The Service requests that written comments be submitted by [INSERT DATE THAT IS [90] DAYS AFTER DATE OF PUBLICATION OF THIS DOCUMENT IN THE INTERNAL REVENUE BULLETIN].'' A new sentence three is added as follows: ''All comments will be available for public inspection and copying.''

Foundations Status of Certain Organizations

Announcement 97–17

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

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

A Cord, Inc., Princeton, NJ
Active Community Coalition Efforts Sponsored by Students, Philadelphia, PA
Adolescent Health Partnership Inc., Philadelphia, PA
Alliance for Developmentally Disabled Adults, Inc., Quincy, MA
Alpha Alpha Scholarship Fund, Inc., Stamford, CT
American Friends of Manchester Seminary for Girls, Brooklyn, NY
Annapolis Childrens Foundation Inc., Annapolis, MD
Archetype Dance Company, Philadelphia, PA
Archway Foundation Inc., Atco, NJ
Arcland Properties, Inc., Rochester, NY
Arc Partnership of the District of Columbia, Inc., Washington, DC
Arthur Ashe Athletic Association, New York, NY
Baby Steps, Inc., Norfolk, VA
Backbone Housing Inc., Baltimore, MD
Belleview Parkview Players, Inc., Belleview, FL
Bienvenidos, Inc., Alexandria, VA
Birmingham CDC Inc., Birmingham, AL
Brunswick Bruins Hockey Booster Club, Inc., Greenwich, CT
Bryant & Stratton Alumni Association of Western NY, Buffalo, NY
Buffalo League of Public Housing Tenants, Buffalo, NY
Building the Way, Temecula, CA
Butterfly Property Management, Freehold, NJ
Carolina Community Development Corporation, Raleigh, NC
Center for Community Education Action, Inc., Northampton, MA
Center for Education and Economic Development, Washington, DC
Center for Partnership Education, Middletown, NY
Center for Perpetual Help, Inc., Brooklyn, NY
Chadd of Lebanon County, Lebanon, PA
Chain Lightning Theatre, Inc., New York, NY
Chester Economic Development and Tenant Management Corporation, Chester, PA
Chestnut House Living History Center, Glen, NY
Childrens World of Safety Inc., Dayton, OH
Chimes Metro Inc., Baltimore, MD
Christian Community Challenge for Change, Inc., Bronx, NY
Christmas in April-Atlanta Inc., Atlanta, GA
Christmas in April of Richmond, Richmond, VA
Christmas in April New Haven, Inc., New Haven, CT
Citizens for a Maryland Monument in Gettysburg, Inc., Baltimore, MD
City of Manassas Housing Trust Fund Incorporated, Manassas, VA
Coalition for Pregnant and Parenting Teens, North Plymouth, MA
Committee for New York City 340th Anniversary Celebration, Inc., New York, NY
Community Counseling Center of Worcester County Inc., Snowhill, MD
Concerns About Kids Environment, Freeport, ME
Concerts at the Old Library Theatre, Inc., Fairlawn, NJ
Connecticut Senior Housing Improvement Program, Inc., Manchester, CT
Connecticut Suicide Education Foundation, Inc., West Hartford, CT

Consortium for Affordable Home Financing Inc., West Palm Beach, FL
County of Amherst Lifelong Learning Literacy Council Call, Amhurst, VA
Creative Greenhouse, Blue Bell, PA
Dare to Care, Sea Girt, NJ
Delanco Playground Association, Inc., Delanco, NJ
Delaware Valley Partnership for Healthy Babies, Philadelphia, PA
Desert Storm Fund of Michigan, Warren, MI
Drew County Literacy Council, Inc., Monticello, AR
Emergency Fuel Group, Philadelphia, PA
Emergency Medical Services Training Foundation of Western MD Inc., Cumberland, MD
Essential Theatre, Washington, DC
Fathers Heart Family Ministries, Inc., Trenton, NJ
Fayette Housing Development Corporation, Union Town, PA
First Health Alliance, Inc., Pittsburgh, PA
For Students Sake, Fairfax, VA
Foundation for Emergency Medical Education and Research, Richmond, VA
Frederick B. Abramson, Inc., Washington, DC
Friends of Victim Witness Serving Loudoun County Virginia, Inc., Leesburg, VA
Friendship Center Inc., Hackettstown, NJ
G B Charities, Inc., Baltimore, MD
Given Wings, Inc., Pittsburgh, PA
Greater Paterson Lou Costello Memorial Inc., Paterson, NJ
G V J T C Inc., San Juan, PR
Institute for African American Development, Philadephia, PA
Institute for Educational Transformation, Fairfax, VA
Institute for the Development of African American Youth, Inc., Philadelphia, PA
Ivy Towers Community Development Corporation, Newport News, VA
Jamaica Progressive League, Inc., Philadelphia, PA
Joint Venture Communications, Washington, DC
Kappa Delta Rho Educational Foundation, Inc., Greensburg, PA
K D A P P, Incorporated, Honesdale, PA
Ken-Crest Housing Del II Inc., Plymouth Meeting, PA
Ken-Crest Housing PA II Inc., Plymouth Meeting, PA
Lakewood Soccer Inc., Lakewood, NJ
La Noche AC Asociacion Civil, Mexico
Liberty Medical Associates, Inc., Baltimore, MD
Life Enhancement Seminars, Inc., Philadelphia, PA
Living Arts Repertory Theatre, Inc., Westmont, NJ
Manos Unidas Community Development Corporation, Philadelphia, PA
Marision Messiah Group Home, Inc., Vineland, NJ
My House, Amityville, NY
National Road Heritage Park of Pennsylvania, Farmington, PA
Northwest New Mexico Fighting Back, Inc., Gallup, NM
Olive Dale Senior Citizens of Fairfield County Ohio, Lancaster, OH
Pacific Research Institute, Eugene, OR
Peer Counseling for Families Headed by Women, Jackson, MS
PVC Trust Fund, Ann Arbor, MI
Restaurants United to Serve the Homeless, Inc., Louisville, KY
St. Augustine Technical Center Foundation, Inc., St. Augustine, FL
Training Registry, Inc., Olney, MD
Trinity Life Center Es, Rosenberg, TX
Tri Prevention Services, San Francisco, CA
Ujima, Trenton, NJ
Vision India, Inc., Columbus, OH

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

Section 7428(c) Validation of Certain Contributions Made During Pendency of Declaratory Judgment Proceedings

This announcement serves notice to potential donors that the organization listed below has recently filed a timely declaratory judgment suit under section 7428 of the Code, challenging revocation of its status as an eligible donee under section 170(c)(2).

Protection under section 7428(c) of the Code begins on the date that the notice of revocation is published in the Internal Revenue Bulletin and ends on the date on which a court first determines that an organization is not described in section 170(c)(2), as more particularly set forth in section 7428(c)(1). In the case of individual contributors, the maximum amount of contributions protected during this period is limited to $1,000.00, with a husband and wife being treated as one contributor. This protection is not extended to any individual who was responsible, in whole or in part, for the acts or omissions of the organization that were the basis for the revocation. This protection also applies (but without limitation as to amount) to organizations described in section 170(c)(2) which are exempt from tax under section 501(a). If the organization ultimately prevails in its declaratory judgment suit, deductibility of contributions would be subject to the normal limitations set forth under section 170.

Charles E. Stevens American Atheist Library and Archives, Inc. Austin, TX

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[1]A cumulative finding list for previously published items mentioned in Internal Revenue Bulletins 1996–27 through 1996–53 will be found in Internal Revenue Bulletin 1997–1, dated January 6, 1997.

Definition of Terms

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

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

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

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

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

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

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

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

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

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

Abbreviations

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

A—Individual.

Acq.—Acquiescence.

B—Individual.

BE—Beneficiary.

BK—Bank.

B.T.A.—Board of Tax Appeals.

C.—Individual.

C.B.—Cumulative Bulletin.

CFR—Code of Federal Regulations.

CI—City.

COOP—Cooperative.

Ct.D.—Court Decision.

CY—County.

D—Decedent.

DC—Dummy Corporation.

DE—Donee.

Del. Order—Delegation Order.

DISC—Domestic International Sales Corporation.

DR—Donor.

E—Estate.

EE—Employee.

E.O.—Executive Order.

ER—Employer.

ERISA—Employee Retirement Income Security Act.

EX—Executor.

F—Fiduciary.

FC—Foreign Country.

FICA—Federal Insurance Contribution Act.

FISC—Foreign International Sales Company.

FPH—Foreign Personal Holding Company.

F.R.—Federal Register.

FUTA—Federal Unemployment Tax Act.

FX—Foreign Corporation.

G.C.M.—Chief Counsel's Memorandum.

GE—Grantee.

GP—General Partner.

GR—Grantor.

IC—Insurance Company.

I.R.B.—Internal Revenue Bulletin.

LE—Lessee.

LP—Limited Partner.

LR—Lessor.

M—Minor.

Nonacq.—Nonacquiescence.

O—Organization.

P—Parent Corporation.

PHC—Personal Holding Company.

PO—Possession of the U.S.

PR—Partner.

PRS—Partnership.

PTE—Prohibited Transaction Exemption.

Pub. L.—Public Law.

REIT—Real Estate Investment Trust.

Rev. Proc.—Revenue Procedure.

Rev. Rul.—Revenue Ruling.

S—Subsidiary.

S.P.R.—Statements of Procedural Rules.

Stat.—Statutes at Large.

T—Target Corporation.

T.C.—Tax Court.

T.D.—Treasury Decision.

TFE—Transferee.

TFR—Transferor.

T.I.R.—Technical Information Release.

TP—Taxpayer.

TR—Trust.

TT—Trustee.

U.S.C.—United States Code.

X—Corporation.

Y—Corporation.

Z—Corporation.

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Key to Abbreviations:

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

EMPLOYMENT TAX

EXCISE TAX

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INCOME TAX—Continued

INCOME TAX—Continued

INCOME TAX—Continued