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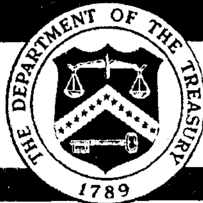
DEPARTMENT OF THE TREASURY

TREASURY NEWS



OFFICE OF PUBLIC AFFAIRS • 1500 PENNSYLVANIA AVENUE, N.W. • WASHINGTON, D.C. • 20220 • (202) 622-2960

EMBARGOED UNTIL 11:00 A.M.
November 27, 2002

CONTACT: Office of Financing
202/691-3550

TREASURY OFFERS 13-WEEK AND 26-WEEK BILLS

The Treasury will auction 13-week and 26-week Treasury bills totaling $29,000 million to refund an estimated $29,818 million of publicly held 13-week and 26-week Treasury bills maturing December 5, 2002, and to pay down approximately $818 million. Also maturing is an estimated $16,000 million of publicly held 4-week Treasury bills, the disposition of which will be announced December 2, 2002.

The Federal Reserve System holds $12,975 million of the Treasury bills maturing on December 5, 2002, in the System Open Market Account (SOMA). This amount may be refunded at the highest discount rate of accepted competitive tenders either in these auctions or the 4-week Treasury bill auction to be held December 3, 2002. Amounts awarded to SOMA will be in addition to the offering amount.

Up to $1,000 million in noncompetitive bids from Foreign and International Monetary Authority (FIMA) accounts bidding through the Federal Reserve Bank of New York will be included within the offering amount of each auction. These noncompetitive bids will have a limit of $100 million per account and will be accepted in the order of smallest to largest, up to the aggregate award limit of $1,000 million.

TreasuryDirect customers have requested that we reinvest their maturing holdings of approximately $1,096 million into the 13-week bill and $815 million into the 26-week bill.

The allocation percentage applied to bids awarded at the highest discount rate will be rounded up to the next hundredth of a whole percentage point, e.g., 17.13%.

This offering of Treasury securities is governed by the terms and conditions set forth in the Uniform Offering Circular for the Sale and Issue of Marketable Book-Entry Treasury Bills, Notes, and Bonds (31 CFR Part 356, as amended).

Details about each of the new securities are given in the attached offering highlights.

oOo

Attachment

P)-3658

For press releases, speeches, public schedules and official biographies, call our 24-hour fax line at (202) 622-2040

HIGHLIGHTS OF TREASURY OFFERINGS OF BILLS
TO BE ISSUED DECEMBER 5, 2002

November 27, 2002

Offering Amount	$14,000 million	$15,000 million
Public Offering	$14,000 million	$15,000 million
NLP Exclusion Amount	$ 4,900 million	None
Description of Offering:		
Term and type of security	91-day bill	182-day bill
CUSIP number	912795 MB 4	912795 MQ 1
Auction date	December 2, 2002	December 2, 2002
Issue date	December 5, 2002	December 5, 2002
Maturity date	March 6, 2003	June 5, 2003
Original issue date	September 5, 2002	December 5, 2002
Currently outstanding	$19,474 million	---
Minimum bid amount and multiples	$1,000	$1,000

The following rules apply to all securities mentioned above:

Submission of Bids:

Noncompetitive bids: Accepted in full up to $1 million at the highest discount rate of accepted competitive bids.

Foreign and International Monetary Authority (FIMA) bids: Noncompetitive bids submitted through the Federal Reserve Banks as agents for FIMA accounts. Accepted in order of size from smallest to largest with no more than $100 million awarded per account. The total noncompetitive amount awarded to Federal Reserve Banks as agents for FIMA accounts will not exceed $1,000 million. A single bid that would cause the limit to be exceeded will be partially accepted in the amount that brings the aggregate award total to the $1,000 million limit. However, if there are two or more bids of equal amounts that would cause the limit to be exceeded, each will be prorated to avoid exceeding the limit.

Competitive bids:

(1) Must be expressed as a discount rate with three decimals in increments of .005%, e.g., 7.100%, 7.105%.
(2) Net long position (NLP) for each bidder must be reported when the sum of the total bid amount, at all discount rates, and the net long position is $1 billion or greater.
(3) Net long position must be determined as of one half-hour prior to the closing time for receipt of competitive tenders.

Maximum Recognized Bid at a Single Rate ....35% of public offering

Maximum Award ....35% of public offering

Receipt of Tenders:

Noncompetitive tenders..... Prior to 12:00 noon eastern standard time on auction day

Competitive tenders........ Prior to 1:00 p.m. eastern standard time on auction day

Payment Terms: By charge to a funds account at a Federal Reserve Bank on issue date, or payment of full par amount with tender. *TreasuryDirect* customers can use the Pay Direct feature which authorizes a charge to their account of record at their financial institution on issue date.

DEPARTMENT OF THE TREASURY

TREASURY NEWS

OFFICE OF PUBLIC AFFAIRS • 1500 PENNSYLVANIA AVENUE, N.W. • WASHINGTON, D.C. • 20220 • (202) 622-2960

EMBARGOED UNTIL 11:00 A.M.
December 2, 2002

Contact: Office of Financing
202/691-3550

TREASURY OFFERS 4-WEEK BILLS

The Treasury will auction 4-week Treasury bills totaling $21,000 million to refund an estimated $16,000 million of publicly held 4-week Treasury bills maturing December 5, 2002, and to raise new cash of approximately $5,000 million.

Tenders for 4-week Treasury bills to be held on the book-entry records of *TreasuryDirect* will not be accepted.

The Federal Reserve System holds $12,975 million of the Treasury bills maturing on December 5, 2002, in the System Open Market Account (SOMA). This amount may be refunded at the highest discount rate of accepted competitive tenders in this auction up to the balance of the amount not awarded in today's 13-week and 26-week Treasury bill auctions. Amounts awarded to SOMA will be in addition to the offering amount.

Up to $1,000 million in noncompetitive bids from Foreign and International Monetary Authority (FIMA) accounts bidding through the Federal Reserve Bank of New York will be included within the offering amount of the auction. These noncompetitive bids will have a limit of $100 million per account and will be accepted in the order of smallest to largest, up to the aggregate award limit of $1,000 million.

The allocation percentage applied to bids awarded at the highest discount rate will be rounded up to the next hundredth of a whole percentage point, e.g., 17.13%.

This offering of Treasury securities is governed by the terms and conditions set forth in the Uniform Offering Circular for the Sale and Issue of Marketable Book-Entry Treasury Bills, Notes, and Bonds (31 CFR Part 356, as amended).

Details about the new security are given in the attached offering highlights.

oOo

Attachment

PO-3659

HIGHLIGHTS OF TREASURY OFFERING
OF 4-WEEK BILLS TO BE ISSUED DECEMBER 5, 2002

December 2, 2002

Offering Amount....................$21,000 million
Public Offering....................$21,000 million
NLP Exclusion Amount...............$10,800 million

Description of Offering:
Term and type of security..........28-day bill
CUSIP number.......................912795 LS 8
Auction date.......................December 3, 2002
Issue date.........................December 5, 2002
Maturity date......................January 2, 2003
Original issue date................July 5, 2002
Currently outstanding..............$42,529 million
Minimum bid amount and multiples....$1,000

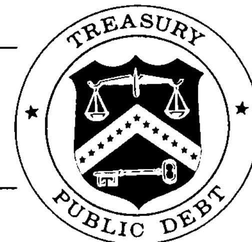
Submission of Bids:
Noncompetitive bids: Accepted in full up to $1 million at the highest discount rate of accepted competitive bids.
Foreign and International Monetary Authority (FIMA) bids: Noncompetitive bids submitted through the Federal Reserve Banks as agents for FIMA accounts. Accepted in order of size from smallest to largest with no more than $100 million awarded per account. The total noncompetitive amount awarded to Federal Reserve Banks as agents for FIMA accounts will not exceed $1,000 million. A single bid that would cause the limit to be exceeded will be partially accepted in the amount that brings the aggregate award total to the $1,000 million limit. However, if there are two or more bids of equal amounts that would cause the limit to be exceeded, each will be prorated to avoid exceeding the limit.
Competitive bids:
(1) Must be expressed as a discount rate with three decimals in increments of .005%, e.g., 4.215%.
(2) Net long position (NLP) for each bidder must be reported when the sum of the total bid amount, at all discount rates, and the net long position is $1 billion or greater.
(3) Net long position must be determined as of one half-hour prior to the closing time for receipt of competitive tenders.

Maximum Recognized Bid at a Single Rate...35% of public offering
Maximum Award..........................35% of public offering

Receipt of Tenders:
Noncompetitive tenders:
Prior to 12:00 noon eastern standard time on auction day
Competitive tenders:
Prior to 1:00 p.m. eastern standard time on auction day

Payment Terms: By charge to a funds account at a Federal Reserve Bank on issue date.

PUBLIC DEBT NEWS



Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

TREASURY SECURITY AUCTION RESULTS
BUREAU OF THE PUBLIC DEBT - WASHINGTON DC

FOR IMMEDIATE RELEASE
December 02, 2002

CONTACT: Office of Financing
202-691-3550

RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Term:	91-Day Bill
Issue Date:	December 05, 2002
Maturity Date:	March 06, 2003
CUSIP Number:	912795MB4

High Rate: 1.210% Investment Rate 1/: 1.231% Price: 99.694

All noncompetitive and successful competitive bidders were awarded securities at the high rate. Tenders at the high discount rate were allotted 53.47%. All tenders at lower rates were accepted in full.

AMOUNTS TENDERED AND ACCEPTED (in thousands)

Tender Type	Tendered	Accepted
Competitive	$ 34,604,737	$ 12,412,417
Noncompetitive	1,417,746	1,417,746
FIMA (noncompetitive)	170,000	170,000
SUBTOTAL	36,192,483	14,000,163 2/
Federal Reserve	5,041,805	5,041,805
TOTAL	$ 41,234,288	$ 19,041,968

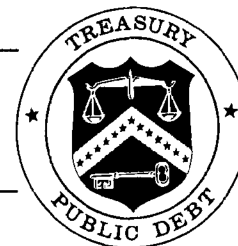
Median rate 1.200%: 50% of the amount of accepted competitive tenders was tendered at or below that rate. Low rate 1.185%: 5% of the amount of accepted competitive tenders was tendered at or below that rate.

Bid-to-Cover Ratio = 36,192,483 / 14,000,163 = 2.59

1/ Equivalent coupon-issue yield.
2/ Awards to TREASURY DIRECT = $1,185,836,000

PO-3660

PUBLIC DEBT NEWS



Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

TREASURY SECURITY AUCTION RESULTS
BUREAU OF THE PUBLIC DEBT - WASHINGTON DC

FOR IMMEDIATE RELEASE
December 02, 2002

CONTACT: Office of Financing
202-691-3550

RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Term: 182-Day Bill
Issue Date: December 05, 2002
Maturity Date: June 05, 2003
CUSIP Number: 912795MQ1

High Rate: 1.290% Investment Rate 1/: 1.316% Price: 99.348

All noncompetitive and successful competitive bidders were awarded securities at the high rate. Tenders at the high discount rate were allotted 51.31%. All tenders at lower rates were accepted in full.

AMOUNTS TENDERED AND ACCEPTED (in thousands)

Tender Type	Tendered	Accepted
Competitive	$ 28,366,512	$ 13,881,598
Noncompetitive	1,018,489	1,018,489
FIMA (noncompetitive)	100,000	100,000
SUBTOTAL	29,485,001	15,000,087 2/
Federal Reserve	5,629,661	5,629,661
TOTAL	$ 35,114,662	$ 20,629,748

Median rate 1.275%: 50% of the amount of accepted competitive tenders was tendered at or below that rate. Low rate 1.250%: 5% of the amount of accepted competitive tenders was tendered at or below that rate.

Bid-to-Cover Ratio = 29,485,001 / 15,000,087 = 1.97

1/ Equivalent coupon-issue yield.
2/ Awards to TREASURY DIRECT = $852,685,000

P03661

FROM THE OFFICE OF PUBLIC AFFAIRS

November 27, 2002
2002-11-27-16-29-9-5061

Treasury Establishes Exchange Stabilization Fund Web Page

Today the Treasury Department announced the establishment of a public web page for the Exchange Stabilization Fund (ESF). The purpose of the page is to provide explanatory information on the ESF and links to official reports in which the finances and operations of the ESF are reflected.

This is the first time that such comprehensive information has been assembled in one place that is readily usable by the public. Information in public documents on the ESF's operations and finances has long been considerable in scope, but many of these documents focus on the broader Treasury or U.S. government financial context of which the ESF is a part, rather than on the ESF itself. Also, the Treasury regularly provides the Congress with reports on ESF operations and finances, including an annual audit report. The new ESF web page makes such information easier to relate specifically to the ESF.

The view of the Treasury Department is that the public can benefit from a better understanding of role of the ESF and that the ESF web page will serve this purpose.

The ESF web page can be accessed at: www.treas.gov/offices/international-affairs/esf/index.html

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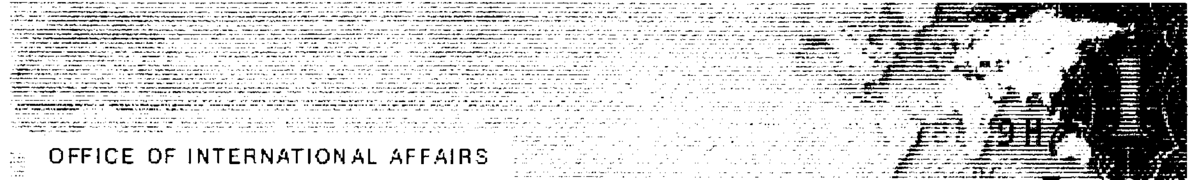
UNITED STATES
DEPARTMENT OF THE TREASURY



Exchange Stabilization Fund

INTRODUCTION

The Exchange Stabilization Fund (ESF) consists of three types of assets: U.S. dollars, foreign currencies, and Special Drawing Rights (SDRs)1. Currently, the ESF has a total of approximately $38 billion in these three assets.

The ESF can be used to purchase or sell foreign currencies, to hold U.S. foreign exchange and Special Drawing Rights (SDR) assets, and to provide financing to foreign governments. All operations of the ESF require the explicit authorization of the Secretary of the Treasury ("the Secretary").

The Secretary is responsible for the formulation and implementation of U.S. international monetary and financial policy, including exchange market intervention policy. The ESF helps the Secretary to carry out these responsibilities. By law, the Secretary has considerable discretion in the use of ESF resources.

The legal basis of the ESF is the Gold Reserve Act of 1934. As amended in the late 1970s, the Act provides in part that "the Department of the Treasury has a stabilization fund ...Consistent with the obligations of the Government in the International Monetary Fund (IMF) on orderly exchange arrangements and an orderly system of exchange rates, the Secretary ..., with the approval of the President, may deal in gold, foreign exchange, and other instruments of credit and securities."

1. The Special Drawing Rights, or SDR, is an international reserve asset that was created by the IMF as a supplement to existing reserve assets.

FROM THE OFFICE OF PUBLIC AFFAIRS

December 2, 2002
PO-3662

Media Advisory
Treasury Department Announces Interim Guidance on Terrorism Insurance for Insurance Industry at Tuesday News Conference

The Treasury Department tomorrow will announce interim guidance for the insurance industry in meeting certain requirements under the Terrorism Risk Insurance Act of 2002, signed into law by President Bush on Nov. 26, 2002.

Treasury Under Secretary Peter Fisher will announce the interim guidance at a news conference at 3:00 p.m. EST on Tuesday, Dec. 3, 2002, in the Media Room (Room 4121) at the Treasury Department, 1500 Pennsylvania Ave., N.W., Washington, DC. He will be joined by Terri Vaughan, president of the National Association of Insurance Commissioners and the Commissioner of Insurance for the state of Iowa.

The news conference will be web cast live at www.treasury.gov.

The room will be available for pre-set at 2:00 p.m. on Tuesday. Media without Treasury or White House press credentials planning to attend should contact Frances Anderson at Treasury's Office of Public Affairs at (202) 622-2960 by 1:00 p.m. on Tuesday with the following information: name, media organization, social security number and date of birth. This information also may be faxed to (202) 622-1999.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

To view or print the PDF content on this page, download the free Adobe® Acrobat® Reader®.

December 3, 2002
PO-3663

Treasury Department Announces Interim Guidance On Terrorism Insurance for Insurance Industry Treasury and State Insurance Commissioners Work Closely Together

The Treasury Department today announced interim guidance for the insurance industry in meeting certain requirements under the Terrorism Risk Insurance Act of 2002, which was signed into law by President Bush on November 26, 2002.

Treasury Under Secretary for Domestic Finance Peter R. Fisher outlined the interim guidance at a Treasury news conference. He was joined by National Association of Insurance Commissioners (NAIC) President Therese M. Vaughan, who also serves as Commissioner of Insurance for the state of Iowa.

"The Terrorism Risk Insurance Program became effective upon enactment by the President," said Fisher. "Commercial property and casualty insurance companies now are required to make terrorism insurance coverage available to their policyholders and, in many cases, such
coverage is in place today as a result of the legislation. That is good news for our economy.

"Through the working of the competitive marketplace, the economic benefits expected as a result of the Program should begin to be realized in the near term."

Fisher emphasized that the Program relies upon the state insurance oversight mechanism to monitor insurance companies' implementation of, and compliance with, many of the program's requirements. "Our partnership with the state insurance regulators has worked very well, and in the upcoming months Treasury will continue to work closely with the state insurance regulators on the implementation process," he said.

"State regulators will continue consulting with the Treasury Department on an array of implementation issues," said Vaughan.

"We are committed to a smooth implementation and want to help companies and regulators comply with the new law's requirements as quickly and uniformly as possible."

The interim guidance covers several mandates of the new law, including policyholder disclosure requirements and the requirement that insurance companies make coverage for terrorism risk, as defined by the Act, available to their policyholders. The interim guidance released today follows the NAIC's release of model disclosure forms last week. Treasury interim guidance states that use of the NAIC's model disclosures constitutes compliance with the Act's disclosure requirements while noting that the model disclosures are not the exclusive means by which insurers may comply with the Act.

Treasury's interim guidance also provides useful information to commercial entities that wish to obtain terrorism risk insurance. Insurance companies generally have 90 days to notify their policyholders of the Program and of any changes that may be

available in their insurance coverage and insurance premium as a result. In some cases, policyholders must respond affirmatively within 30 days of the notice in order to be covered under the Program.

Fisher also pointed to more work ahead for Treasury:

Near Term
Treasury plans to follow-up on the interim guidance by drafting regulations, where appropriate. It also expects to provide guidance or regulations in the near future on several other aspects of the program, including how Treasury intends to apply the law to captive insurers and other self-insurance arrangements.

Treasury today also released a request for public comment on group life insurance coverage. The Act requires Treasury to prepare, on an expedited basis, a study of the impact of terrorism risk on group life insurers and on the availability of group life insurance coverage and then to determine, in consultation with NAIC, whether to apply the Program to group life insurers. The request for public comments, which will be published shortly in the Federal Register, solicits information from the public to assist in the study.

Moreover, Treasury intends to begin right away its work on a separate study and report on the Program required by Section 108(d). In that provision, Congress directed Treasury to "assess the effectiveness of the Program and the likely capacity of the property and casualty insurance industry to offer insurance for terrorism risk after termination of the Program, and the availability and affordability of such insurance for various policyholders, including railroads, trucking and public transit." By initiating the study now, Treasury hopes to establish a baseline from which to monitor developments in the industry and evaluate the Program on an ongoing basis over its life.

Intermediate Term
Treasury intends to establish a Terrorism Risk Insurance Program Office, headed by a Program Administrator, to carry out many of Treasury's responsibilities under the Act, including claims processing.
As part of that effort, Treasury will carry out the President's instructions for a rule requiring approval of settlement of causes of action as part of the claims processing framework.

Treasury expects to send the interim guidance this week to the Federal Register for publication, and it is also available on Treasury's website, www.treasury.gov/trip.

Related Documents:

- Interim Guidance
- Group Life

Billing Code 4810-25-M

DEPARTMENT OF THE TREASURY

Departmental Offices

Interim Guidance Concerning New Statutory Disclosure and Mandatory Availability Requirements of the Terrorism Risk Insurance Act of 2002

AGENCY: Department of the Treasury, Departmental Offices

ACTION: Notice.

SUMMARY: This notice provides interim guidance to insurers concerning certain statutory disclosure and mandatory availability requirements contained in the Terrorism Risk Insurance Act of 2002 (Pub.L.107-297). In addition, this notice provides interim guidance to insurers concerning the types of commercial property and casualty insurance covered by the Act and concerning the term "direct earned premium" as used in the Act.

DATES: This notice is effective immediately and will remain in effect until superceded by regulations or by subsequent notice.

FOR FURTHER INFORMATION CONTACT: Mario Ugoletti, Deputy Director, Office of Financial Institutions and GSE Policy 202-622-2730; Martha Ellett, Attorney-Advisor, Office of Assistant General Counsel (Banking and Finance) 202-622-0480.

SUPPLEMENTARY INFORMATION:
This notice provides interim guidance to assist insurers in meeting certain requirements of the Terrorism Risk Insurance Act of 2002 pending the issuance of regulations by the Department of the Treasury. The interim guidance contained in this notice may be relied upon by insurers in complying with these statutory requirements prior to the issuance of regulations, but is not the exclusive means of compliance. This interim guidance remains in effect until superceded by regulations or subsequent notice.

I. Background

On November 26, 2002, the President signed into law the Terrorism Risk Insurance Act of 2002 (the Act). The Act became effective immediately. It establishes a temporary federal program of shared public and private compensation for insured commercial property and casualty losses resulting from an act of terrorism, as defined in the Act. The Terrorism Risk Insurance Program is administered and implemented by the Department of the Treasury (Treasury) and will sunset on December 31, 2005.

II. Interim Guidance

Treasury will be issuing regulations to administer and implement the Program. This notice is issued to assist insurers in complying with certain statutory requirements prior to the issuance of regulations. This notice contains interim guidance on disclosures required by sections 103 and 105 of the Act and concerning compliance with the mandatory availability requirements in section 103(c) of the Act. In addition, this notice provides interim guidance concerning commercial lines of property and casualty insurance covered by section 102(12) and concerning the statutory term "direct earned premium." Treasury also may issue additional interim guidance as necessary prior to the issuance of regulations.

A. Disclosures to Policyholders

What Disclosures Are Required by the Act in Section 103 (b)(2)?

The Act requires that disclosures be made to policyholders as part of the conditions for Federal payments under the Terrorism Risk Insurance Program. Section 103(b)(2) requires an insurer to provide clear and conspicuous disclosure to the policyholder of the premium charged for insured losses covered by the Terrorism Risk Insurance Program and the Federal share of compensation for insured losses under the Program.

- For existing (in-force) policies issued before the date of enactment (November 26, 2002), the Act requires that disclosure to the policyholder be made not later than 90 days after November 26, 2002;
- For policies issued within 90 days of November 26, 2002, the Act requires the disclosure to the policyholder be made at the time of offer, purchase and renewal of the policy; and
- For policies issued more than 90 days after November 26, 2002, the Act requires disclosure on a separate line item in the policy at the time of offer, purchase and renewal of the policy.

What Disclosures (or Statements) Are Required by the Reinstatement Provisions in Section 105(c) of the Act?

Section 105(c) of the Act allows an insurer to reinstate *preexisting* exclusions of coverage for an act of terrorism in a contract for property and casualty insurance that is in force on the date of enactment, notwithstanding the general nullification and general preemption of terrorism exclusions in force on the date of enactment of the Act in Sections 105(a) and (b), *but only if* 1) the insurer has received a written statement from the insured that affirmatively authorizes such reinstatement or 2) if (A) the insured fails to pay any increased premium charged by the insurer for providing such terrorism coverage and (B) the insurer provided notice, at least 30 days before any such reinstatement of (i) the

increased premium for such terrorism coverage and (ii) the rights of the insured with respect to such coverage, including the date upon which the exclusion would be reinstated if no payment is received.

How May an Insurer Comply with the Disclosure Requirements of Section 103(b)(2)(A) If There is No Change in the Premium?

Prior to the issuance of regulations or further guidance by Treasury, any insurer that uses the Model Form No. 2 attached to the model bulletin on Terrorism Risk Insurance dated November 26, 2002 of the National Association of Insurance Commissioners (NAIC), and posted on the NAIC website at

as a policyholder disclosure form for in-force policies, if the insurer makes no change in the existing premium, will be deemed by Treasury to be in compliance with section 103(b)(2)(A).

How May an Insurer Comply with the Disclosure Requirements of Section 103(b)(2)(B) for Policies Issued Within 90 Days of Enactment?

Either NAIC Model Disclosure Form No. 1 which is posted on the NAIC website at ____________________, or NAIC Model Disclosure Form No. 2 which is posted on the NAIC website at

____
may be modified as appropriate by insurers for the particular policy and used for policies issued within 90 days of enactment. Prior to the issuance of regulations or further guidance by Treasury, any insurer that modifies as appropriate and uses either of these model disclosure forms as its disclosure for policies issued within 90 days of enactment of the Act will be deemed by Treasury to be in compliance with the Section 103(b)(2)(B) disclosure requirements.

May an Insurer Use the Same Form to Comply with the Reinstatement Requirements of Section 105(c) and the Disclosure Requirements of Section 103(b)(2)(A) if Applicable?

Yes. Prior to the issuance of regulations or further guidance by Treasury, if applicable to an existing policyholder, *e.g.* for in-force policies where there is a change of premium, Treasury will deem disclosure by an insurer to an existing policyholder using NAIC Model Disclosure Form 1, posted on the NAIC website at

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to comply with the disclosure requirements of Section 105(c) of the Act, as well as with the requirements of section 103(b)(2)(A).

Is This Interim Guidance the Exclusive Means By Which an Insurer May Comply with Disclosure or Reinstatement Requirements of the Act?

No. This interim guidance concerning certain disclosures as specified above may be relied upon by insurers as a safe harbor in complying with these requirements of the Act

until regulations or further guidance is issued by Treasury, but it is not the exclusive means by which an insurer may comply with these requirements of the Act.

How May an Insurer Comply with the "Separate Line Item" Requirement in Section 103(b)(2)(C) for policies issued more than 90 days after the date of enactment?

Treasury will be issuing additional interim guidance as appropriate, and will be issuing regulations concerning other disclosure requirements, such as the separate line item disclosure requirement.

May an Insurer Comply With the Disclosure Requirements of the Act Through a Broker or Other Agent?

Yes. In many situations, commercial property and casualty insurance is procured for policyholders through an insurance broker or other intermediary acting as agent for the insurer. Prior to the issuance of regulations or further guidance by Treasury, if the normal form of communication between an insurer and the policyholder is through an insurance broker (or other intermediary acting as agent for the insurer), an insurer may provide the Act's required disclosures through such agents. While this interim guidance permits an insurer to provide disclosures to its policyholders through an insurance broker or other agent, the responsibility for ensuring that such disclosures are provided to policyholders still rests with the insurer.

B. Mandatory Availability

What Does "Make Available" Mean?

From enactment through the end of Program Year 2 (December 31, 2004), Section 103 (c) (1) of the Act requires that an insurer:

> (A) shall make available, in all of its property and casualty insurance policies, coverage for insured losses; and
> (B) shall make available property and casualty insurance coverage for insured losses that does not differ materially from the terms, amounts, and other coverage limitations applicable to losses arising from events other than acts of terrorism.

Until Treasury issues regulations or provides further guidance on the requirements of section 103(c), "make available" means an insurer is required to offer coverage to a policyholder for acts of terrorism (as defined in the Act) that does not differ materially from the terms, amounts, and other coverage limitations offered to the policyholder for losses from events other than acts of terrorism. For example, compliance with "make available" means that insurers offer coverage for acts of terrorism (as defined in the Act) at deductibles and limits that do not differ materially from the coverage provided for other perils.

For the purposes of this interim guidance, the "make available" requirement does not mean that insurers must make available coverage for all types of risks. For example, if an insurer does not cover all types of risks, either because the insurer is outside of direct State regulatory oversight or a State permits exclusions for certain types of losses (*e.g.*, nuclear, biological, or chemical events) an insurer would not be required to make such coverage available.

This interim guidance is consistent with the Act's stated purpose of ensuring widespread availability of terrorism risk insurance while preserving State insurance regulation. During the course of implementing the Program, Treasury will be monitoring the pricing and availability of terrorism risk insurance coverage as part of the Act's requirements that Treasury study the effectiveness of the Program (Section 108(d)(1)) and compile information on the premium rates of insurers (Section 104(f)).

How May Insurers Comply with the "Make Available" Provision?

For purposes of this interim guidance, an insurer that makes a formal offer of coverage to a policyholder that does not differ materially from the terms (other than price), amounts and other coverage limitations offered to the policyholder will be deemed in compliance with the "make available" requirement.

May an Insurer Offer Coverage for Acts of Terrorism (as Defined in the Act) that Differs Materially from the Terms, Amounts, and Other Coverage Limitations for Losses Arising From Events Other than Acts of Terrorism?

For the purposes of this interim guidance, an insurer may offer coverage that is on different terms, amounts, or coverage limitations as long as the insurer satisfies the "make available" requirements (as described in the previous question and answer) and as long as such offers do not violate any State laws or regulations. For example, in a State that requires the provision of full coverage without any exclusion, the Act would not preempt that State's preexisting requirements. In contrast, if a State permits certain exclusions or allows for other limitations, or if an insurance policy is not directly governed by State requirements, then after first satisfying the "make available" requirement (as described in the previous question and answer), an insurer could offer limited coverage or coverage with exclusions.

C. Property and Casualty Insurance and Direct Earned Premium

What Types of Property and Casualty Insurance are Covered by the Program?

Section 102(12) of the Act defines property and casualty insurance to mean commercial lines of property and casualty insurance, including excess insurance, workers' compensation insurance, and surety insurance.

As interim guidance prior to the issuance of regulations, Treasury deems the following lines of insurance from the NAIC's Exhibit of Premiums and Losses (commonly know as

Statutory Page 14) to be included in the Program: Line 1 – Fire; Line 2.1 – Allied Lines; Line 3 – Farmowners Multiple Peril; Line 5.1 – Commercial Multiple Peril (non-liability portion); Line 5.2 – Commercial Multiple Peril (liability portion); Line 8 – Ocean Marine; Line 9 – Inland Marine; Line 16 – Workers' Compensation; Line 17 – Other Liability; Line 18 – Products Liability; Line 19.3 – Commercial Auto No-Fault (personal injury protection); Line 19.4 – Other Commercial Auto Liability; Line 21.2 – Commercial Auto Physical Damage; Line 22 – Aircraft (all perils); Line 24 – Surety; Line 26 – Burglary and Theft; and Line 27 – Boiler and Machinery.

Section 102(12) (B) of the Act lists types of insurance coverage that are excluded from the Program. These are private mortgage or title insurance; financial guaranty insurance issued by monoline financial guaranty insurance corporations; insurance for medical malpractice; health or life insurance, including group life insurance; flood insurance provided under the National Flood Insurance Act of 1968; and reinsurance or retrocessional reinsurance.

In addition, the Act excludes, "Federal crop insurance issued or reinsured under the Federal Crop Insurance Act, or any other type of crop or livestock insurance that is privately issued or reinsured." As interim guidance to facilitate implementation, Treasury deems the phrase "any other type of crop or livestock insurance that is privately issued or reinsured" to mean Multiple Peril Crop insurance reported on Line 2.2 of the NAIC's Exhibit of Premiums and Losses (commonly know as Statutory Page 14).

How is Direct Earned Premium Measured?

The Act contains the term "direct earned premium." The Act specifies an insurer's direct earned premiums over a given calendar year as the deductible base for purposes of calculating an "insurer deductible" as defined in section 102(7) of the Act. For purposes of interim guidance to enable insurers that report to the NAIC to calculate their "insurer deductible" and to facilitate immediate implementation of the Program, the term "direct earned premium" means the direct premiums earned as reported to the NAIC in the Annual Statement in column 2 of the Exhibit of Premiums and Losses (commonly known as Statutory Page 14). Treasury will be issuing additional guidance for entities covered under the Program that do not report to the NAIC.

Dated: December 3, 2002

Peter R. Fisher
Under Secretary of the Treasury

Billing Code 4810-25

DEPARTMENT OF THE TREASURY

Departmental Offices

Study of the Impact of Threat of Terrorism on Availability of Group Life Insurance

AGENCY: Department of the Treasury, Departmental Offices.

ACTION: Notice; Request for Comments.

SUMMARY: Recently enacted terrorism insurance legislation requires the Secretary of the Treasury (Treasury) to study, on an expedited basis, whether adequate and affordable catastrophe reinsurance for acts of terrorism is available to life insurers in the United States that issue group life insurance, and the extent to which the threat of terrorism is reducing the availability of group life insurance for consumers in the United States. To assist in this study, the Treasury is soliciting comments on the questions listed below.

DATES: Comments must be in writing and received by [INSERT DATE THAT IS 30 DAYS AFTER THE DATE OF PUBLICATION].

ADDRESSES: Send comments by e-mail to grouplifestudy@do.treas.gov. Please include your name, affiliation, address, e-mail address, and telephone number. All submissions should be captioned "Comments on Group Life Insurance Study".

FOR FURTHER INFORMATION CONTACT: Lucy Huffman, Project Manager, Office of Microeconomic Analysis, 202-622-0198; John Worth, Acting Director, Office of Microeconomic Analysis, 202-622-2683; U.S. Treasury Department.

SUPPLEMENTARY INFORMATION:

Section 4(h) of the Terrorism Risk Insurance Act of 2002 (Public Law No. 107-297) (Act) requires the Treasury to study, on an expedited basis, whether adequate and affordable catastrophe reinsurance for acts of terrorism is available to life insurers in the United States that offer group life insurance, and the extent to which the threat of terrorism is reducing the availability of group life insurance coverage for consumers in the United States. To the extent that the Treasury determines that such coverage is not or will not be reasonably available to both such insurers and consumers, the Treasury is directed to apply, in consultation with the National Association of Insurance Commissioners, the provisions of the Act, as appropriate, to group life insurers; and provide such restrictions, limitations, or conditions with respect to any financial assistance provided that Treasury deems appropriate, based on this study.

The purpose of the Act is to establish a temporary Federal program that provides for a transparent system of shared public and private compensation for insured losses resulting from acts of terrorism, in order to protect consumers by addressing market disruptions and ensure the continued widespread availability and affordability of property and casualty insurance for terrorism risk; and to allow for a transitional period for the private

markets to stabilize, resume pricing of such insurance, and build capacity to absorb any future losses, while preserving state insurance regulation and consumer protections.

Treasury is soliciting comment in response to the following questions, including empirical data in support of such comments where appropriate and available.

I. The impact of terrorism risk on group life insurers

1.1 Who are the suppliers of the group life insurance in the U.S.; who are the buyers; and how are sellers and buyer brought together?

1.2 What is the corporate status of group life insurers? Are they generally stand-alone companies, or affiliates of other corporations? If the latter, what are the major business interests of the other corporations?

1.3 What characterizes group life insurance offerings? Please describe typical terms of coverage, offer and renewal procedures, and other relevant information.

1.4 How is group life insurance regulated in the U.S.? Are there are significant differences in group life regulation among the states and, if so, what are these differences?

1.5 What are the risk exposures of customers and how are they concentrated—by locality, by type of employer, other? What is the annual premium structure for these different exposures?

1.6 What amounts of loss exposure are typically reinsured? Please describe the structure of typical reinsurance contracts, including the period of coverage and typical renewal process.

1.7 What was the amount of group life insurance losses in the terrorist attack of September 11, 2001; and how was it distributed—losses to insurers versus losses to reinsurers? How was it distributed within each group?

1.8 What was the availability and price of reinsurance in the period before and following September 11, 2001, for group life insurance? What is it today? Please be specific by type and amount of coverage available, deductible, sublimit, renewability, and other relevant characteristics.

1.9 What is the current capacity of group life insurers in the U.S. to bear terrorism risk, individually and as affiliates of other companies, taking into consideration their reinsurance situation? Please provide empirical support for responses as available and appropriate.

1.10 Are there other sources of protection for terrorism risks in group life insurance, e.g., through capital markets? To what extent are these sources used currently? What are the issues associated with expanded use of these sources?

1.11 Please address and provide empirical support for whether group life insurers have reasonable access to adequate and affordable catastrophe reinsurance, and, if not, why inclusion in the Act would correct this situation. In so doing, please compare the magnitude and scope of the situation of group life insurers to the situation previous to the passage of the Act of those property and casualty insurers that are included in the Act.

II. The impact of terrorism risk on group life insurance markets

2.1 Please describe in detail, current group life insurance market conditions, including availability and pricing, by type and location of employers and other purchasers.

2.2 What is the impact of terrorism risk on group life insurance availability for employees and other consumers? Please describe in as much detail as possible which employees and other consumers have been significantly affected, including availability and pricing, by type and location of employer or other purchaser of group life coverage.

2.3 What is the cost and availability of alternative sources of life insurance coverage for those employees and other consumers affected by the reduced availability and affordability of group life insurance?

2.4 Please explain and provide empirical support concerning the extent to which the threat of terrorism is reducing reasonable availability of group life insurance coverage for employees and other consumers in the U.S., and whether it would continue to be reduced if group life insurers continue to be excluded from the Program. Please compare the magnitude and scope of the impact on consumers of not including group life insurance to the impact on consumers previous to the passage of the Act of those property and casualty insurance lines covered under the Act. Please explain how inclusion would correct this situation.

III. The Potential for Inclusion in the Federal Program

3.1 Treasury presumes that, if it would be appropriate to include group life insurance under the Act, Treasury would apply the current provisions of the Act to group life insurers. If this is not the case, please discuss and provide a detailed explanation of the changes that would need to be made to implement the Program for group life insurers. Please include discussion of any operational difficulties with applying the current provisions in the Act to group life insurers, any other characteristics of group life insurance that should be considered with respect to any financial assistance if group life insurers were included under the Act, and the benefits and costs, including administrative costs, of any proposed changes to the provisions for group life insurers.

Dated:

Mark Warshawsky

Deputy Assistant Secretary for Economic Policy

Microeconomic Analysis

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

December 3, 2002
PO-3664

"A Fresh Perspective on U.S.-EU Economic Relations"
U.S. Deputy Treasury Secretary Kenneth W. Dam
CSIS Transatlantic Conference
Washington, D.C.
December 3, 2002

This morning I'd like to offer a fresh perspective on U.S.-EU economic relations. If you've been reading the financial press on a regular basis, you might think the U.S. and the EU were fighting a transatlantic trade war.

Let me read you some recent headlines: "EU allowed to retaliate up to $4 billion dollars;" "Steel tariffs stir transatlantic trade unrest;" "U.S. farm bill coldly received in Europe." Fortunately, international economic relations are about more than just headlines.

The facts tell a different story. In the last decade, the U.S.-EU economic relationship, when measured as trade plus investment, has swelled into the largest and most complex on earth. U.S. investors are deeply invested in Europe's growth, and vice-versa. You might not realize it, but more than 800 of Europe's best companies choose to list their shares, in the form of American Depository Receipts, on U.S. stock exchanges.

Sure, every so often, the U.S. and the EU experience "trade rows," - as our British friends call them - but trade disputes are inevitable given the scope of our economic ties. In any event, the real action today in international trade is not in the WTO dispute settlement process, but in the new Doha Round of negotiations. There we have put on the table unprecedented proposals for the reduction of barriers in both agricultural and industrial products. We propose to eliminate agricultural export subsidies and greatly reduce agricultural support payments, as well as to eliminate all tariffs on industrial products by 2015.

The fact is that the overall U.S.-EU relationship is about more than just trade. We have devoted new resources to fighting the financial war on terrorism, collaborating with our EU counterparts on new financial and regulatory changes, and working to find common ground on the issue of data privacy.

Therefore, while I am open to questions regarding U.S.-EU trade relations, I'd like to spend the next few minutes exploring some of the less sensational aspects of the U.S.-EU economic relationship. Let's start with the financial war against terrorism.

The Financial War on Terrorism

Since September 11th, the U.S. and the EU have campaigned jointly to designate terrorist entities and their financial backers, and then to freeze their assets. For example, nearly every terrorist individual and entity designated by the U.S. also has been designated by the EU or some of its member states. Moreover, the U.S. and the EU have established a fluid, informal mechanism for sharing information on terrorists and their supporters. Action also was taken by the EU against the al-Aqsa Martyrs Brigade, a group that has taken responsibility for a number of suicide bombings in Israel.

Recent terrorist finance developments at the EU member-state level also are positive. In September, we co-chaired with Spain an important meeting of the Financial Action Task Force to discuss international standards and measures being taken in the war against terrorist financing. In August, Italy joined the U.S. in submitting to the UN 1267 Sanctions Committee the names of 25 individuals and entities linked to al Qaida for asset freezes. The Dutch Government recently froze the assets of the "New Peoples Army" and its leader Jose Sison, both known to be responsible for the killing of American citizens in the Philippines. Both France and Germany have submitted names in the past few months to the UN 1267 list.

However, differences remain on key issues of process and implementation, and they need to be resolved.

For instance, the EU's "clearinghouse process" is too cumbersome, and it should be streamlined. Given the threat we face, it still takes far too long for terrorist names to submitted and considered for designation by the EU.

Equally troubling is the fact that under current EU treaty interpretation, the EU cannot direct member states to block the assets of individuals and entities of so-called "internal terrorists." Since not all of the fifteen EU countries have domestic blocking laws that allow them to block assets of terrorism-linked persons independent of EU action, the assets of "internal terrorists" are being left unblocked in a number of European countries. The terrorist threat is too serious to be left unchallenged because of how the EU chooses to organize itself in the terrorist finance area.

Separately, there also is a general reluctance throughout Europe to designate the social and religious arms of Hamas and Hizballah as terrorist entities. The United States has rejected the notion that "firewalls" exist between the militant, social and religious arms of Hamas and Hizballah, and I urge our European counterparts to do the same. Not only is money fungible, but no evidence has been brought forward to establish the existence of any such "firewall."

Our EU counterparts should understand that Secretary O'Neill and I are committed to pressing for resolution on these critical issues. In fact, we anticipate doing so again next week, when EU Commissioner Bolkenstein will be visiting the Treasury. We welcome the generally good cooperation in the financial war on terrorism to date, and now is the time to confront the remaining issues.

During the meeting with Commissioner Bolkenstein, we also plan to discuss a host of financial and regulatory matters of mutual concern.

U.S.-EU Financial and Regulatory Cooperation

As in the financial war on terrorism, we are working together on financial and regulatory changes that have transatlantic consequences. A good example is Europe's plans to introduce a single financial market in 2005.

Ever since the idea of took shape, the United States has been very supportive of the EU's Financial Services Action Plan (FSAP) for a single financial market. If properly implemented, we believe the Plan will stimulate economic growth in Europe while facilitating international capital flows and providing advantageous opportunities to borrowers and savers. Our most general concern is in seeing that the process of European capital market integration is well-managed and fair to all market participants.

Specifically, we have made our EU counterparts aware of cases where newly proposed EU financial directives adversely impact non-EU companies operating in EU-regulated markets. Recently, we voiced concerns that new EU directives under consideration governing the issuance of prospectuses, capital adequacy, investment services and financial conglomerates, for example, could discriminate against U.S. firms in unintended ways.

Take, for example, the Financial Conglomerates Directive. Under the directive, U.S.-based investment banks operating in Europe would be subject to supervision at the holding company level. In the United States, however, investment banks are supervised by the SEC at the broker-dealer level – not at the holding company level. Therefore, absent a finding of "equivalent" oversight by EU authorities, U.S.-based investment banks operating in Europe no doubt would face higher compliance and operating costs. Presently, officials in Brussels have been supportive of our efforts to resolve this problem, and we are continuing to work with officials from the UK's Financial Services Authority to try to address specific concerns they have raised.

In order to manage these and other cases of regulatory "spillover" that crop up on both sides of the Atlantic, and more generally to have a two-way dialogue on key financial market issues of import to both sides, Treasury created an informal US-EU financial markets dialogue early this year. Treasury and the European Commission chair the dialogue and are accompanied by our financial regulators. A number of informal dialogue meetings have been held in Brussels and Washington to date. Next week, Commissioner Bolkestein who overseas the Internal Market Directorate will visit Washington and he plans to meet with Secretary O'Neill at that time for further discussions on these financial market issues.

While conflicts are inevitable given our varied experiences and attitudes toward financial regulation and oversight, the Financial Market Dialogue has been a successful forum for openly airing concerns on both sides. Both sides share the same objectives: sound financial market supervision and regulation and efficient capital markets that generate real benefits to firms and investors on both sides of the Atlantic. I have been impressed by the depth and professionalism of the talks thus far.

The Financial Markets Dialogue has also begun dealing with the issue of accounting. Here, the general level of cooperation is high, and for the moment convergence between our respective standards of accounting seems a mid-range possibility.

In June 2002, the EU called upon all 15 member states to move from national accounting standards to International Accounting Standards (IAS) by 2005. This means that all 7,000 firms listed in the EU soon will be adopting the same accounting standards. Only a month later, President Bush signed the Sarbanes-Oaxley Act, which introduces stricter government oversight of the audit process for public companies, in accordance with Generally Accepted Accounting Principles (GAAP). Though we share common goals on better corporate disclosure, both actions – as you might imagine – raised eyebrows on the opposite side of the Atlantic, as corporations feared that the costs of reconciliation and compliance would increase significantly.

Fortunately, how these more muscular regulatory schemes will be implemented and enforced is being discussed openly by U.S. and EU regulatory officials, with market input. This needs to continue. The SEC recently even indicated its willingness to reconsider accepting IAS for firms listed on U.S. exchanges without reconciliation to U.S. GAAP, provided there is consistent interpretation and enforcement at the EU level, across all member countries. Convergence needs to be about not just reducing differences in treatment, but also about optimizing the respective advantages of each approach to ensure the best reporting and specific guidance on particular kinds of transactions.

I also understand that the Financial Accounting Standards Board (FASB), which mandates accounting standards in the United States, recently added convergence to its formal work agenda. This is a positive development, as is the FASB's and IAS' recent "Norwalk Agreement," which acknowledges a commitment to the development of high-quality compatible accounting standards that could be used for domestic and cross-border financial reporting. After all, capital markets are rapidly becoming a worldwide feature and regulations need to keep pace.

Data Privacy

Finally, my discussion of U.S.-EU economic relations would not be complete without a brief word or two on data privacy.

Last July, Peter Fisher, Treasury's Under Secretary for Domestic Finance led a group of financial regulators to Brussels for a set of talks on the issue. Initial meetings with EU Commission officials and with EU member state data protection commissioners were highly educational, for both sides.

Even on this complex issue, we hope to continue to work toward understanding the concerns of our EU counterparts, so that we may explain best how U.S. laws and regulations provide adequate protection under the EU directive. After all, we have a common interest in privacy on both sides of the Atlantic, and it is not so important what we term the resolution of our differences, but that we recognize that both sides' interests can be accommodated when we make doing so our primary objective.

Thank you.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

December 3, 2002
PO-3665

Statement of
Treasury Under Secretary for Domestic Finance Peter R. Fisher
On Interim Guidance on Terrorism Insurance for Insurance Industry

Thank you all for coming.

I would like to welcome Terri Vaughan, President of the National Association of Insurance Commissioners and the Iowa Insurance Commissioner.

I would also like to introduce Wayne Abernathy who was sworn in yesterday as our new Assistant Secretary for Financial Institutions. Wayne has arrived just in time to lead the implementation of the Terrorism Risk Insurance Program.

Last Tuesday, President Bush signed into law the Terrorism Risk Insurance Act of 2002.

Effective Immediately – Benefits Start now

The Terrorism Risk Insurance Program became effective upon enactment by the President. Commercial property and casualty insurance companies now are required to make terrorism insurance coverage available to their policyholders and, in many cases, such coverage is in place today as a result of the legislation. That is good news for our economy.

Through the working of the competitive marketplace, the economic benefits expected as a result of the Program should begin to be realized in the near term.

The new law establishes a temporary Federal program that provides for a system of shared public and private compensation for insured commercial property and casualty losses arising from acts of terrorism under the Act. The program will be administered by the Treasury Department and will sunset on December 31, 2005.

Role of State Insurance Regulators

Terri Vaughan's presence here today is very important to Treasury.

The Program relies upon the state insurance oversight mechanism to monitor insurance companies' implementation of and compliance with, many of the program's requirements.

Our partnership with the state insurance regulators has worked very well, and in the upcoming months Treasury will continue to work closely with the state insurance regulators on the implementation process.

Purpose Today – Issue Interim Guidance

The purpose of today's press conference is to announce that Treasury is releasing today interim guidance that will assist the insurance industry in meeting certain

requirements under the Act.

This guidance is available on the web site we set up for the program, www.treas.gov/trip. We expect to send the interim guidance this week to the Federal Register for publication.

The interim guidance covers several requirements of the new law, including policyholder disclosure requirements and the requirement that insurance companies make coverage for terrorism risk, as defined by the Act, available to their policyholders.

Policyholder Disclosures

Last week, Terri Vaughan and her fellow state insurance commissioners issued a bulletin to insurers that contained model disclosures that insurance companies could use in satisfying the Act's policyholder disclosure requirements.

The interim guidance Treasury is releasing today states that use of the NAIC's model disclosures constitutes compliance with the Act's disclosure requirements. In other words, if an insurer uses the appropriate NAIC model disclosure form in disclosing the Program to its policyholders, it will be deemed by Treasury to be in compliance with the law's disclosure requirements.

We are grateful to the NAIC for their quick action in preparing these model disclosures. At the same time, insurers should also note that the model disclosures are not the exclusive means by which they may comply with the Act.

The disclosure guidance also provides useful information to commercial entities that wish to obtain terrorism risk insurance. Insurance companies generally have 90 days to notify their policyholders of the Program and of any changes that may be available in their insurance coverage and insurance premium as a result. In some cases, policyholders must respond affirmatively within 30 days of the notice in order to be covered under the Program.

Make Available

From enactment through the end of December 2004, the Act requires that an insurer shall make available, in all of its property and casualty insurance policies, coverage for insured losses that does not differ materially from the terms, amounts, and other coverage limitations applicable to losses arising from events other than acts of terrorism.

Until Treasury issues regulations or provides further guidance on this requirement, "make available" means an insurer is required to offer coverage to a policyholder for acts of terrorism (as defined in the Act) that does not differ materially from the terms, amounts, and other coverage limitations offered to the policyholder for losses from events other than acts of terrorism.

For example, compliance with "make available" means that insurers offer coverage for acts of terrorism (as defined in the Act) at deductibles and limits that do not differ materially from the coverage provided for other perils.

Group Life

Today we are also releasing a request for public comment on group life insurance coverage.

The Act requires Treasury to prepare, on an expedited basis, a study of the impact of terrorism risk on group life insurers and on the availability of group life insurance coverage and then to determine, in consultation with NAIC, whether to apply the Program to group life insurers.

The request for public comments, which will be published shortly in the Federal Register, solicits information from the public to assist in the study.

Next Steps – Near Term

Treasury plans to follow-up on the interim guidance by drafting regulations, where appropriate.

We also expect to provide guidance or regulations in the near future on several other aspects of the program, including how Treasury intends to apply the law to captive insurers and other self-insurance arrangements.

We also intend to begin right away our work on a separate study and report on the Program required by Section 108(d). In that provision, Congress directed Treasury to "assess the effectiveness of the Program and the likely capacity of the property and casualty insurance industry to offer insurance for terrorism risk after termination of the Program, and the availability and affordability of such insurance for various policyholders, including railroads, trucking and public transit." By initiating the study now, Treasury hopes to establish a baseline from which to monitor developments in the industry and evaluate the Program on an ongoing basis over its life.

Next Steps - Intermediate Term

As the Secretary announced last week, Treasury intends to establish a Terrorism Risk Insurance Program Office, headed by a Program Administrator, to carry out many of Treasury's responsibilities under the Act, including claims processing.

As part of that effort, Treasury will carry out the President's instructions for a rule requiring approval of settlement of causes of action as part of the claims processing framework.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

December 4, 2002
PO-3666

Remarks of Treasury Deputy Assistant Secretary for Federal Finance
Timothy S. Bitsberger
To The Fixed Income Summit
Palm Beach, FL

When I was invited to participate in today's panel on interest rates, I was as surprised as anyone that the word "yes" came out of my mouth. It is not a surprising invitation, given how important interest rates are to me in meeting my job objective of providing Secretary O'Neill with advice on how to best finance the Government. After all, our number one objective is to finance the Government at the lowest cost over time. What you may not be aware of, is how little a role interest rates play in the advice I provide.

We issue debt regularly and in predictable quantities, rather than opportunistically. A consequence of regular and predictable issuance is that we are not in a position to tailor debt issuance to interest rates. And as I just said, not only does this make sense for Treasury but we really have no other choice.

If Treasury officials were to alter issuance to take advantage of interest rate fluctuations, they would not necessarily lower borrowing costs – any price concessions from exercising market power are likely to be more than offset by the your superior resources devoted to understanding interest rate movements and modeling our behavior.

Aside from lacking resources -- the office of market finance has no more than four people devoted to debt policy -- it is difficult to think of a multi trillion-dollar-a-year annual issuer of debt as nimble. The shear scale of our operations dictates a high degree of regularity in issuance. What we have done at Treasury is turn some degree of necessity into a high degree of commitment. So we don't hold snap unscheduled auctions for a given maturity when yields appear low, and we don't even take the yield curve into account when we allocate how much to raise by different maturities. Our issuance calendar is well known to every trader or investor involved in our market. The auction calendar is published months in advance. I have no doubt that the trader in all of us believes that he or she could "beat" the market by opportunistically managing treasury's debt issuance. But once we start to try and capture interest rate moves on the margin we will have become traders and not debt managers. The risks associated with our own judgments are insurmountable. We can't trade our way out of a bad position.

Underlying this regularity of issuance, however, is an entity managing the world's largest cash flows. Over the past year, Treasury received and spent roughly $2 trillion.
As most of you know expenditures and receipts do not coincide – we make large entitlement payments at the beginning of months and receive cash sporadically throughout months, with receipts lumped unevenly around only a few tax dates. Part of my job is to figure out how to efficiently manage uneven cash flows with regular debt issuance. Part of the consequence of my advice is huge cash swings in Treasury accounts held in the banking system.

It is not unusual for our cash accounts to swing by more than $50 billion over the space of a few days. By contrast, if we were to change issuance by more than a

few billion from one auction to the next, we would surprise market participants. Our situation is further constrained by Treasury's strict collateral requirements with the banks that hold our cash balances. Constraints, however, do not alter our objective: the better we can manage our cash balances, the better we can serve the taxpayer.

In managing these balances, we face a significant challenge in how we respond to the uncertainty associated with our cash flows. We know that we will have large seasonal swings in our cash balances and we know when those swings will occur, but we don't know how big they will be. Our ability to respond to these fluctuations is limited by our auction calendar – our most flexible tool, weekly bill issuance, settles once a week and our longer term securities only settle on a monthly or quarterly basis.

Uncertainty about the future also constrains debt management planning. We have to be prepared to finance either sustained surpluses or deficits. The range of potential fiscal outcomes is pretty remarkable – CBO measures this range over a five-year horizon in trillions of dollars. My job is to ensure that, no matter which outcome materializes, Treasury will be able to finance the Government's needs without forgoing its commitment to regular issuance. Because we are regular, because we want to prepare the market, our auction calendar must be able to adapt to a variety of outcomes.

The average miss on the current year of forecasting, and this includes street economists, CBO and OMB – and I repeat – the average miss on the current year after four months of actuals is $75B. That's pretty amazing. This makes the job of debt manager tricky because we already saw how limited our options can be.

As a result of this uncertainty, we cannot "time" expectations. That is, debt management cannot be predicated on daily, weekly or monthly concerns about what may or may not be a change in the economy. Changes in debt management are based on a deliberative process after consultation with market participants. We have a formalized, transparent process around our quarterly borrowing so that we can solicit your views before we make issuance changes and you can read about the factors that influence our decisions. The process deliberately prohibits decisions based on short-term expectations. This slow and predictable behavior is frustrating to many of you, but once again, if our decisions are wrong, we can't call up dealers and get out of positions.

While we do not, and cannot, base our decisions on current interest rates, we think continuously about how our issuance pattern influences our cost of borrowing. This thinking is motivated by Secretary O'Neill who has challenged us to improve all facets of our operations. Faster auction times, increased transparency, better systems, and improved analytics are helping us achieve this goal, but we seek further improvements.

On the operations side, I invite you to test our systems by participating directly in our auctions. Our current distribution system works exceptionally well, but for those of you who have or considered participating in an auction, Treasury now offers safe (word) point and click capability.

On the debt policy side, I encourage you to think about our issuance and how we can reduce our interest costs. In October, we solicited views from our private sector advisory committee on how to measure debt management performance. Going forward, we will continue to seek views and formulate methodologies that will provide better quantification of what we do and how we do it.

I will conclude with a couple of observations about our issuance from a historical perspective. Debt markets in the U.S. have grown more rapidly over the past two decades than Treasuries. I view this as good for two reasons. One, it is a sign that the government is playing a smaller role in financial markets. Two, from the perspective of a debt issuer, our smaller portion of supply means that we can issue more cheaply and that our responses to the inevitable forecasting errors we face are more easily absorbed by market participants.

In spite of this reduced position, I recognize that Treasuries act almost as a currency for a wide range of transactions and that Treasuries play a special role in asset allocations. I expect that these roles will grow over time as you, the users of Treasuries, continue to develop faster and more efficient financing mechanisms.

I would like to thank you for your time and would be happy to take any questions.

Chart Package

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

TREASURY SECURITY AUCTION RESULTS
BUREAU OF THE PUBLIC DEBT - WASHINGTON DC

FOR IMMEDIATE RELEASE
December 03, 2002

CONTACT: Office of Financing
202-691-3550

RESULTS OF TREASURY'S AUCTION OF 4-WEEK BILLS

Term:	28-Day Bill
Issue Date:	December 05, 2002
Maturity Date:	January 02, 2003
CUSIP Number:	912795LS8

High Rate: 1.210% Investment Rate 1/: 1.227% Price: 99.906

All noncompetitive and successful competitive bidders were awarded securities at the high rate. Tenders at the high discount rate were allotted 82.27%. All tenders at lower rates were accepted in full.

AMOUNTS TENDERED AND ACCEPTED (in thousands)

Tender Type	Tendered	Accepted
Competitive	$ 60,375,000	$ 20,957,677
Noncompetitive	42,589	42,589
FIMA (noncompetitive)	0	0
SUBTOTAL	60,417,589	21,000,266
Federal Reserve	2,303,232	2,303,232
TOTAL	$ 62,720,821	$ 23,303,498

Median rate 1.200%: 50% of the amount of accepted competitive tenders was tendered at or below that rate. Low rate 1.180%: 5% of the amount of accepted competitive tenders was tendered at or below that rate.

Bid-to-Cover Ratio = 60,417,589 / 21,000,266 = 2.88

1/ Equivalent coupon-issue yield.

http://www.publicdebt.treas.gov

PO-3667

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

December 4, 2002
PO-3668

Deputy U.S. Treasury Secretary Kenneth Dam Announces Trip to South America

Deputy Secretary Dam will travel to Chile, Ecuador, Colombia and Peru, December 7-14.

In high-level meetings with a wide array of senior government officials and private sector political, financial and economic experts, Dam will discuss issues affecting the common interest of the United States and the region; particularly development efforts - such as investing in people through education and water projects, regional stability, capital market development, and our continued cooperation on law enforcement and money laundering efforts.

This is Dam's second trip to South America. In November 2002, Dam traveled to Brazil to attend a World Economic Forum summit on Latin American business in Rio de Janeiro.

FROM THE OFFICE OF PUBLIC AFFAIRS

December 4, 2002
PO-3669

U.S. International Reserve Position

The Treasury Department today released U.S. reserve assets data for the latest week. As indicated in this table, U.S. reserve assets totaled $75,749 million as of the end of that week, compared to $75,941 million as of the end of the prior week.

I. Official U.S. Reserve Assets *(in US millions)*						
	November 22, 2002			**November 29, 2002**		
TOTAL	**75,941**			**75,749**		
1. Foreign Currency Reserves [1]	**Euro**	**Yen**	**TOTAL**	**Euro**	**Yen**	**TOTAL**
a. Securities	6,426	12,805	19,231	6,407	12,817	19,225
Of which, issuer headquartered in the U.S.			0			0
b. Total deposits with:						
b.i. Other central banks and BIS	10,609	2,571	13,180	10,579	2,573	13,152
b.ii. Banks headquartered in the U.S.			0			0
b.ii. Of which, banks located abroad			0			0
b.iii. Banks headquartered outside the U.S.			0			0
b.iii. Of which, banks located in the U.S.			0			0
2. IMF Reserve Position [2]			20,582			20,482
3. Special Drawing Rights (SDRs) [2]			11,907			11,849
4. Gold Stock [3]			11,042			11,042
5. Other Reserve Assets			0			0

II. Predetermined Short-Term Drains on Foreign Currency Assets						
	November 22, 2002			**November 29, 2002**		
	Euro	**Yen**	**TOTAL**	**Euro**	**Yen**	**TOTAL**
1. Foreign currency loans and securities			0			0
2. Aggregate short and long positions in forwards and futures in foreign currencies vis-à-vis the U.S. dollar:						

2.a. Short positions			0			0
2.b. Long positions			0			0
3. Other			0			0

III. Contingent Short-Term Net Drains on Foreign Currency Assets

	November 22, 2002			November 29, 2002		
	Euro	Yen	TOTAL	Euro	Yen	TOTAL
1. Contingent liabilities in foreign currency			0			0
1.a. Collateral guarantees on debt due within 1 year						
1.b. Other contingent liabilities						
2. Foreign currency securities with embedded options			0			0
3. Undrawn, unconditional credit lines			0			0
3.a. With other central banks						
3.b. With banks and other financial institutions						
Headquartered in the U.S.						
3.c. With banks and other financial institutions						
Headquartered outside the U.S.						
4. Aggregate short and long positions of options in foreign						
Currencies vis-à-vis the U.S. dollar			0			0
4.a. Short positions						
4.a.1. Bought puts						
4.a.2. Written calls						
4.b. Long positions						
4.b.1. Bought calls						
4.b.2. Written puts						

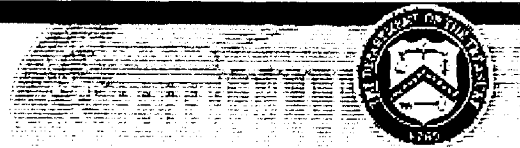
Notes:

/ Includes holdings of the Treasury's Exchange Stabilization Fund (ESF) and the Federal Reserve's System Open Market Account SOMA), valued at current market exchange rates. Foreign currency holdings listed as securities reflect marked-to-market values, and leposits reflect carrying values. Foreign Currency Reserves for the latest week may be subject to revision. Foreign Currency

Reserves for the prior week are final.

2/ The items, "2. IMF Reserve Position" and "3. Special Drawing Rights (SDRs)," are based on data provided by the IMF and are valued in dollar terms at the official SDR/dollar exchange rate for the reporting date. The entries for the latest week reflect any necessary adjustments, including revaluation, by the U.S. Treasury to the prior week's IMF data. IMF data for the latest week may be subject to revision. IMF data for the prior week are final.

3/ Gold stock is valued monthly at $42.2222 per fine troy ounce.



PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

To view or print the PDF content on this page, download the free Adobe® Acrobat® Reader®.

December 4, 2002
PO-3670

Air Transportation Stabilization Board's Decision on United Air Lines' Proposal for a Federal Loan Guarantee

The Air Transportation Stabilization Board (Board) announced today that it cannot approve the proposal submitted by United Air Lines, Inc. for a $1.8 billion federal guarantee of a $2.0 billion loan.

The Board believes that the business plan submitted by the company is not financially sound. This plan does not support the conclusion that there is a reasonable assurance of repayment and would pose an unacceptably high risk to U.S. taxpayers.

The Board believes that United's business plan does not position the company to meet the challenges of the current airline industry environment and to achieve long-term financial stability. Specifically, the plan is based on unreasonably optimistic revenue projections. The Board believes that with a more reasonable revenue forecast, United's revenues and costs still would not be aligned, even with the benefit of all proposed cost reduction initiatives. Thus, even with the proceeds of the proposed guaranteed loan, United would face a high probability of another liquidity crisis within the next few years.

Two members of the Board also believe that the suggested revisions that United proposed by e-mail and fax the evening of December 3 are highly unlikely to change their assessment of United's proposal. Considering all of the foregoing factors, Governor Gramlich and Under Secretary Fisher voted not to approve this proposal. Mr. Van Tine, General Counsel of the Department of Transportation, voted to defer a decision on the Application until December 9, 2002, to allow United to submit additional financial information.

The Board conducted its review pursuant to the standards set out by the Air Transportation Safety and System Stabilization Act and by the implementing regulations promulgated by the Office of Management and Budget. The Board considered all relevant information, including information obtained during numerous meetings between United, Board staff, and agency representatives beginning in April 2002, throughout the summer and fall.

The Board's letter to United is attached.

Additional information about the ATSB is available on its web site, http://www.ustreas.gov/offices/domestic-finance/atsb/.

Related Documents:

- Letter to United
- Gramlich Statement
- Fisher Statement

AIR TRANSPORTATION STABILIZATION BOARD

December 4, 2002

Mr. Frederick Brace
Executive Vice President
and Chief Financial Officer
United Air Lines, Inc.
P.O. Box 66100
Chicago, IL 60666

Dear Mr. Brace:

This letter refers to the application of United Air Lines, Inc. ("United"), dated June 21, 2002 as supplemented (the "Application") to the Air Transportation Stabilization Board (the "Board"), for a Federal loan guarantee under the Air Transportation Safety and System Stabilization Act, Pub. L. No. 107-42, 115 Stat. 230 (the "Act") and the regulations promulgated thereunder, 14 CFR Part 1300 (the "Regulations").

The Board staff and the broader working group, consisting of representatives of the Board's voting members, have reviewed and considered all the materials submitted by United, as well as the explanatory information presented by United at our meetings beginning in April 2002, throughout the summer, and on October 28, November 5, November 11, November 12, November 20 and November 26. The Board staff asked United a series of questions (as referenced in your letter of November 27) and carefully considered the company's answers. Also, the Board's financial, industry and legal consultants have submitted their reports and analyses which have been taken into consideration. In addition, the Board staff has prepared for the Board members a comprehensive analysis of all these materials. The voting Board members held discussions of these materials at meetings on November 4, November 26 and December 4, 2002.

Based on this information and applying the criteria set forth in the Act and the Regulations, the Board cannot approve the proposal submitted by United. The Board believes that the business plan proposed by United is not financially sound. In the Board's view, United's management presented a business plan that does not position the company to meet the challenges of the current airline industry environment and to achieve long-term financial stability. The Board believes that, even if the company were to receive the proceeds of a guaranteed loan, there is a high probability that United would face another liquidity crisis within the next few years. The Board's financial consultant assigned the proposed loan an extremely low credit rating, implying that United is more likely than not to default. The Board believes that the company's proposal poses an unacceptably high risk to U.S. taxpayers and does not support the conclusion

that there is a reasonable assurance of repayment of the proposed loan. The Board would like to make you aware of the following fundamental deficiencies in United's proposal:

First, the Board has concluded that United's revenue projections are unreasonably optimistic.

- United's business plan is predicated upon a significant near-term rebound in revenue. In particular, United forecasts that its passenger unit revenue (revenue per available seat mile) will rise sharply in the near-term due to a significant increase in yields. This forecast for unit revenue growth in the next few years is substantially more optimistic than forecasts of industry observers and the Board's consultants. The Board does not concur with United's explanation for this divergence.

- The more conservative alternative projections submitted by United, which assume a delayed industry revenue recovery, anticipate near-term unit revenue growth that is still in excess of the base case expectations of industry observers.

- The Board also believes that the company's revenue forecast does not make sufficient allowance for the likely effects of continued expansion by low-cost carriers in United's markets as well as other potential structural changes affecting industry revenue.

Second, the Board believes that more reasonable revenue forecasts for United would not support the company's cost structure as presented in the business plan. The Board notes that even with the benefit of United's proposed cost reduction initiatives, United would remain among the highest cost carriers in the industry. If competitors are successful in achieving additional cost savings, United's relative cost position could weaken further.

Third, the Board has substantial concerns about the underfunded status of United's pension plan. Even if United obtains a waiver to reduce near-term funding requirements, required cash outflows will likely remain substantial over the term of the proposed loan. The Board is concerned about United's ability to generate sufficient cash flows to meet its pension funding obligations concurrent with other obligations, including repayment of the guaranteed loan.

Fourth, United has proposed that the loan be secured by a significant collection of assets. The proposed collateral package does not overcome the deficiencies of the business plan and associated default risk. Analysis by the Board's consultants and staff indicates that the collateral package is likely to have substantially less value in the event of default than is estimated by United. The Board believes that there is a significant risk that the recovery value will be less than the outstanding amount of the loan.

Finally, the Board considered United's proposal of November 26, 2002 for a staggered draw on the loan facility. The Board did not view the alternative structure as a material change to United's proposal. The Board's financial consultant assessed this proposal and affirmed the credit rating it had previously assigned. Two members of the Board also believe that the

suggested revisions that United proposed by e-mail and fax on the evening of December 3 are highly unlikely to change their assessment of United's proposal.

Considering all of the foregoing factors, Governor Gramlich and Under Secretary Fisher voted not to approve this proposal. Mr. Van Tine, General Counsel of the Department of Transportation, voted to defer a decision on the Application until December 9 to allow United to submit additional financial information.

Sincerely,

Daniel Montgomery

FEDERAL RESERVE press release

For immediate release December 4, 2002

Statement of Edward M. Gramlich

Chairman

Air Transportation Stabilization Board

These are hard decisions, and I certainly feel for the affected employees. At the same time, the Loan Board has a responsibility to taxpayers, and to fostering the long-term health of the airline industry. Given our conclusion that the business plan submitted by the company is financially unsound, I believe it best not to approve the United proposal.

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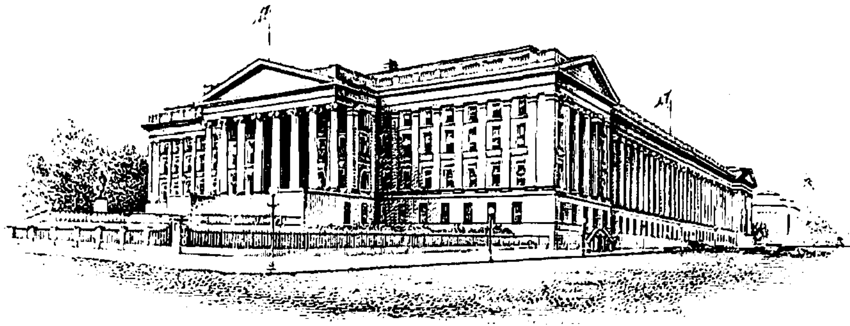


DEPARTMENT OF THE TREASURY

OFFICE OF PUBLIC AFFAIRS

For Immediate Release **Contact: Betsy Holahan**
December 4, 2002 **202-622-2960**

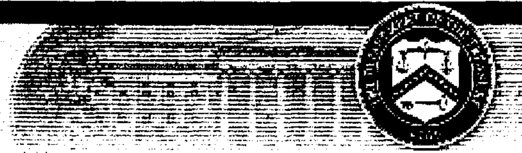
**Statement of Treasury Under Secretary Peter R. Fisher
On ATSB Announcement on United Air Lines**

I could not approve United's proposal for a federal loan guarantee because their submission failed to meet the requirements of the statute and the regulations that must guide our decisions. This is not just about costs, it's about a business plan that is fundamentally flawed.

-30-

PO-3671

PRESS ROOM



FROM THE OFFICE OF PUBLIC AFFAIRS

December 5, 2002
PO-3672

Using Clauses to Reform the Process for Sovereign Debt Workouts: Progress and Next Steps - Prepared Remarks at the EMTA Annual Meeting John B. Taylor Under Secretary of Treasury for International Affairs December 5, 2002

Thank you for giving me the opportunity to speak here today. It is a pleasure to engage with so many knowledgeable and experienced emerging market participants in one setting. I have found that frequent and candid discussions between the private and the public sector are essential for good economic policy whether they take place on trading floors, in government offices, on the phone, by email, or at formal meetings like this one. And I want to say that I am grateful for the useful analysis and comments provided by EMTA members and staff-especially by EMTA Executive Director Michael Chamberlin. I hope that my comments can be as useful to you today.

I would like to focus on a topic that many of us have been discussing for the past year-incorporating new clauses into sovereign bonds, clauses that can create a better process for countries and their creditors to follow in the event of a debt workout. The lack of a clear, well-defined process for sovereign debt workouts is a design weakness in the emerging markets that impedes broader participation in the market. The uncertainty prevents the market from accurately pricing the risk of a restructuring event. The uncertainty also complicates official sector and private sector decision-making thereby leaving emerging markets more susceptible to costly and painful crises than they need be. For this reason, incorporating such clauses into sovereign bonds is an important component of the Administration's overall emerging market strategy.

The goals of the overall strategy are to increase economic growth and reduce economic instability in emerging market countries. To achieve these goals, strong and stable private capital flows to emerging markets are essential. Unfortunately those flows declined markedly after the increase in the frequency and severity of financial crises in the 1990s. To restore these flows we are following an action plan that aims to (1) better prevent crises, (2) reduce contagion from crises, (3) limit and clarify official sector financial response to crises, and (4) improve the process of sovereign debt workouts. The incorporation of new clauses into bonds by sovereign issuers and creditors is a key means to achieve the fourth part of this action plan.

The Decentralized Approach

Last April in a speech in Washington I outlined the Administration's proposals for putting new clauses into sovereign debt and I asked for action on its implementation as soon as possible. The proposals had been under development in the U.S. government since last fall in response to a request by Treasury Secretary Paul O'Neill to find a better process for sovereign debt workouts. Others in the private and the public sector had been developing similar proposals. Indeed, a G-10 working group suggested such an approach way back in 1996. And, as you know, some collective action clauses are already incorporated in emerging market sovereign bonds governed by the laws of the United Kingdom and Japan. About 30 percent of the total outstanding volume of emerging market sovereign bonds now includes collective action clauses.

Under the U.S. proposal, sovereign bonds governed by the laws of the United States, Germany, and other key jurisdictions would also include collective action clauses. We stressed the need for a particular type of a collective action clause-a majority action clause that would allow a super-majority of bondholders to alter the key financial terms of a bond. Over time, the 30 percent of debt with majority action clauses would grow to 100 percent. The proposal also suggested including new types of clauses-which we called engagement clauses and initiation clauses. These new clauses would set forth the modalities of a sovereign debt workout. The clauses would provide for early dialogue, coordination, and communication among creditors and a sovereign and limit disruptive legal actions. Each type of clause-majority action, engagement, and initiation-had the purpose of better defining the sovereign debt workout process and thereby making it more predictable.

We pointed out that this approach was market-based and decentralized in two important senses. First, the clauses themselves would be developed and agreed to by creditors and the issuers in a decentralized way. In other words, within the parameters or guidelines in our proposal, sovereign borrowers along with their creditors and their lawyers would work out the details as new bonds would be issued. Eventually, new templates with these clauses would replace existing templates without the clauses. The second way in which this approach was market-based and decentralized is that in the event of a restructuring, the sovereign government and its creditors would work out the terms of the restructuring on their own guided by the clauses but without the involvement of a central group or panel.

The Response from EMTA and Others

Let me emphasize how pleased we were with the reactions to this proposal. Representatives from the private sector stated their general support for the introduction of clauses and have been working to develop the details much as we had hoped. We have made much progress in the last six months. I very much appreciate these efforts.

The EMTA Position Regarding the Quest for More Orderly-Sovereign Work-Outs (October 17, 2002) is particularly helpful in this regard because it endeavors to lay out a set of details that fit into the broad parameters of the decentralized approach. The EMTA position emphasizes two principles. First, the clauses must be "marketable" in the sense that they must be acceptable by the marketplace of issuers and investors. Second, to the extent that the clauses make bonds easier to restructure, they should not also make defaults and/or restructurings more likely. We agree wholeheartedly with both of these principles.

Regarding the particular clauses, the EMTA proposal includes a majority action clause, which would permit the amendment and waiver of key bond terms by approval of an appropriate super-majority of bonds outstanding. The proposal also includes an engagement clause "to facilitate constructive dialogue between a sovereign debtor and its creditors when restructuring seems necessary." And there is also an initiation clause "to inhibit precipitous litigation as a practical matter." With this initiation clause "bonds should require 25 percent bondholder vote to accelerate principal for event of default and provide for a 75 percent vote to rescind acceleration." Note that this last suggestion is a type of majority enforcement provision.

It is also very encouraging to see that many emerging market countries have expressed their support for the decentralized approach. In early September, the members of the European Union - including Italy, Spain and Sweden, which are all countries that regularly issue in foreign jurisdictions - committed to using collective action clauses in their external sovereign bond issuances. Eventually we would expect new emerging market members of the European Union such as Poland and Hungary to do the same. Moreover, the G-7 has not only stated its strong support for the clauses in emerging market countries, it has agreed that G-7 countries that issue bonds governed by the jurisdiction of another sovereign will include collective action clauses. That is the strongest statement of support for collective action clauses ever issued by the G-7.

2003 is the Year for Action

With all this progress and show of support, the conditions now appear to be ripe for issuers and their creditors, investment bankers, and lawyers to roll up their sleeves and get to work writing new clauses into bonds as they are issued. There are enough emerging market issuers-many with investment grade ratings-expected to come forth in 2003 that the first mover problem should not be a problem. Each issue that proceeds without the new clauses delays the day when we resolve this uncertainty that still hangs over the markets.

I recognize, of course, that there are still some concerns and reservations about incorporating new clauses into sovereign bonds, and that these concerns are holding some issuers and market participants back. Let me try to address some of the concerns that I have heard.

Concerns

One concern is simply that the clauses are unnecessary-that the current process for sovereign debt restructuring works just fine. It is true that the market has found a solution in some recent sovereign debt restructuring cases, including Pakistan and Ukraine. But even in cases such as Pakistan and Ukraine, the process was by no means straightforward. Uncertainty about how the restructuring would unfold-or even if restructuring could unfold-complicated decision-making and potentially left countries cut off from credit markets for longer periods than they would have been if a more clearly defined process for restructuring had been in place. Clarification of the debt restructuring process would most certainly be helpful in more complex situations.

Ukraine is an interesting case in point. Ukraine's restructuring is frequently held up as a successful example. But even in this case, complications arose because one of Ukraine's bonds in the restructuring did not have majority action clauses. As a result, the authorities needed to track down the bondholders and try to secure 100 percent consent to amend the financial terms of their bonds. This proved especially difficult because retail investors owned a large portion of this bond. These problems were not insurmountable in the case of Ukraine largely because the authorities had only a small number of external debt instruments outstanding. But this is not the case for so many other emerging market countries.

Others have raised concerns that the new clauses would not allow for aggregation of debt across different instruments. It is true that most proposals do not allow for collective action across different classes of debt. But this does not mean that the process would not work or that it would not provide sufficient clarity to attract additional investors and greatly improve predictability. Even without aggregation, the clauses can be helpful in describing a process for workouts without the added delay of developing a complex aggregation procedure.

Another worry is that the clauses will raise borrowing costs. But this is at odds with empirical evidence and with comments we have received from many buy-side participants. By comparing spreads on bonds with and without clauses studies have found that majority action clauses have not raised borrowing costs. A key advantage, as I already mentioned, of the clauses is that by providing a process for workouts the risk of such workouts can be better priced. In fact, empirical evidence shows that countries with good credit ratings have had their borrowing costs go down with collective action clauses. Many investors have been favorable towards collective action clauses and have indicated that they would buy bonds with collective action clauses, provided such clauses do not infringe upon the rights of creditors.

Another criticism is that the new clauses would only apply to new bonds and would therefore impact a relatively narrow scope of debt. It would take many years before the entire stock of outstanding bonds was covered. To me this is a reason to get started now. Had the majority action clauses been introduced in New York and

Germany starting in 1996, when the idea was first proposed, we would have dealt with a large part of the problem by now. According to the latest IMF Global Financial Stability Report, from 1996 through the present, there have been about $150 billion in sovereign bonds issued without collective action clauses.

Some have criticized the decentralized approach because it does not appear to be new. Well, not all old ideas are bad. But more to the point, our decentralized proposals went well beyond traditional collective action clauses to include both engagement and initiation clauses. Still others have argued that the rogue creditor problem is not so bad. To be sure, I did not even mention the rogue creditor problem in my April speech. What we are trying to address is the current uncertainty and lack of a well-defined process. Clauses requiring agreements by 100 percent of bondholders create more uncertainty and difficulty than clauses requiring 75 percent.

Yet another criticism is that the improved sovereign debt process will only deal with some crises. It is certainly true that not all crises are related to the sustainability of sovereign debt issued in foreign jurisdictions. Currency and maturity mismatches in the private sector, exchange rate pegs, poor supervision of financial institutions, and indexed domestic debt are other potential sources of financial crises. We are working in these areas too-and there have been improvements-especially in the areas of exchange rate policy and transparency. But even if only a few crises could be prevented, reforming the restructuring process should still be a high priority. Moreover, crisis prevention is not the only goal. The attraction of a broader class of investors to the emerging markets would strengthen the flows of capital and increase economic growth in these countries.

In recent months another concern has been raised about going ahead with the clause approach now. Namely there are worries about the impact of the recent work by the International Monetary Fund on a centralized sovereign debt restructuring process-frequently called the sovereign debt restructuring mechanism (SDRM)-which would create a supra-national panel or court through an amendment of the IMF Articles. This concern has been registered, for example, in the EMTA position paper: "The possibility of an over-riding bankruptcy regime chills the market-based approach because neither creditors nor issuers know what changes can safely be made in existing documentation." I would like to address this concern too.

First, let me state the U.S. position on the debate on the decentralized versus the centralized approach. In our view, good public policy requires carefully investigating all alternatives and pursuing the option or combination of options that will work best. Regarding sovereign bonds there are three main possibilities: (1) the decentralized approach, (2) the centralized approach, and (3) a combination of the two where clauses are inserted into new debt instrument and a panel or court is created to deal with aggregation and other issues not captured in the clauses. If there is convincing evidence that the decentralized approach does a better job of preventing crises and strengthening capital flows than the centralized or the combined approaches, then the decentralized approach will be the choice supported by the Bush Administration. Similarly, if one of the other approaches can be shown to work better, then that option will be the one supported.

There has been a lot of discussion of the SDRM over the past year, but there is as yet no specific proposal. That is why the G-7 Finance Ministers and Central Bank Governors called for such a proposal by the time of the Spring IMF/World Bank meetings next year. The G-7 has not endorsed the SDRM approach. It has simply asked for a proposal by the spring of 2003 so that it can consider the pros and cons of this proposal in a rational fashion.

Clearly there are differences between the clause approach and the SDRM. As I have already mentioned, the clauses are much more decentralized than the SDRM. Also, the SDRM would aggregate claims across different issues while the clause approach would not. The SDRM would establish a panel or court, while the clause approach would not. Obviously, the establishment of such a group raises many issues about appointments and accountability that need to be considered carefully. The SDRM would override existing bond contracts; the clauses would

apply to new issues or perhaps to old issues if they are swapped for new issues. The clause approach could be implemented quickly, while the SDRM approach would require a good deal of time in light of its relative complexity and the need to gain legislative approval, including in the United States. So there are many questions left to be answered. What we, and others, have urged is that work be done to raise these questions so that decisions about an SDRM be made in light of a thorough analysis and a full airing and discussion of the issues.

Conclusion

In sum, the introduction of new clauses into sovereign bonds offers an effective approach to reforming the emerging market sovereign debt restructuring process. We are very pleased about the positive support for this approach expressed by the private sector during the last six months and for the work that has gone into developing the details of this approach. We are also pleased that a number of emerging market countries have expressed interest in the decentralized approach. Given this support and the work that has been done already, I think it is time to begin actually including these clauses. Although strong reservations about the alternative centralized approach have been expressed, ongoing research on the centralized approach is no reason not to proceed with the decentralized approach as soon as possible.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

December 5, 2002
PO-3673

Remarks of Treasury Deputy Assistant Secretary for Federal Finance Timothy S. Bitsberger To The Fixed Income Summit Palm Beach, FL

Treasury is Committed to Inflation Indexed Securities

Good morning. It is a pleasure to have the opportunity to speak with you again. Yesterday, I tried to give you a feel for debt management at Treasury as well as our position in the marketplace. We talked about the regularity and predictability of Treasury debt management. I stressed that Treasury is not an opportunistic borrower. We believe a regular auction calendar will provide investors with certainty. That certainty will help translate into broader investor participation which will then help lower Treasury's borrowing costs.

We also seek to lower Treasury's borrowing by increasing the pool of potential investors. Which leads me to today's topic: inflation indexed securities, or TIIS.

If there is one message I want you to take away from my presentation today, it is that we are committed to the TIIS market. This commitment is based on sound debt management principles. By broadening our investor base and diversifying our funding sources, we reduce our borrowing costs over time. By diversifying our types of borrowing, we reduce exposure to a single adverse shock.

We believe that TIIS are a different asset class. As more and more investors accept this distinction, growth of the TIIS market has been accelerating. Many investors have had huge success with TIIS as a tactical allocation. Some have had even greater success with TIIS as a strategic allocation. I believe that for many investors and money mangers a percentage of their portfolios should be focused on real rather than nominal rates of return. The market is still quite young—essentially five years old—and it is still evolving. In fact, a year or two ago, there were concerns that the TIIS program was in jeopardy. I am here to put those fears to rest. Even with a return to surpluses, we are committed to the TIIS program.

I just said that TIIS represent a different asset class, but that does not mean we manage them differently. We issue TIIS the same way we do nominal bonds. At Treasury, we are committed to issuing large, liquid securities. We announced a new TIIS policy in May of this past year. We increased the number of 10-year note auctions from two to three. We now auction a new security in July and reopen it in both October and January. Reopenings can sometimes cost Treasury money because we do not capture the on-the-run premium often associated with new issuance. However, the benefits of large and predictable issuance – a more stable and liquid secondary market – outweigh the cost of reopening.

We considered several options before we announced our current issuance program [the high amount of TIIS maturing in July and the value in reopening securities over six rather than twelve months]. However, it is important that we expand the auction calendar without moving too fast and getting ahead of the market.

One point on this slide that I want to highlight is the deflation protection. Principal is guaranteed at maturity. That is not a comment on interest rates but it is an option that does have some value.

Our commitment to TIIS is also evident in our issuance. We have become the world's largest IIS issuer with more than $150 billion outstanding. However, at this point we do plan to target our issuance as a percentage of gross issuance. Even though we strive to be regular and predictable, we can not limit our flexibility as debt managers by committing to specific issuance in the future. On the margin, factors beyond my control, such as outlays and receipts, determine our borrowing needs.

A much higher percentage of auction awards are allocated to investment funds, a further indication that the market has come to believe that we are committed to TIIS. Though I have no empirical evidence to support this, I believe many of these investors view TIIS as a tactical as well as a strategic investment.

Increased issuance and greater market acceptance has led to increased liquidity. TIIS may never trade with the liquidity of nominal Treasuries, but that may not be the appropriate standard – by any other measure, liquidity is good and promises to get better. I also believe many dealers are committing more capital TIIS. Until Treasury publicly announced commitment to TIIS, I think the dealers were a little wary of committing personnel and capital. I am excited at the prospects for the dealer community.

Over the 5 years we have been issuing inflation-indexed securities, some analysts have said they are a more expensive form of borrowing than the comparable nominal securities. It's too early to pass judgment on the cost effectiveness of these instruments. It takes time and effort to build a critical mass of liquidity.

Diversifying our investor base may be the most important contribution of TIIS, but I believe that over time they will be viewed as cost-effective. We are a long way from making that assessment – at a minimum, cost-effectiveness should only be determined after a product has been through an entire interest rate cycle. Even then I think we have to be careful how to judge TIIS. The market does not judge, for example, whether or not 3-month bills are more expensive to issue than 5-year notes over time. Market participants recognize that Treasury is diversifying its investor base and its exposure to adverse interest rate movements.

The decision to invest is yours and I do not want to encourage an investment that may or may not be appropriate for you. But I do want to point out a few things. These securities are of particular value to investors because their prices move differently from conventional securities. As you can see they have lower risk than the Lehman index and 10-year note, both absolute and relative. Their real (inflation unadjusted) price varies inversely with real U.S. interest rates, not nominal interest rates, making them very attractive for risk diversification. We also think that Treasury Inflation-Indexed Securities are a unique asset class – dollar-denominated, inflation- protected, backed by U.S. full faith and credit – that every diversified investor should own.

Investors should also find the scale of TIIS attractive. Comparably sized markets include global high yield debt, emerging market securities, and European corporates. In comparison, the inflation-indexed market is highly liquid due to the quality of the issuers, large issuance sizes and broad range of maturities.

We believe there is and will be strong demand for inflation protected notes backed by the full faith and credit of the US Government. We are excited about the growth prospects for TIIS. I would like to encourage everyone here to contact Treasury or myself should you have any suggestions in how to grow this asset class.

Thank you very much. I would be happy to take any questions

DEPARTMENT OF THE TREASURY

TREASURY NEWS

OFFICE OF PUBLIC AFFAIRS • 1500 PENNSYLVANIA AVENUE, N.W. • WASHINGTON, D.C. • 20220 • (202) 622-2960

EMBARGOED UNTIL 11:00 A.M.
December 5, 2002

Contact: Office of Financing
202/691-3550

TREASURY OFFERS CASH MANAGEMENT BILLS

The Treasury will auction approximately $13,000 million of 6-day Treasury cash management bills to be issued December 10, 2002.

Tenders for Treasury cash management bills to be held on the book-entry records of *TreasuryDirect* will not be accepted.

Up to $1,000 million in noncompetitive bids from Foreign and International Monetary Authority (FIMA) accounts bidding through the Federal Reserve Bank of New York will be included within the offering amount of the auction. These noncompetitive bids will have a limit of $100 million per account and will be accepted in the order of smallest to largest, up to the aggregate award limit of $1,000 million.

Note: The closing times for receipt of noncompetitive and competitive tenders will be at 11:00 a.m. and 11:30 a.m. eastern standard time, respectively.

The allocation percentage applied to bids at the highest discount rate will be rounded up to the next hundredth of a whole percentage point, e.g., 17.13%.

This offering of Treasury securities is governed by the terms and conditions set forth in the Uniform Offering Circular for the Sale and Issue of Marketable Book-Entry Treasury Bills, Notes, and Bonds (31 CFR Part 356, as amended).

Details about the new security are given in the attached offering highlights.

oOo

Attachment

PO-3674

HIGHLIGHTS OF TREASURY OFFERING
OF 6-DAY CASH MANAGEMENT BILLS

December 5, 2002

Offering Amount .... $13,000 million
Public Offering .... $13,000 million

Description of Offering:
Term and type of security .... 6-day Cash Management Bill
CUSIP number .... 912795 MW 8
Auction date .... December 9, 2002
Issue date .... December 10, 2002
Maturity date .... December 16, 2002
Original issue date .... December 10, 2002
Currently outstanding .... ---
Minimum bid amount and multiples ... $1,000

Submission of Bids:
Noncompetitive bids: Accepted in full up to $1 million at the highest discount rate of accepted competitive bids.
Foreign and International Monetary Authority (FIMA) bids: Noncompetitive bids submitted through the Federal Reserve Banks as agents for FIMA accounts. Accepted in order of size from smallest to largest with no more than $100 million awarded per account. The total noncompetitive amount awarded to Federal Reserve Banks as agents for FIMA accounts will not exceed $1,000 million. A single bid that would cause the limit to be exceeded will be partially accepted in the amount that brings the aggregate award total to the $1,000 million limit. However, if there are two or more bids of equal amounts that would cause the limit to be exceeded, each will be prorated to avoid exceeding the limit.
Competitive bids:
(1) Must be expressed as a discount rate with three decimals in increments of .005%, e.g., 7.100%, 7.105%.
(2) Net long position for each bidder must be reported when the sum of the total bid amount, at all discount rates, and the net long position is $1 billion or greater.
(3) Net long position must be determined as of one half-hour prior to the closing time for receipt of competitive tenders.

Maximum Recognized Bid at a Single Rate...35% of public offering
Maximum Award...........................35% of public offering

Receipt of Tenders:
Noncompetitive tenders:
Prior to 11:00 a.m. eastern standard time on auction day
Competitive tenders:
Prior to 11:30 a.m. eastern standard time on auction day

Payment Terms: By charge to a funds account at a Federal Reserve Bank on issue date.

DEPARTMENT OF THE TREASURY

TREASURY NEWS

OFFICE OF PUBLIC AFFAIRS • 1500 PENNSYLVANIA AVENUE, N.W. • WASHINGTON, D.C. • 20220 • (202) 622-2960

EMBARGOED UNTIL 11:00 A.M.
November 27, 2002

CONTACT: Office of Financing
202/691-3550

TREASURY OFFERS 13-WEEK AND 26-WEEK BILLS

The Treasury will auction 13-week and 26-week Treasury bills totaling $29,000 million to refund an estimated $29,818 million of publicly held 13-week and 26-week Treasury bills maturing December 5, 2002, and to pay down approximately $818 million. Also maturing is an estimated $16,000 million of publicly held 4-week Treasury bills, the disposition of which will be announced December 2, 2002.

The Federal Reserve System holds $12,975 million of the Treasury bills maturing on December 5, 2002, in the System Open Market Account (SOMA). This amount may be refunded at the highest discount rate of accepted competitive tenders either in these auctions or the 4-week Treasury bill auction to be held December 3, 2002. Amounts awarded to SOMA will be in addition to the offering amount.

Up to $1,000 million in noncompetitive bids from Foreign and International Monetary Authority (FIMA) accounts bidding through the Federal Reserve Bank of New York will be included within the offering amount of each auction. These noncompetitive bids will have a limit of $100 million per account and will be accepted in the order of smallest to largest, up to the aggregate award limit of $1,000 million.

TreasuryDirect customers have requested that we reinvest their maturing holdings of approximately $1,096 million into the 13-week bill and $815 million into the 26-week bill.

The allocation percentage applied to bids awarded at the highest discount rate will be rounded up to the next hundredth of a whole percentage point, e.g., 17.13%.

This offering of Treasury securities is governed by the terms and conditions set forth in the Uniform Offering Circular for the Sale and Issue of Marketable Book-Entry Treasury Bills, Notes, and Bonds (31 CFR Part 356, as amended).

Details about each of the new securities are given in the attached offering highlights.

oOo

Attachment

PO-3675

HIGHLIGHTS OF TREASURY OFFERINGS OF BILLS
TO BE ISSUED DECEMBER 5, 2002

November 27, 2002

Offering Amount	$14,000 million	$15,000 million
Public Offering	$14,000 million	$15,000 million
NLP Exclusion Amount	$ 4,900 million	None

Description of Offering:

Term and type of security	91-day bill	182-day bill
CUSIP number	912795 MB 4	912795 MQ 1
Auction date	December 2, 2002	December 2, 2002
Issue date	December 5, 2002	December 5, 2002
Maturity date	March 6, 2003	June 5, 2003
Original issue date	September 5, 2002	December 5, 2002
Currently outstanding	$19,474 million	---
Minimum bid amount and multiples	$1,000	$1,000

The following rules apply to all securities mentioned above:

Submission of Bids:

Noncompetitive bids: Accepted in full up to $1 million at the highest discount rate of accepted competitive bids.

Foreign and International Monetary Authority (FIMA) bids: Noncompetitive bids submitted through the Federal Reserve Banks as agents for FIMA accounts. Accepted in order of size from smallest to largest with no more than $100 million awarded per account. The total noncompetitive amount awarded to Federal Reserve Banks as agents for FIMA accounts will not exceed $1,000 million. A single bid that would cause the limit to be exceeded will be partially accepted in the amount that brings the aggregate award total to the $1,000 million limit. However, if there are two or more bids of equal amounts that would cause the limit to be exceeded, each will be prorated to avoid exceeding the limit.

Competitive bids:

(1) Must be expressed as a discount rate with three decimals in increments of .005%, e.g., 7.100%, 7.105%.
(2) Net long position (NLP) for each bidder must be reported when the sum of the total bid amount, at all discount rates, and the net long position is $1 billion or greater.
(3) Net long position must be determined as of one half-hour prior to the closing time for receipt of competitive tenders.

Maximum Recognized Bid at a Single Rate .... 35% of public offering

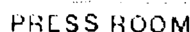
Maximum Award .... 35% of public offering

Receipt of Tenders:

Noncompetitive tenders..... Prior to 12:00 noon eastern standard time on auction day

Competitive tenders........ Prior to 1:00 p.m. eastern standard time on auction day

Payment Terms: By charge to a funds account at a Federal Reserve Bank on issue date, or payment of full par amount with tender. *TreasuryDirect* customers can use the Pay Direct feature which authorizes a charge to their account of record at their financial institution on issue date.



FROM THE OFFICE OF PUBLIC AFFAIRS

December 10, 2002
PO-3676

Treasury and IRS Propose Regulations for Cash Balance Pension Plans

Today the Treasury Department and the IRS issued proposed regulations on cash balance pension plans. The regulations address the application of the pension plan age discrimination rules to cash balance plans.

"The proposed regulations would provide long-needed guidance on significant questions about cash balance plans. Cash balance plans are a type of defined benefit plan adopted by many employers over the past ten years," stated Treasury Assistant Secretary for Tax Policy Pam Olson. "Guidance on defined benefit plans is important because under these plans the employer bears the investment risk which results in retirement security not available under a defined contribution plan."

A cash balance pension plan combines the benefit formula of a defined contribution plan with the investment security of a defined benefit plan. A cash balance plan establishes a "hypothetical account" for each employee and credits the account with hypothetical "pay credits" and "interest credits." The proposed regulations would apply to cash balance plans the same rule that applies to defined contribution plans. Consequently, a cash balance plan would generally satisfy the age discrimination rules if the pay credits to an employee's account are not less than the pay credits that would be made if the employee were younger.

The proposed regulations also address "conversions" of traditional pension plans to cash balance plans. Under these rules, the plan must be age-neutral before the conversion, age-neutral after the conversion, and age-neutral in the process of the conversion. This means that each employee following a conversion must start with a cash balance account calculated on an age-neutral basis. Assuming that is the case, a "wear-away" period, during which cash balance benefits catch up with benefits under the traditional plan would not run afoul of the proposed rules.

The proposed regulations are subject to public comment. The IRS will not begin issuing administrative "determination letters" on converted cash balance plans prior to consideration of all comments and the publication of final regulations.

The text of the proposed regulations is attached.

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-209500-86, REG-164464-02]
RIN 1545-BA10,1545-BB79

Reductions of Accruals and Allocations Because of the Attainment of Any Age; Application of Nondiscrimination Cross-Testing Rules to Cash Balance Plans

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations that would provide rules regarding the requirements that accruals or allocations under certain retirement plans not cease or be reduced because of the attainment of any age. In addition, the proposed regulations would provide rules for the application of certain nondiscrimination rules to cash balance plans. These regulations would affect retirement plan sponsors and administrators, and participants in and beneficiaries of retirement plans. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments, requests to speak and outlines of oral comments to be discussed at the public hearing scheduled for April 10, 2003, at 10 a.m., must be received by March 13, 2003.

ADDRESSES: Send submissions to: CC:ITA:RU (REG-209500-86), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered to: CC:ITA:RU (REG-209500-86), room 5226, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC.

Alternatively, taxpayers may submit comments electronically via the Internet by submitting comments directly to the IRS Internet site at: www.irs.gov/regs. The public hearing will be held in room 4718, Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Linda S. F. Marshall, 202-622-6090, or R. Lisa Mojiri-Azad, 202-622-6030; concerning submissions and the hearing, and/or to be placed on the building access list to attend the hearing, Sonya Cruse, 202-622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR Part 1) under sections 401 and 411 of the Internal Revenue Code of 1986 (Code). Section 411(b)(1)(H), which was added in subtitle C of the Omnibus Budget Reconciliation Act of 1986 (OBRA '86) (100 Stat. 1874), provides that a defined benefit plan fails to comply with section 411(b) if, under the plan, an employee's benefit accrual is ceased, or the rate of an employee's benefit accrual is reduced, because of the attainment of any age. Under section 411(b)(2)(A), added by subtitle C of OBRA '86, a defined contribution plan fails to comply with section 411(b) unless, under the plan, allocations to the employee's account are not ceased, and the rate at which amounts are allocated to the employee's account is not reduced, because of the attainment of any age.

Section 411(b)(1)(H)(iii) provides that any requirement of continued accrual of benefits after normal retirement age is treated as satisfied to the extent benefits are

distributed to the participant or the participant's benefits are actuarially increased to reflect the delay in the distribution of benefits after attainment of normal retirement age. Section 411(a) requires a qualified plan to meet certain vesting requirements. In the case of a participant in a defined benefit plan who works after attaining normal retirement age, these vesting requirements are not satisfied unless the plan provides an actuarial increase after normal retirement age for accrued benefits, distributes benefits while the participant is working after normal retirement age, or suspends benefits as described in section 411(a)(3)(B) (and the regulations of the Department of Labor at 29 CFR 2530.203-3). Section 401(a)(9)(C)(iii), added to the Code by the Small Business Job Protection Act of 1996 (110 Stat. 1755) (1996), requires that the accrued benefit of any employee who retires after age 70½ be actuarially increased to take into account the period after age 70½ during which the employee is not receiving benefits.

Section 4(i) of the Age Discrimination in Employment Act (ADEA) and sections 204(b)(1)(H) and 204(b)(2) of the Employee Retirement Income Security Act of 1974 (ERISA) provide requirements comparable to those in sections 411(b)(1)(H) and 411(b)(2) of the Code. Section 4(i)(4) of ADEA provides that compliance with the requirements of section 4(i) with respect to an employee pension benefit plan constitutes compliance with the requirements of section 4 of ADEA relating to benefit accrual under the plan.

Under section 101 of Reorganization Plan No. 4 of 1978 (43 FR 47713), the Secretary of the Treasury has interpretive jurisdiction over the subject matter addressed in these regulations for purposes of ERISA, as well as the Code. Therefore, these

regulations apply for purposes of the parallel requirements of sections 204(b)(1)(H) and 204(b)(2) of ERISA, as well as for section 411(b) of the Code.

The Equal Employment Opportunity Commission (EEOC) has jurisdiction over section 4 of ADEA. Section 9204(d) of OBRA '86 requires that the regulations and rulings issued by the Department of Labor, the Treasury Department, and the EEOC pursuant to the amendments made by subtitle C of OBRA '86 each be consistent with the others. It further requires the Secretary of Labor, the Secretary of the Treasury, and the EEOC to each consult with the others to the extent necessary to meet the requirements of the preceding sentence. Executive Order 12067 requires all Federal departments and agencies to "advise and offer to consult with the Equal Employment Opportunity Commission during the development of any proposed rules, regulations, policies, procedures or orders concerning equal employment opportunity." The IRS and Treasury have consulted with the Department of Labor and the EEOC prior to the issuance of these proposed regulations under sections 411(b)(1)(H) and 411(b)(2) of the Code.

The EEOC published proposed regulations interpreting section 4(i) of ADEA in the **Federal Register** on November 27, 1987 (52 FR 45360). Proposed regulations REG-209500-86 (formerly EE-184-86) under sections 411(b)(1)(H) and 411(b)(2) were previously published by the IRS and Treasury in the **Federal Register** on April 11, 1988 (53 FR 11876), as part of a package of regulations (the 1988 proposed regulations) that also included proposed regulations under sections 410(a), 411(a)(2), 411(a)(8) and 411(c) (relating to maximum age for participation, vesting, normal retirement age, and actuarial

adjustments after normal retirement age). The IRS, Treasury, the Department of Labor, and the EEOC consulted prior to the issuance of both sets of proposed regulations.

Notice 88-126 (1988-2 CB 538), addressed certain effective date issues for sections 411(b)(1)(H) and 411(b)(2). The EEOC issued a similar notice addressing those effective date issues in the **Federal Register** on January 9, 1989 (54 FR 604). The United States Supreme Court subsequently issued an opinion addressing the effective date of section 411(b)(1)(H) in Lockheed Corp. v. Spink, 517 U.S. 882 (1996), which is discussed below.

On October 20, 1999, the IRS and Treasury published a solicitation for comments in the **Federal Register** (64 FR 56578) inviting comments regarding potential issues under their jurisdiction with respect to cash balance plans (a type of defined benefit plan under which the normal form of benefit is an immediate payment of a participant's hypothetical account, which is adjusted periodically to reflect pay credits and interest credits), conversions of traditional defined benefit plans to cash balance plans and associated wear-away or benefit plateau effects. Hundreds of comments were received from a wide range of parties with interests in cash balance plans, including employees, employers, and their representatives. The most significant issue raised in the comments relates to the application of section 411(b)(1)(H) to cash balance plans and conversions of traditional defined benefit plans to cash balance plans.

These proposed regulations are being issued after consideration of the comments on the 1988 proposed regulations, as well as more recent comments concerning the

application of sections 411(b)(1)(H) and 411(b)(2). These proposed regulations address the application of section 411(b)(1)(H) to cash balance plans, including conversions.

These proposed regulations would also amend the provisions of the regulations under section 401(a)(4) to provide rules for nondiscrimination testing for certain cash balance plans.

Explanation of Provisions

Overview

These proposed regulations provide guidance on the requirements of section 411(b)(1)(H), under which a defined benefit plan fails to be a qualified plan if, under the plan, benefit accruals on behalf of a participant are ceased or the rate of benefit accrual on behalf of a participant is reduced because of the participant's attainment of any age.[1] Similarly, these proposed regulations provide guidance on the requirements of section

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[1]While section 4(i) of the ADEA, section 204(b)(1)(H) of ERISA, and section 411(b)(1)(H) of the Code are worded similarly, the words "attainment of any" are not in section 4(i) of the ADEA. The legislative history states that no differences among the provisions is intended (OBRA 86 House Report No. 99-727 at 378-9), and the agencies

411(b)(2), under which a defined contribution plan fails to be a qualified plan if, under the plan, allocations to a participant's account are ceased or the rate of allocations to a participant's account is reduced because of the participant's attainment of any age.

These proposed regulations follow the 1988 proposed regulations in many respects. In particular, these proposed regulations would adopt many of the positions taken under the 1988 proposed regulations for determining whether a plan ceases benefit accruals or allocations because of the attainment of any age or provides for a direct or indirect reduction in the rate of benefit accrual or allocation because of the attainment of any age.

These proposed regulations also provide guidance on how to determine the rate of benefit accrual or rate of allocation. In the case of defined benefit plans, the proposed regulations would provide two basic approaches to determining the rate of benefit accrual: a general approach applicable to all defined benefit plans; and a separate approach applicable to eligible cash balance plans, as defined in these proposed regulations. These proposed regulations also provide guidance on determining the rate of allocation under a defined contribution plan.

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have concluded that this particular difference in language has no effect.

Finally, these proposed regulations address other related issues also addressed in the 1988 proposed regulations, including the application of sections 411(b)(1)(H) and 411(b)(2) to optional forms of benefits, ancillary benefits and other rights and features, the coordination of the requirements of sections 411(b)(1)(H) and 411(b)(2) with certain other qualification requirements under the Code, such as sections 401(a)(4), 411(a), and 415, and the effective date of sections 411(b)(1)(H) and 411(b)(2).

Applicability Prior to Normal Retirement Age

Sections 411(b)(1)(H) and 411(b)(2) prohibit cessation of accruals or allocations, and reduction in the rate of benefit accrual or allocation, because of the attainment of any age. Under these sections, attainment of any age means a participant's growing older. Accordingly, these regulations, like the 1988 proposed regulations, would apply regardless of whether the participant is older than, younger than, or at normal retirement age.

Some commentators have suggested that only cessations or reductions after attainment of normal retirement age are prohibited by these sections. This interpretation is not consistent with the language of the statute, which does not specify any minimum age at which the rule applies, and is not adopted under these proposed regulations.

Reduction in Rate of Benefit Accrual Because of Attainment of Any Age

Under these proposed regulations, a defined benefit plan fails to comply with section 411(b)(1)(H) if, either directly or indirectly, a participant's rate of benefit accrual is reduced (which includes a cessation of participation in the plan or other discontinuance of benefit accruals) because of the participant's attainment of any age. A plan provides for a reduction in the rate of benefit accrual that is directly because of the attainment of any age

if, during a plan year, under the terms of the plan, any participant's rate of benefit accrual for the plan year would be higher if the participant were younger. Thus, a plan fails to comply with section 411(b)(1)(H) if, under the terms of the plan, the rate of benefit accrual for any individual who is or could be a participant under the plan would be lower solely as a result of such individual being older. Whether there is an actual participant at any particular age is not relevant. Similarly, whether a reduction in the rate of benefit accrual is because of the attainment of any age does not depend on a comparison of a participant's rate of benefit accrual for a year to that participant's rate of benefit accrual in an earlier year. These proposed regulations include a number of examples (at §1.411(b)-2(b)(3)(iii) of these regulations) which illustrate whether a reduction in the rate of benefit accrual is because of the attainment of any age.

A reduction in the rate of benefit accrual is indirectly because of a participant's attainment of any age if any participant's rate of benefit accrual for the plan year would be higher if the participant were to have a different characteristic that is a proxy for being younger, based on all the relevant facts and circumstances. For example, if a company assigns older workers to one division and younger workers to another even though they perform the same work, then assignment to a division would be a proxy for being older or younger.

Like the 1988 proposed regulations, these proposed regulations provide that a reduction in a participant's rate of benefit accrual is not indirectly because of the attainment of any age in violation of section 411(b)(1)(H) solely because of a positive correlation between attainment of any age and a reduction in the rate of benefit accrual. In addition, a

defined benefit plan does not fail to satisfy section 411(b)(1)(H) solely because, on a uniform and consistent basis without regard to a participant's age, the plan limits the amount of benefits a participant may accrue under the plan or limits the number of years of service or participation taken into account for purposes of determining the accrual of benefits under the plan, whether the plan reduces or ceases accruals for service in excess of such limit. A limitation that is expressed as a percentage of compensation (whether averaged over a participant's total years of credited service for the employer or over a shorter period) is a permissible limitation on the amount of benefits a participant may accrue under the plan.

Rate of Benefit Accrual

Neither section 411(b)(1)(H) nor the 1988 proposed regulations define the rate of benefit accrual. These proposed regulations would provide two basic approaches to determining the rate of benefit accrual, based on the way the benefit is expressed in the plan. One approach may be used by all defined benefit plans. A second approach may be used only by an eligible cash balance plan, as defined in these proposed regulations.

Under the general rule, the rate of benefit accrual for any plan year that ends before the participant attains normal retirement age is the increase in the participant's accrued normal retirement benefit for the year. Because the rate of benefit accrual is determined by reference to the increase in the accrued benefit during the plan year, any subsidized portion of an early retirement benefit, any qualified disability benefit, or any social security supplement is disregarded.

Section 411(b)(1)(H)(iii)(II) provides that a defined benefit plan does not fail to comply with section 411(b)(1)(H) for a plan year to the extent of any adjustment in the benefit payable under the plan during such plan year attributable to the delay in the distribution of benefits after the attainment of normal retirement age. These proposed regulations implement this rule (i.e., permit a plan to offset any actuarial adjustment during the year against the otherwise required accruals under the plan), by providing that the rate of benefit accrual after normal retirement age is equal to the excess, if any, of the annual benefit to which the participant is entitled at the end of the plan year over the annual benefit to which the participant would have been entitled at the end of the preceding plan year. For this purpose, the annual benefit is determined assuming that payment commences in the normal form of benefit under the plan at the end of the applicable year. For purposes of these proposed regulations, the normal form of benefit is the form under which payments due to the participant are expressed under the plan, prior to adjustment for form of benefit.

The methodology of determining a year-by-year rate of accrual, taking into account any actuarial increases during the plan year, is a departure from the methodology used in the 1988 proposed regulations. As a consequence of the methodology used in these proposed regulations, the plan may not reduce a participant's rate of benefit accrual in a plan year to take into account the fact that, in the preceding plan year, the actuarial increase was greater than the accrual under the plan formula.

While any actuarial adjustment made to the annual benefit to which the participant would have been entitled at the end of the preceding plan year is included in the rate of benefit accrual after normal retirement age, a defined benefit plan must separately comply

with the requirements of section 411(a), which are not addressed in these proposed regulations. Thus, for example, a plan that does not provide for suspension of benefits in accordance with section 411(a)(3) must provide for actuarial adjustments of the amount that would otherwise be paid (or distributions of that amount) that are adequate to satisfy section 411(a) and 29 CFR 2530.203-3 of the regulations of the Department of Labor. In addition, the plan must comply with section 401(a)(9)(C)(iii) with respect to actuarial adjustments for participants who retire after attainment of 70½.

Section 411(b)(1)(H)(iii)(I) provides that a defined benefit plan will not fail to satisfy section 411(b)(1)(H) to the extent of the actuarial equivalent of in-service distribution of benefits. Under these proposed regulations, the rate of benefit accrual for a participant who has attained normal retirement age may be reduced by the actuarial value of plan benefit distributions made during the year. This reduction is the equivalent of the provision described above under which a defined benefit plan may offset any actuarial adjustment during the year against the otherwise required accruals for the year. As described immediately below, the manner in which distributions made under the plan are taken into account for a plan year under these regulations is designed so that compliance with section 411(b)(1)(H) is not affected by the optional form in which the distribution is made.

In the plan year during which a distribution is made, distributions are taken into account to the extent the actuarial value of the distribution does not exceed the actuarial value of distributions that would have been made during the plan year had distribution of the participant's full accrued benefit at the beginning of the plan year commenced at the beginning of the plan year (or, if later, at the participant's normal retirement age) in the

normal form of benefit. Distributions in excess of the actuarial value of the distribution that would have been made during the plan year had the distribution of the participant's full accrued benefit commenced in the normal form (called accelerated benefit payments) are disregarded for that plan year, but, as described below, are taken into account in subsequent periods. If the participant is receiving a distribution in an optional form of benefit under which the amount payable annually is less than the amount payable under the normal form of benefit (for example, a QJSA under which the annual benefit is less than the amount payable annually under a straight life annuity normal form), the participant may be treated as receiving payments under an actuarially equivalent normal form of benefit.

Any accelerated benefit payments are taken into account in plan years after the plan year in which the distribution was made by converting the accelerated benefit payments to an actuarially equivalent stream of annual benefit payments under the plan's normal form of benefit distributions, commencing at the beginning of the next following plan year. This equivalent stream of annual benefit payments is then deemed to be paid in plan years after the plan year in which the distribution was made, and the calculation of the rate of benefit accrual after normal retirement age is adjusted by adding any of these deemed payments for future plan years to the annual benefit to which the participant is entitled at the end of a plan year. As so adjusted, therefore, the rate of benefit accrual is determined as the excess, if any, of the sum of the annual benefit to which the participant is entitled at the end of the plan year (assuming payment commences in the normal form at the end of the plan year) plus the annuity equivalent of accelerated benefit payments deemed paid in the next plan year, over the sum of the annual benefit to which the participant would have been

entitled at the end of the preceding plan year (assuming that payment commences in the normal form at the later of normal retirement age and the end of the preceding plan year), plus the annuity equivalent of accelerated benefit payments deemed paid during the plan year. The effect of this adjustment, in the case of a single sum distribution, is to put the participant in the same position as if the participant had received the distribution in the normal form.

Eligible Cash Balance Plans

The 1988 proposed regulations did not contain any guidance specific to cash balance plans. A cash balance plan is a type of defined benefit plan that determines benefits by reference to an employee's hypothetical account. Since the 1988 proposed regulations were issued, the number of cash balance plans has increased. The development of cash balance plans has raised the issue of whether this design complies with section 411(b)(1)(H).

Under a cash balance plan, an employee's hypothetical account balance is credited with hypothetical allocations, often referred to as service credits or pay credits, and hypothetical earnings, often referred to as interest credits. Under some cash balance plans, the right to interest credits for future periods accrues at the same time as the pay credit (i.e., the interest credit is not contingent on the performance of services in the future). Under other cash balance plans, all or some portion of the interest credit for future periods is contingent on the performance of services in the future. The benefit under a cash balance plan is expressed in the plan document (and communicated to employees) as the

hypothetical account balance, although not all cash balance plans provide a single sum distribution.

Under a cash balance plan, the interest credits for a younger participant will compound over a greater number of years until normal retirement age than for an older participant. This will result in a larger accrual for younger employees, when measured as the increase in the benefit payable at normal retirement age. Accordingly, some commentators have argued that the basic cash balance plan design violates section 411(b)(1)(H). Others have asserted that cash balance plans do not violate section 411(b)(1)(H) if the additions to the hypothetical account are not smaller because of the attainment of any age. They argue that, because pay credits under a cash balance plan are comparable to allocations under a defined contribution plan, these pay credits are an appropriate measure for testing whether a cash balance plan satisfies section 411(b)(1)(H).

These proposed regulations would provide that the rate of benefit accrual under an eligible cash balance plan, as defined in these proposed regulations, is permitted to be determined as the additions to the participant's hypothetical account for the plan year, except that previously accrued interest credits are not included in the rate of benefit accrual. Because the rate of benefit accrual is determined based on how benefits are expressed under the plan, this method of determining the rate of benefit accrual is restricted to eligible cash balance plans, as defined in these proposed regulations.

An eligible cash balance plan is a defined benefit plan that satisfies certain requirements. First, for accruals in the current plan year, the normal form of benefit is an

immediate payment of the balance in a hypothetical account. As long as the normal form of benefit is an immediate payment of the balance in a hypothetical account, a plan does not fail to be an eligible cash balance plan merely because a single-sum distribution of that amount is not actually available as a distribution option under the plan.

Second, a plan is an eligible cash balance plan only if the plan provides that, at the same time that the participant accrues an addition to the hypothetical account, the participant accrues the right to future interest credits (without regard to future service) at a reasonable rate of interest that does not decrease because of the attainment of any age. Because the rate of benefit accrual under an eligible cash balance plan is generally determined by reference to additions to the hypothetical account disregarding interest credits, these interest credits must be provided for all future periods, including after normal retirement age, and an eligible cash balance plan cannot treat interest credits after normal retirement age as actuarial increases that are offset against the otherwise required accrual. A participant is not treated as having the right to future interest credits if the plan provides that additions to the hypothetical account under the plan are reduced for the actuarial equivalent of any in-service distributions because, as discussed above, such a reduction is the equivalent of an offset for an actuarial adjustment. Any additional interest credits under an eligible cash balance plan that do not accrue at the same time as the corresponding addition to the hypothetical account are included in determining the rate of benefit accrual in the year in which those additional interest credits are accrued.

In addition, a plan that is converted to a cash balance plan is subject to certain requirements, discussed below.

There are other hybrid designs that would satisfy some, but not all, of the requirements for an eligible cash balance plan. For example, there are some designs under which the normal form of benefit is the immediate payment of an account balance, but which do not provide for reasonable interest credits on that account balance. Under these proposed regulations, the rate of benefit accrual under these plans would be determined under the general rules applicable to traditional defined benefit plans.

Plans With Mixed Formulas

Some defined benefit plans have both a traditional defined benefit formula and a cash balance formula, and these proposed regulations provide rules for plans with such a mixed formula. If a portion of the plan formula under a defined benefit plan would satisfy the requirements for an eligible cash balance plan if that were the only formula under the plan, then that portion of the plan formula is referred to as an eligible cash balance formula in these proposed regulations. Any other portion of the plan formula is referred to as a traditional defined benefit formula.

The portion that is an eligible cash balance formula (or formulas if the plan has multiple eligible cash balance formulas) would be permitted to be tested using the rules for eligible cash balance plans, with the remainder of the plan tested under the rules for a traditional defined benefit formula (regardless of how many traditional defined benefit formulas the plan may have). This rule applies only if each such separately-treated plan would satisfy the maximum age conditions in section 410(a)(2) and the eligible cash balance and traditional defined benefit formulas interact in one of three specific ways for current and future accruals. The three ways are: (1) the plan provides that the participant's

benefit is based on the sum of accruals under two different formulas (either sequentially where the cash balance formula goes into effect during the year or simultaneously where the plan provides for a participant to accrue benefits under both a traditional defined benefit formula and a cash balance formula at the same time with the participant to be entitled to the sum of the two); (2) the plan provides a benefit for a participant equal to the greater of the benefit determined under two or more formulas, one of which is an eligible cash balance formula and the other of which is not; or (3) under the plan, some participants are eligible for accruals only under an eligible cash balance formula and the remaining participants are eligible for accruals only under a traditional defined benefit formula or the other 2 specific methods. If the eligible cash balance formula and the traditional defined benefit formula interact in any other manner, the plan is not treated as an eligible cash balance plan for any portion of the plan formula.

Amendments Establishing an Eligible Cash Balance Formula

In many cases, a plan sponsor amends a traditional defined benefit plan to make it a cash balance plan. This process is often referred to as a "conversion." The terms of cash balance conversions vary, but often provide an opening hypothetical account balance for each participant. In some cases, the opening balance may be based on the participant's prior accrued benefit under the traditional defined benefit plan or on the participant's prior service with the plan sponsor. In other cases, the opening balance is set at zero, and each participant is entitled to the sum of the participant's accrued benefit under the traditional defined benefit plan and the cash balance account.

Some commentators have questioned whether certain cash balance conversions that provide for the establishment of an opening account balance satisfy section 411(b)(1)(H). These commentators have noted that, under section 411(d)(6), the participant can never be denied payment of the prior accrued benefit. They note that, if the opening account balance and subsequent interest credits through normal retirement age generate benefits that are not at least as large as the prior accrued benefit, the participant will not accrue net benefits for some period after the conversion. This period, often referred to as a "wear-away" period, will continue until the participant's account balance generates benefits that exceed the prior accrued benefit. These commentators argue that the wear-away period inherently produces a lower rate of accrual for older participants.[2]

Other commentators have argued that a wear-away period does not violate section 411(b)(1)(H) because the length of the wear-away period is determined not by the participant's age but by the size of the participant's prior accrued benefit under the traditional defined benefit plan. Additionally, commentators have pointed out that, because the prior accrued benefit is calculated using an interest rate determined at the time of the

[2] This type of wear-away differs from a wear-away that results from the fact that certain optional forms of benefit may be subsidized under the traditional defined benefit plan but not under the cash balance plan or that other actuarial factors may produce a larger benefit amount prior to normal retirement age under the traditional defined benefit plan but not under the cash balance plan. This may occur even though the actuarial value of the accrued benefit under the traditional defined benefit plan is included in the participant's opening account balance. Although section 411(d)(6) protects optional forms of benefit under the pre-amendment formula, section 411(b)(1)(H)(iv) specifically provides that a reduction because of the attainment of any age does not occur as a result of the subsidized portion of an early retirement benefit.

amendment but the interest credits under the cash balance plan often fluctuate under a variable index, a participant may move in or out of a wear-away period after a cash balance conversion solely because of future changes in interest rates.

Under these proposed regulations, the mere conversion of a traditional defined benefit plan to a cash balance plan would not cause the plan to fail section 411(b)(1)(H). However, a converted plan that otherwise would be treated as an eligible cash balance plan must satisfy one of two alternative rules. Under the first alternative, the converted plan must determine each participant's benefit as not less than the sum of the participant's benefits accrued under the traditional defined benefit plan and the cash balance account. A plan satisfying this first alternative will not have a wear-away period for benefits accrued under the traditional defined benefit plan.

Under the second alternative, the converted plan must establish each participant's opening account balance as an amount not less than the actuarial present value of the participant's prior accrued benefit, using reasonable actuarial assumptions. For this purpose, an interest rate assumption is not treated as reasonable if it increases, directly or indirectly, because of the participant's attainment of any age (which would result in lower present values for older participants). This alternative does not preclude the possibility of a wear-away period for some or all the participants in the plan, but it ensures that the opening account balance of each participant reflects the actuarial value of the prior accrued benefit, determined by using reasonable assumptions. Any excess in the opening account balance over the present value of a participant's previously accrued benefit is included as part of the participant's rate of benefit accrual for the plan year, and thus is tested under section

411(b)(1)(H) along with other pay credits for the year. Effectively, this alternative provides that a converted plan will not fail to satisfy section 411(b)(1)(H) if the benefit formula before the conversion satisfies section 411(b)(1)(H), the opening account balance is based on actuarial assumptions that are reasonable (and an interest rate that does not increase for older participants), and the benefit formula after the conversion -- including any excess in the opening account balance over the present value of a participant's previously accrued benefit -- satisfies section 411(b)(1)(H).

Use of Compensation in Calculating Rate of Benefit Accrual

A participant's rate of benefit accrual for a plan year can be determined as a dollar amount. Alternatively, if a plan's formula bases a participant's accruals on current compensation, then a participant's rate of benefit accrual can be determined as a percentage of the participant's current compensation. Likewise, if a plan's formula bases a participant's accruals on average compensation, then a participant's rate of benefit accrual can be determined as a percentage of that measure of the participant's average compensation. In order for the participant's rate of benefit accrual to be determined as a percentage of the participant's current or average compensation, compensation must be determined without regard to attainment of any age. The alternative of using current or average compensation simplifies testing, without changing the result.

Defined Contribution Plans

A defined contribution plan fails to comply with section 411(b)(2) if, either directly or indirectly, because of a participant's attainment of any age, the allocation of employer contributions or forfeitures to the account of the participant is discontinued or the rate at

which the allocation of employer contributions or forfeitures is made to the account of the participant is decreased. For determining if there is a cessation or reduction in allocations because of attainment of any age, these proposed regulations would adopt a substantive standard that is similar to the standard that applies under these proposed regulations for defined benefit plans and to the standard that was proposed in the 1988 proposed regulations.

A reduction in the rate of allocation is directly because of a participant's attainment of any age for a plan year if under the terms of the plan, any participant's rate of allocation during the plan year would be higher if the participant were younger.

A reduction in the rate of allocation is indirectly because of a participant's attainment of any age if any participant's rate of allocation during the plan year would be higher if the participant were to have any characteristic which is a proxy for being younger, based on applicable facts and circumstances. A cessation or reduction in allocations is not indirectly because of the attainment of any age solely because of a positive correlation between attainment of any age and a reduction in the allocations or rate of allocation. Thus, a defined contribution plan does not provide for cessation or reduction in allocations solely because the plan limits the total amount of employer contributions and forfeitures that may be allocated to a participant's account or limits the total number of years of credited service that may be taken into account for purposes of determining allocations for the plan year.

Target benefit plans (defined contribution plans under which contributions are determined by reference to a targeted benefit described in the plan) are subject to section

411(b)(2) which applies to defined contribution plans. Under these proposed regulations, a target benefit plan would satisfy section 411(b)(2) only if the defined benefit formula used to determine allocations would satisfy section 411(b)(1)(H) without regard to section 411(b)(1)(H)(iii) relating to adjustments for distributions and actuarial increases. A target benefit plan would not fail to satisfy section 411(b)(2) with respect to allocations after normal retirement age merely because the allocation for a plan year is reduced to reflect an older participant's shorter longevity using a reasonable actuarial assumption regarding mortality. These proposed regulations also would authorize the Commissioner to develop additional guidance with respect to the application of section 411(b)(2) to target benefit plans.

Optional Forms of Benefit and Other Rights and Features

These proposed regulations generally retain the requirements applicable to optional forms of benefit that were in the 1988 proposed regulations. Under these rules, with the exceptions noted below, a participant's rate of benefit accrual under a defined benefit plan and a participant's allocations under a defined contribution plan are considered to be reduced because of the participant's attainment of any age if optional forms of benefits, ancillary benefits, or other rights or features otherwise provided to a participant under the plan are not provided, or are provided on a less favorable basis, with respect to benefits or allocations attributable to credited service because of the participant's attainment of any age. In addition, a plan would not fail to satisfy section 411(b)(1)(H) merely due to variance because of the attainment of any age with respect to the subsidized portion of an early retirement benefit (whether provided on a temporary or permanent basis), a qualified

disability benefit (as defined in §1.411(a)-7(c)(3)), or a social security supplement (as defined in §1.411(a)-7(c)(4)(ii)).[3] These proposed regulations also clarify that a plan would not fail to satisfy section 411(b)(1)(H) merely because the plan makes actuarial adjustments using a reasonable assumption regarding mortality to calculate optional forms of benefit or to calculate the cost of providing a qualified preretirement survivor annuity, as defined in section 417(c).

Coordination With Other Provisions

Sections 411(b)(1)(H)(v) and 411(b)(2)(C) both provide for the coordination of the requirements of each section with other applicable qualification requirements. Under these proposed regulations, a plan will not fail to satisfy section 411(b)(1)(H) or 411(b)(2) because of a limit on accruals or allocations necessary to comply with the limitations of section 415 or to prevent discrimination in favor of highly compensated employees within the meaning of section 401(a)(4). Additionally, these proposed regulations would authorize the Commissioner to provide additional guidance relating to prohibited discrimination in favor of highly compensated employees. These proposed regulations would also provide that no benefit accrual or allocation is required under section 411(b)(1)(H) or 411(b)(2) for a plan year to the extent such allocation or accrual would cause the plan to fail to satisfy the requirements of section 401(l) (relating to permitted disparity) for the plan year, such as if a younger person has a smaller permitted disparity due to having a later social security retirement age. Further, under these proposed

[3]The ADEA also includes special rules relating to certain of these benefits. See 29 U.S.C. 623(f)(2) and (l).

regulations, a plan would not fail to satisfy section 411(b)(1)(H) or 411(b)(2) for a plan year merely because of the distribution rights provided under section 411(a)(11), including deferral rights for participants whose benefits are immediately distributable within the meaning of §1.411(a)-11(c).

Application of Section 401(a)(4) to New Comparability Cash Balance Plans

These proposed regulations also include a proposed amendment to the regulations under section 401(a)(4). This amendment would provide that a defined benefit plan that determines compliance with section 411(b)(1)(H) by using the special definition of rate of accrual for an eligible cash balance plan is not permitted to demonstrate that the benefits provided under the arrangement do not discriminate in favor of highly compensated employees by using an inconsistent method (i.e., an accrual rate based on the normal retirement benefit), unless the plan complies with a modified version of the provisions of the regulations under section 401(a)(4) related to cross-testing by a defined contribution plan. Under these requirements, an eligible cash balance plan under which the additions to the hypothetical account are neither broadly available nor reflect a gradual age and service schedule, as defined under existing regulations relating to cross-tested defined contribution plans, may test on the basis of benefits only if the plan satisfies a minimum allocation gateway.

The minimum allocation gateway generally requires that the hypothetical allocation rate for each nonhighly compensated employee be at least one-third of the hypothetical allocation rate for the highly compensated employee with the highest hypothetical allocation rate. However, the minimum allocation gateway is also satisfied if the hypothetical

allocation rate for each nonhighly compensated employee is no less than 5%, provided the highest hypothetical allocation rate for any highly compensated employee is not in excess of 25%. If the highest hypothetical allocation rate is above 25%, the 5% factor is increased, up to as much as 7.5%. This minimum allocation gateway, which is normally applicable to DB/DC plans (i.e., defined benefit plans and defined contribution plans that are combined for nondiscrimination testing), is used for purposes of eligible cash balance plans, rather than the minimum allocation gateway normally applicable to defined contribution plans, because hypothetical allocations under a cash balance plan can be significantly greater than allocations under a defined contribution plan.

If the eligible cash balance plan is aggregated with other plans that are not cash balance plans, the regulations would treat the cash balance plan as a defined contribution plan for purposes of applying the rules applicable to aggregated plans. For this purpose, a plan with both an eligible cash balance formula and a traditional defined benefit formula is treated as an aggregation of two plans.

Effective Date of Sections 411(b)(1)(H) and 411(b)(2)

The 1988 proposed regulations included provisions related to the effective date of sections 411(b)(1)(H) and 411(b)(2). The effective date provisions in these proposed regulations differ from the 1988 proposed regulations (and Notice 88-126) in order to reflect the decision in Lockheed Corp. v. Spink, 517 U.S. 882 (1996).

In general, sections 411(b)(1)(H) and 411(b)(2) are effective for plan years beginning on or after January 1, 1988 with respect to a participant who is credited with at least one hour of service in a plan year beginning on or after January 1, 1988. In the case

of a participant who is credited with at least one hour of service in a plan year beginning on or after January 1, 1988, section 411(b)(1)(H) is effective with respect to all years of service completed by the participant, except that, in accordance with Lockheed Corp. v. Spink, plan years beginning before January 1, 1988 are excluded. For purposes of these proposed regulations, an hour of service includes any hour required to be recognized under the plan by section 410 or 411.

Similarly, section 411(b)(2) does not apply with respect to allocations of employer contributions or forfeitures to the accounts of participants under a defined contribution plan for a plan year beginning before January 1, 1988.

These proposed regulations would also provide a special effective date for a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers, ratified before March 1, 1986. For such plans, sections 411(b)(1)(H) and 411(b)(2) are effective for benefits provided under, and employees covered by, any such agreement with respect to plan years beginning on or after the later of (i) January 1, 1988 or (ii) the earlier of January 1, 1990 or the date on which the last of such collective bargaining agreements terminates (determined without regard to any extension of any such agreement occurring on or after March 1, 1986). The otherwise generally applicable effective date rules would apply to a collectively bargained plan, as of the effective date of section 411(b)(1)(H) or 411(b)(2) applicable to such plan.

Proposed Effective Date

The regulations are proposed to be applicable to plan years beginning after the date final regulations are published in the **Federal Register**. These proposed regulations

cannot be relied upon until adopted in final form. However, until these regulations are adopted in final form, the reliance provided on the 1988 proposed regulations continues to be available. In addition, the proposed regulations at §§1.410(a)-4A, 1.411(a)-3, 1.411(b)-3 and 1.411(c)-1(f)(2) (relating to maximum age for participation, vesting, normal retirement age, and actuarial adjustments after normal retirement age), which were published in the same notice of proposed rulemaking as the 1988 proposed regulation and which are not republished here, are also expected to be finalized for future plan years.

Special Analyses

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

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to written comments (preferably a signed original and eight (8) copies) that are submitted timely to the IRS. Alternatively, taxpayers may submit comments electronically to the IRS Internet site at www.irs.gov/regs. All comments will be available for

public inspection and copying. The IRS and Treasury request comments on the clarity of the proposed rules and how they may be made easier to understand or to implement. Comments are also requested on the following issues:

Because these proposed regulations are based on a year-by-year determination of the rate of benefit accrual that does not accommodate averaging over a period of earlier years, one result would be that, if a higher accrual is provided for older workers in one year, the rates cannot be leveled out in subsequent periods in a manner that takes the earlier higher accruals into account. This might occur for a change from a fractional accrual method to a unit credit method for all years of service. Comments are requested on whether rates should be permitted to be averaged and, if so, under what conditions.

In the case of a conversion of a traditional defined benefit plan to a cash balance plan, these proposed regulations generally provide for any excess of a participant's opening hypothetical account balance over the present value of the participant's prior accrued benefit to be tested for age discrimination. Comments are requested on whether any other portion of the hypothetical account balance should be disregarded in applying section 411(b)(1)(H) under other circumstances, for example, if the opening account balance is a reconstructed cash balance account (i.e., the account balance that each participant would have had at the time of the conversion if the cash balance formula had been in effect for the participant's entire period of service). In addition, comments are requested on the effect of these

rules on employers, if any, that may have used the extended wear-away transition rule of §1.401(a)(4)-13(f)(2)(i).

Because these proposed regulations provide for the rate of benefit accrual under section 411(b)(1)(H) to be based on the annual increase in the accrued benefit under the plan, the rate of benefit accrual under a floor offset plan, as described in Rev. Rul. 76-259 (1976-2 CB 111), would be determined after taking into account the amount of the offset. Comments are requested on whether the rate of benefit accrual for a floor offset plan should be tested before application of the offset and, if so, under what conditions. For example, should the rate of benefit accrual for a floor offset plan be tested before application of the offset if the plan provides an actuarial increase after normal retirement age or if the annuity purchase rate used to calculate the offset is not less favorable after normal retirement age than the annuity purchase rate applicable at normal retirement age.

A public hearing has been scheduled for April 10, 2003, at 10 a.m. in room 4718 of the Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC. All visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts at the Constitution Avenue entrance. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written comments and an outline of the

topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by March 13, 2003. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal authors of these proposed regulations are Linda S. F. Marshall and R. Lisa Mojiri-Azad of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

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 the following citation in numerical order:

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

Section 1.411(b)-2 is also issued under 26 U.S.C. 411(b)(1)(H) and 411(b)(2). * * *

Par. 2. Section 1.401(a)(4)-3 is amended as follows:

1. A new sentence is added before the last sentence of paragraph (a)(1).

2. Paragraph (g) is added.

The additions and revisions read as follows:

§1.401(a)(4)-3 Nondiscrimination in amount of employer-provided benefits under a defined benefit plan.

(a) Introduction--(1) Overview. * * * Paragraph (g) of this section provides additional rules that apply to a plan that satisfies the requirements of section 411(b)(1)(H) and §1.411(b)-2 using the rate of benefit accrual determined pursuant to the rules of §1.411(b)-2(b)(2)(iii) for eligible cash balance plans. * * *

* * * * *

(g) Additional rules for eligible cash balance plans--(1) In general. Notwithstanding the provisions of paragraphs (a) through (f) of this section, a plan that satisfies the requirements of section 411(b)(1)(H) and §1.411(b)-2 using the rate of benefit accrual under the plan or a portion of the plan determined pursuant to the rules of §1.411(b)-2(b)(2)(iii) for eligible cash balance plans is permitted to satisfy the requirements of section 401(a)(4) by satisfying the requirements of this section (relating to nondiscrimination in amount of employer-provided benefits) only if the plan satisfies paragraph (g)(2) or (3) of this section, as applicable.

(2) Eligible cash balance plans not aggregated with another defined benefit plan. A plan described in paragraph (g)(1) of this section under which benefits are determined solely in accordance with an eligible cash balance formula (as defined in §1.411(b)-2(b)(2)(iii)(C)(1)) satisfies this paragraph (g)(2) only if the plan meets either of the following conditions--

(i) The plan would satisfy the requirements of §1.401(a)(4)-8(b)(1)(iii) or (iv) by treating the additions to the hypothetical account that are included in the rate of benefit accrual under the rules of §1.411(b)-2(b)(2)(iii)(A) as allocations under a defined contribution plan; or

(ii) The plan would satisfy the requirements of §1.401(a)(4)-9(b)(2)(v)(D) by treating the additions to the hypothetical account that are included in the rate of benefit accrual under the rules of §1.411(b)-2(b)(2)(iii)(A) as allocations under a defined contribution plan for purposes of determining equivalent normal allocation rates (within the meaning of §1.401(a)(4)-9(b)(2)(ii)).

(3) Eligible cash balance plans aggregated with another defined benefit plan. In the case of a plan described in paragraph (g)(1) of this section that is not described in paragraph (g)(2) of this section (for example, an eligible cash balance plan that is aggregated with another defined benefit plan that is not an eligible cash balance plan or a plan that uses an eligible cash balance formula with a traditional defined benefit plan formula as described in §1.411(b)-2(b)(2)(iii)(C)), the plan would satisfy the requirements of §1.401(a)(4)-9(b)(2)(v)(D) by treating the additions to the hypothetical account that are included in the rate of benefit accrual under the rules of §1.411(b)-2(b)(2)(iii)(A) as allocations under a defined contribution plan.

Par. 3. Section 1.401(a)(4)-9 is amended by:

1. Amending paragraph (b)(2)(v) by removing the language "For plan years" and adding in its place "Except as provided in paragraph (b)(2)(vi) of this section, for plan years".

2. Adding paragraph (b)(2)(vi).

The addition reads as follows:

§1.401(a)(4)-9 Plan aggregation and restructuring

* * * * *

(b) * * *

(2) * * *

(vi) Special rules for cash balance plans aggregated with defined contribution plans--(A) In general. In the case of a DB/DC plan where the defined benefit plan (or any portion thereof) satisfies the requirements of section 411(b)(1)(H) using the rate of benefit accrual determined pursuant to the rules of §1.411(b)-2(b)(iii) for eligible cash balance plans, the DB/DC plan is permitted to demonstrate satisfaction of the nondiscrimination in amount requirement of §1.401(a)(4)-1(b)(2) on the basis of benefits only if--

(1) The plan would satisfy the requirements of paragraph (b)(2)(v) of this section if the additions to the hypothetical account that are included in the rate of benefit accrual under the rules of §1.411(b)-2(b)(2)(iii)(A) are treated as allocations under a defined contribution plan; or

(2) The plan is described in paragraph (b)(2)(vi)(B) of this section (regarding eligible cash balance plans aggregated only with defined contribution plans).

(B) Special rule for cash balance plans aggregated with defined contribution plans that are not aggregated with other defined benefit plans. A DB/DC plan is described in this paragraph (b)(2)(vi)(B) if the DB/DC plan satisfies the following conditions--

(1) All defined benefit plans that are included in the DB/DC plan satisfy the requirements of section 411(b)(1)(H) using the rate of benefit accrual determined pursuant to the rules of §1.411(b)-2(b)(iii) for eligible cash balance plans; and

(2) The DB/DC plan would satisfy the requirements of §1.401(a)(4)-8(b)(1)(i)(B)(1) or (2) (regarding broadly available allocation rates or certain age-based allocation rates) if the additions to the hypothetical account that are included in the rate of benefit accrual under the rules of §1.411(b)-2(b)(2)(iii)(A) are treated as allocations under a defined contribution plan.

Par. 4. Proposed §1.411(b)-2 published at 53 FR 11876 on April 11, 1988, is revised to read as follows.

§1.411(b)-2 Reductions of accruals or allocations because of attainment of any age.

(a) In general--(1) Overview. Section 411(b)(1)(H) provides that a defined benefit plan does not satisfy the minimum vesting standards of section 411(a) if, under the plan, benefit accruals on behalf of a participant are ceased or the rate of benefit accrual on behalf of a participant is reduced because of the participant's attainment of any age. Section 411(b)(2) provides that a defined contribution plan does not satisfy the minimum vesting standards of section 411(a) if, under the plan, allocations to a participant's account are ceased or the rate of allocation to a participant's account is reduced because of the participant's attainment of any age. Paragraph (b) of this section provides general rules for defined benefit plans. Paragraph (c) of this section provides general rules for defined contribution plans. Paragraph (d) of this section provides rules applying this section to optional forms of benefit, ancillary benefits, and other rights or features under defined

benefit and defined contribution plans. Paragraph (e) of this section provides rules coordinating the requirements of this section with certain other qualification requirements. Paragraph (f) of this section contains effective date provisions.

(2) Attainment of any age. For purposes of sections 411(b)(1)(H), 411(b)(2), and this section, a participant's attainment of any age means the participant's growing older. Thus, the rules of sections 411(b)(1)(H), 411(b)(2), and this section apply regardless of whether a participant is younger than, at, or older than normal retirement age.

(b) Defined benefit plans--(1) In general--(i) Requirement. A defined benefit plan does not satisfy the requirements of section 411(b)(1)(H) if a participant's rate of benefit accrual is reduced, either directly or indirectly, because of the participant's attainment of any age. A reduction in a participant's rate of benefit accrual includes any discontinuance in the participant's accrual of benefits or cessation of participation in the plan.

(ii) Definition of normal form. For purposes of this paragraph (b), the normal form of benefit (also referred to as the normal form) means the form under which payments to the participant under the plan are expressed under the plan formula, prior to adjustment for form of benefit.

(2) Rate of benefit accrual--(i) Rate of benefit accrual before normal retirement age. For purposes of this paragraph (b), except as provided in paragraph (b)(2)(iii) of this section, a participant's rate of benefit accrual for any plan year that ends before the participant attains normal retirement age is the excess (if any) of--

(A) The participant's accrued normal retirement benefit at the end of the plan year; over

(B) The participant's accrued normal retirement benefit at the end of the preceding plan year.

(ii) Rate of benefit accrual after normal retirement age. In the case of a plan for which the rate of benefit accrual before normal retirement age is determined under paragraph (b)(2)(i) of this section, except as provided in paragraph (b)(4)(iii)(C) of this section, a participant's rate of benefit accrual for the plan year in which the participant attains normal retirement age or any later plan year (taking into account the provisions of section 411(b)(1)(H)(iii)(II)) is the excess (if any) of--

(A) The annual benefit to which the participant is entitled at the end of the plan year, determined as if payment commences at the end of the plan year in the normal form (or the straight life annuity that is actuarially equivalent to the normal form if the normal form is not an annual benefit that does not decrease during the lifetime of the participant); over

(B) The annual benefit to which the participant was entitled at the end of the preceding plan year, determined as if payment commences at the later of normal retirement age or the end of the preceding plan year in the normal form (or the straight life annuity that is actuarially equivalent to the normal form if the normal form is not an annual benefit that does not decrease during the lifetime of the participant).

(iii) Rate of benefit accrual for eligible cash balance plans--(A) General rule. For purposes of this paragraph (b), in the case of an eligible cash balance plan, a participant's rate of benefit accrual for a plan year is permitted to be determined as the addition to the participant's hypothetical account for the plan year, except that interest credits added to the hypothetical account for the plan year are disregarded to the extent the participant had

accrued the right to those interest credits as of the close of the preceding plan year as described in paragraph (b)(2)(iii)(B)(2) of this section.

(B) Eligible cash balance plans. For purposes of this section, a defined benefit plan is an eligible cash balance plan for a plan year if it satisfies each of the following requirements for current accruals under the plan for that plan year--

(1) Plan design. The normal form of benefit is an immediate payment of the balance in a hypothetical account (without regard to whether such an immediate payment is actually available under the plan).

(2) Right to future interest. With respect to a participant's hypothetical account balance, the participant has accrued the right to annual (or more frequent) interest credits to be added to the hypothetical account for all future periods without regard to future service at a reasonable rate of interest that is not reduced, either directly or indirectly, because of the participant's attainment of any age. A plan is treated as not satisfying the requirement of this paragraph (b)(2)(iii)(B)(2) if it provides for any adjustment for benefit distributions described in paragraph (b)(4) of this section.

(3) Plan amendments adopting cash balance formula. In the case of a plan amendment that has been amended to adopt a cash balance formula (as described in paragraphs (b)(2)(iii)(B)(1) and (2) of this section) for a participant, the plan as amended satisfies the requirements of either paragraph (b)(2)(iii)(D) or (E) of this section.

(C) Plans with mixed benefit formulas--(1) Eligible cash balance formula. If a portion of the plan formula under a defined benefit plan would satisfy the requirements to be an eligible cash balance plan if it were the only formula under the plan, then, for purposes of

this section, such portion of the plan formula is referred to as an eligible cash balance formula and the other portion of the plan formula is referred to as a traditional defined benefit formula. If the eligible cash balance formula and the traditional defined benefit formula interact in a manner described in paragraph (b)(2)(iii)(C)(2), (3), or (4) of this section for current and future accruals under the plan, then, for purposes of determining whether the plan satisfies section 411(b)(1)(H), the plan is permitted to be treated as two separate plans, one of which is an eligible cash balance plan and the other of which is not, but only if each such plan would satisfy section 410(a)(2). Thus, such a plan satisfies the requirements of section 411(b)(1)(H) if the eligible cash balance formula satisfies the requirements of paragraph (b)(1) of this section with the participant's rate of benefit accrual determined under paragraph (b)(2)(iii)(A) of this section and the portion of the plan's formula that is a traditional defined benefit formula satisfies the requirements of paragraph (b)(1) of this section with the participant's rate of benefit accrual determined under paragraph (b)(2)(i) or (ii) of this section, as applicable. If the eligible cash balance formula and the traditional defined benefit formula interact in a manner other than as set forth in paragraphs (b)(2)(iii)(C)(2), (3), or (4) of this section, the plan is not treated as an eligible cash balance plan for any portion of the plan formula.

(2) Plans with additive formulas. A plan is described in this paragraph (b)(2)(iii)(C)(2) if the participant's benefit is based on the sum of accruals under two different formulas, one of which is an eligible cash balance formula and the other of which is not.

(3) Plans with greater of formulas. A plan is described in this paragraph (b)(2)(iii)(C)(3) if the plan provides a benefit for a participant equal to the greater of the benefit determined under two or more formulas under the plan for a plan year, one of which is an eligible cash balance formula and another of which is not.

(4) Different formulas for different participants. A plan is described in this paragraph (b)(2)(iii)(C)(4) if some participants are eligible for accruals only under an eligible cash balance formula and the remaining participants are eligible for accruals only under a traditional defined benefit formula or a combination of a traditional defined benefit formula or eligible cash balance formula described in paragraphs (b)(2)(iii)(C)(2) and (3) of this section.

(D) Plan amendment adopting eligible cash balance formula using a sum of formula. A plan satisfies this paragraph (b)(2)(iii)(D) only if for all periods after the amendment becomes effective the plan provides benefits that are not less than the sum of the benefits accrued as of the later of the date the amendment becomes effective or the date the amendment is adopted, plus the benefits provided by the participant's hypothetical account under the eligible cash balance formula.

(E) Plan amendment adopting eligible cash balance formula using an opening account balance--(1) Calculation of opening account balance. A plan satisfies this paragraph (b)(2)(iii)(E) only if the balance in the participant's hypothetical account, determined immediately after the amendment becomes effective, is not less than the actuarial present value of the participant's accrued benefit payable in the normal form of benefit, determined as of the later of the date the amendment becomes effective or the

date the amendment is adopted, with such present value determined using reasonable actuarial assumptions. For this purpose, the actuarial assumptions are not reasonable if they include an interest rate that increases, either directly or indirectly, because of a participant's attainment of any age. The actuarial assumptions do not fail to be reasonable merely because pre-retirement mortality is not taken into account.

(2) Bifurcation for purposes of determining rate of benefit accrual. If a plan satisfies the requirements of paragraph (b)(2)(iii)(E)(1), only the portion of the participant's hypothetical account balance in excess of the actuarial present value of the participant's accrued benefit payable in the normal form of benefit is treated as an addition to the participant's hypothetical account balance for the plan year for purposes of determining the participant's rate of benefit accrual under paragraph (b)(2)(iii)(A) of this section.

(3) Treatment of employees past normal retirement age. In addition, a plan does not satisfy this paragraph (b)(2)(iii)(E) if the opening balance for a participant who has attained normal retirement age is less than the balance that would apply if the participant were at his or her normal retirement age.

(iv) Determination of rate of benefit accrual--(A) In general. A participant's rate of benefit accrual for a plan year can be determined as a dollar amount. Alternatively, if a plan's formula bases a participant's accruals on current compensation, then a participant's rate of benefit accrual can be determined as a percentage of the participant's current compensation. For example, for an accumulation plan (as defined in §1.401(a)(4)-12), the participant's rate of benefit accrual under paragraph (b)(2)(i) of this section can be determined as the excess of the accrued portion of the participant's normal retirement

benefit at the end of the plan year over the accrued portion of the participant's normal retirement benefit at the end of the preceding plan year, divided by compensation taken into account under the plan for the plan year. Likewise, if a plan's formula bases a participant's accruals on average compensation, then a participant's rate of benefit accrual can be determined as a percentage of that measure of the participant's average compensation. For a plan that determines benefits as a percentage of average annual compensation (as defined in §1.401(a)(4)-3(e)(2)), the rate of benefit accrual under paragraph (b)(2)(i) of this section is determined as the excess of the accrued portion of the participant's normal retirement benefit at the end of the plan year divided by average annual compensation taken into account under the plan at the end of the plan year, over the accrued portion of the participant's normal retirement benefit at the end of the preceding plan year divided by average annual compensation taken into account under the plan at the end of such preceding plan year. A plan is permitted to determine the participant's rate of benefit accrual as a percentage of the participant's current or average compensation only if compensation under the plan is determined without regard to attainment of any age.

(B) Benefits included in rate of benefit accrual. For purposes of determining a participant's rate of benefit accrual, only benefits that are included in a participant's accrued benefit are taken into account. Thus, for example, a participant's rate of benefit accrual does not take into account benefits such as the benefits described in paragraph (d)(3) of this section (relating to qualified disability benefits, social security supplements, and early retirement benefits).

(v) Examples. The following examples illustrate the application of this paragraph (b)(2). In each of the examples, normal retirement age is 65. The examples are as follows:

Example 1. Plan L is a defined benefit plan under which the normal form of benefit is a monthly straight life annuity commencing at normal retirement age (or the date of actual retirement, if later) equal to $30 times the participant's years of service. For purposes of this section, a participant's rate of benefit accrual for any plan year is $30.

Example 2. (i) Plan M is a defined benefit plan under which the normal form of benefit is an annual straight life annuity commencing at normal retirement age (or the date of actual retirement, if later) equal to 1% of the average of a participant's highest 3 consecutive years of compensation times the participant's years of service.

(ii) For purposes of this section, a participant's rate of benefit accrual for any plan year can be expressed as a dollar amount. Alternatively, a participant's rate of benefit accrual for a plan year can be expressed as 1% of the participant's highest 3 consecutive years of compensation (determined using the same rules applicable to determining compensation under the plan for purposes of computing the normal form of benefit), provided that the definition of compensation used for this purpose is determined without regard to the attainment of any age. A participant's rate of benefit accrual cannot be determined as a percentage of any other measure of compensation or average compensation.

(iii) If Plan M were to provide that compensation earned after the attainment of age 65 is not taken into account in determining average compensation or were otherwise to determine compensation in a manner that depends on a participant's age, then, for purposes of this section, a participant's rate of benefit accrual would have to be expressed as a dollar amount, and could not be expressed as a percentage of any measure of compensation or average compensation.

Example 3. (i) Plan N is a defined benefit plan under which the normal form of benefit is an immediate payment of the balance in a participant's hypothetical account. A compensation credit equal to 6% of each participant's wages for the year is added to the hypothetical account of a participant who is an employee. At the end of each plan year, the hypothetical account is credited with interest based on the applicable interest rate under section 417(e), as provided under the plan. All participants accrue the right to receive interest credits on their hypothetical account in the future regardless of performance of services in the future, including after normal retirement age.

(ii) Under paragraph (b)(2)(iii)(B) of this section, Plan N satisfies the requirements to be an eligible cash balance plan. Participant A's compensation for a plan year is $40,000. The compensation credit for Participant A allocated to A's hypothetical account

for that plan year is $2,400. Because Plan N is an eligible cash balance plan, the rate of benefit accrual for Participant A is permitted to be determined as the addition to Participant A's hypothetical account for the plan year, disregarding interest credits. Therefore, Participant A's rate of benefit accrual is equal to $2,400, or 6% of wages.

Example 4. (i) The facts are the same as in Example 3, except that the cash balance formula under Plan N is the result of a plan amendment. Under the plan, as amended, the benefits equal the sum of --

(1) 1% of the average of the participant's highest 3 consecutive years of base salary times years of service, but disregarding service and salary after the effective date of the amendment, in a normal form of benefit that is a straight life annuity commencing at normal retirement age (or the date of actual retirement, if later); and

(2) the participant's hypothetical account under the same cash balance formula in Example 3 that applies after the effective date of the amendment, in a normal form of benefit expressed as an immediate payment of the balance of the participant's hypothetical account.

(ii) Under paragraph (b)(2)(iii)(B)(3) of this section, the plan is an eligible cash balance plan if the plan satisfies the requirements of paragraph (b)(2)(iii)(D) or (E) of this section. The plan's formula is described in paragraph (b)(2)(iii)(D) of this section. Accordingly, the portion of the plan formula that provides for compensation credits on a participant's hypothetical account is an eligible cash balance formula under paragraph (b)(2)(iii)(B) of this section. Therefore, a participant's rate of benefit accrual under the eligible cash balance formula is permitted to be determined as the addition to the participant's hypothetical account for the plan year, disregarding interest credits. Participant B's base salary for the year is $50,000. The compensation credit for Participant B credited to B's hypothetical account for the year is $3,000. The rate of benefit accrual under the eligible cash balance formula for Participant B is equal to $3,000, or 6% of base salary.

Example 5. (i) The facts are the same as in Example 3, except that Plan N is a defined benefit plan that is converted to a cash balance plan by the adoption of a plan amendment, effective at the beginning of the next plan year, establishing an opening hypothetical account for each participant with an accrued benefit under the plan prior to conversion. Prior to conversion, Plan N provided a benefit equal to 1% of the average of a participant's highest 3 consecutive years of compensation times years of service. Effective as of the date of the conversion, hypothetical accounts are established equal to the present value of a participant's accrued benefit using section 417(e) interest and reasonable mortality assumptions (except no pre-retirement mortality is used). Under the cash balance portion of the formula, compensation and interest credits are made as described in Example 3.

(ii) Under paragraph (b)(2)(iii)(B)(3) of this section, the plan is an eligible cash balance plan only if the plan satisfies the requirements of paragraph (b)(2)(iii)(D) or (E) of this section. The plan's formula is described in paragraph (b)(2)(iii)(E) of this section. Accordingly, the portion of the plan formula that provides for compensation credits on a participant's hypothetical account is an eligible cash balance formula. The rate of benefit accrual for a participant is therefore permitted to be determined as the addition to the participant's hypothetical account for the plan year, disregarding interest credits. In addition, under paragraph (b)(2)(iii)(E) of this section, because the opening hypothetical account balance is equal to the actuarial present value of the participant's accrued benefit, that balance is not treated as an addition for the plan year. The result would not be different if the opening accounts were established using another interest rate or another mortality assumption if the actuarial assumptions were reasonable. Participant C's wages for the year are $60,000. The compensation credit allocated to C's hypothetical account for the year is $3,600. The rate of accrual under the eligible cash balance formula for C is equal to $3,600, or 6% of compensation.

Example 6. (i) The facts are the same as in Example 5, except that Plan N provides for only new participants and participants who are less than age 55 at the time of the conversion to be eligible for benefits under the cash balance formula. Accordingly, participants who are age 55 or older at the time of the conversion are only eligible for the benefit payable under the plan formula in effect before the conversion (1% of the participant's highest 3 consecutive years of compensation times years of service) taking into account compensation and service after the conversion.

(ii) Because Plan N provides benefits based on a mixed formula under paragraph (b)(2)(iii)(C) of this section, Plan N is permitted under paragraph (b)(2)(iii)(C)(1) of this section to be treated as two separate plans for purposes of section 411(b)(1)(H), one of which is an eligible cash balance plan and the other of which is not, but only if each plan would satisfy section 410(a)(2). No portion of Plan N can be treated as an eligible cash balance plan because the portion of Plan N that would otherwise be an eligible cash balance plan would fail to satisfy section 410(a)(2) as a result of having a maximum age of 55 for individuals who are participants at the time of the conversion.

Example 7. (i) The facts are the same as in Example 5, except that Plan N provides for participants to receive the greater of the benefit payable under the cash balance formula or the benefit payable under the plan formula in effect before the conversion (1% of the participant's highest 3 consecutive years of compensation times years of service) taking into account compensation and service after the conversion.

(ii) Because Plan N provides benefits based on the greater of the amount payable under two different formulas, under paragraph (b)(2)(iii)(C)(4) of this section, Plan N is tested for satisfaction of the requirements of section 411(b)(1)(H) and this paragraph (b) by

separately testing the eligible cash balance formula using a rate of benefit accrual equal to compensation credits of 6% of compensation and the traditional defined benefit formulas using a rate of benefit accrual equal to 1% of highest 3 consecutive years of compensation.

(3) Reduction that is directly or indirectly because of a participant's attainment of any age--(i) Reduction in rate of benefit accrual that is directly because of a participant's attainment of any age. A plan provides for a reduction in the rate of benefit accrual that is directly because of a participant's attainment of any age for any plan year if, under the terms of the plan, any participant's rate of benefit accrual for the plan year would be higher if the participant were younger. Thus, a plan fails to satisfy section 411(b)(1)(H) and this paragraph (b) if, under the terms of the plan, the rate of benefit accrual for any individual who is or could be a participant under the plan would be lower solely as a result of the individual being older.

(ii) Reduction in rate of benefit accrual that is indirectly because of a participant's attainment of any age--(A) In general. A plan provides for a reduction in the rate of benefit accrual that is indirectly because of a participant's attainment of any age for any plan year if any participant's rate of benefit accrual for the plan year would be higher if the participant were to have a different characteristic which is a proxy for being younger, based on the all of relevant facts and circumstances. Thus, a plan fails to satisfy section 411(b)(1)(H) and this paragraph (b) if the rate of benefit accrual for any individual who is or could be a participant under the plan would be lower solely as a result of such individual having a different characteristic which is a proxy for being older, based on all of the relevant facts and circumstances.

(B) Permissible limitations. A reduction in a participant's rate of benefit accrual is not indirectly because of the attainment of any age in violation of section 411(b)(1)(H) solely because of a positive correlation between attainment of any age and a reduction in the rate of benefit accrual. In addition, a defined benefit plan does not fail to satisfy section 411(b)(1)(H) and this paragraph (b) solely because, on a uniform and consistent basis without regard to a participant's age, the plan limits the amount of benefits a participant may accrue under the plan, limits the number of years of service or years of participation taken into account for purposes of determining the accrual of benefits under the plan (credited service), or provides for a reduced rate of accrual for credited service in excess of a fixed number of years. For this purpose, a limitation that is expressed as a percentage of compensation (whether averaged over a participant's total years of credited service for the employer or over a shorter period) is treated as a permissible limitation on the amount of benefits a participant may accrue under the plan.

(iii) Examples. The provisions of this paragraph (b)(3) may be illustrated by the following examples. In each of the examples, except as specifically indicated, normal retirement age is 65, the plan contains no limitations on the maximum amount of benefits the plan will pay to any participant (other than the limitations imposed by section 415), on the maximum number of years of credited service taken into account under the plan, or on the compensation used for purposes of determining the amount of any participant's accrued benefit (other than the limitation imposed by section 401(a)(17)), and the plan uses the following actuarial assumptions in determining actuarial equivalence: a 7.5% rate of interest and the 83 GAM (male) mortality table. The examples are as follows:

Example 1. (i) Plan M provides an accrued benefit of 1% of a participant's average annual compensation, multiplied by the participant's years of credited service under the plan payable in the normal form of a straight life annuity commencing at normal retirement age or the date of actual retirement if later. Plan M suspends payment of benefits for participants who work past normal retirement age, in accordance with section 411(a)(3)(B) and 29 CFR 2530.203-3 of the regulations of the Department of Labor, and does not provide for an actuarial increase in computing the accrued benefit for participants who commence benefits after normal retirement age.

(ii) The rate of benefit accrual for all participants in Plan M is 1% of average annual compensation. Thus, there could be no participant who would have a rate of benefit accrual that is greater than 1% if the individual were younger. Accordingly, there is no reduction in the rate of benefit accrual because of the individual's attainment of any age under this paragraph (b)(3) and Plan M satisfies the requirements of section 411(b)(1)(H) and this paragraph (b).

Example 2. (i) Assume the same facts as in Example 1, except that Plan M provides that not more than 35 years of credited service are taken into account in determining a participant's accrued benefit under the plan. Participant A became a participant in the plan at age 25 and worked continuously in covered service under Plan M until A retires at age 70.

(ii) The rate of benefit accrual under Plan M is 1% of average annual compensation for participants who have up to 35 years of credited service and zero for participants who have more than 35 years of credited service. Because a reduction from a rate of benefit accrual from 1% of average annual compensation to zero is based on service, and would not be affected if any participant were younger (with the same number of years of service), Plan M does not provide for a reduction in the rate of benefit accrual that is directly because of an individual's attainment of any age as provided in paragraph (b)(3)(i) of this section. Under paragraph (b)(3)(ii) of this section, a uniform limit on the number of years of service taken into account for purposes of determining the accrual of benefits under the plan is not considered to be a reduction in the rate of benefit accrual that is indirectly because of a participant's attainment of any age.

(iii) Upon A's retirement at age 70, A will have an accrued benefit under the plan's benefit formula of 35% of A's average annual compensation at age 70 (1% per year of credited service x 35 years of credited service). Plan M will not fail to satisfy the requirements of section 411(b)(1)(H) and this paragraph (b) merely because the plan provides that the final 10 years of A's service under the plan are not taken into account in determining A's accrued benefit. The result would be the same if Plan M provided that no participant could accrue a benefit in excess of 35% of the participant's average annual compensation.

Example 3. Assume the same facts as in Example 1, except that Plan M provides that a participant's years of service after attainment of social security retirement age are disregarded for purposes of determining a participant's accrued benefit under the plan. Because a participant who is covered under the plan after social security retirement age would have a higher rate of benefit accrual if he or she were younger (and had not attained social security retirement age), that participant's rate of benefit accrual is reduced directly because of the participant's attainment of any age under paragraph (b)(3)(i) of this section. Consequently, Plan M fails to satisfy the requirements of section 411(b)(1)(H) and this paragraph (b).

Example 4. (i) Assume the same facts as in Example 1, except that Plan M provides that a participant's compensation after the attainment of age 62 is not taken into account in determining the participant's accrued benefit under the plan.

(ii) Accordingly, the plan's measure of average compensation cannot be used in determining a participant's rate of benefit accrual because it does not apply to participants in a uniform manner that is independent of age. Because a participant who is or could be covered under Plan M after the attainment of age 62 whose compensation increases after age 62 would have a higher rate of benefit accrual if the participant were younger than age 62, that participant's rate of benefit accrual is reduced directly because of the participant's attainment of any age under paragraph (b)(3)(i) of this section. This reduction occurs whether or not there is any actual participant in Plan M who has attained age 62 or whose average annual compensation has increased after age 62. Consequently, the plan fails to satisfy the requirements of section 411(b)(1)(H) and this paragraph (b).

Example 5. (i) Assume the same facts as in Example 1, except that Plan M is amended to cease all benefit accruals for all participants and is subsequently terminated.

(ii) After all benefit accruals have ceased, the rate of benefit accrual of all participants is zero. Thus, there could not be any participant who would have a rate of benefit accrual that is greater than zero if the participant were younger, so that there is no reduction in the rate of benefit accrual that is because of the individual's attainment of any age under paragraph (b)(3) of this section. Accordingly, Plan M satisfies the requirements of section 411(b)(1)(H) and this paragraph (b).

Example 6. (i) Employer Y maintains Plan O, a defined benefit plan that provides an accrued benefit of 1% of a participant's highest 5 consecutive years of compensation, multiplied by the sum of the participant's age and years of service, payable in the normal form of a straight life annuity commencing at normal retirement age or the date of actual retirement if later. Plan O provides that a participant's years of service after the sum of a participant's age and years of service reach a total of 55 are disregarded for purposes of determining the normal retirement benefit. Participant C is 45 years old and has 10 years of credited service as of the beginning of a plan year. Thus, for that plan year, C's rate of benefit accrual is 1% of C's highest 5 consecutive years of compensation.

(ii) If C were younger, for example age 39 (with the same years of service), C would have a rate of benefit accrual of 2% of C's highest 5 consecutive years of compensation. Accordingly, C's rate of benefit accrual is reduced directly because of C's attainment of any age as provided in this paragraph (b)(3)(i). Consequently, Plan O fails to satisfy the requirements of section 411(b)(1)(H) and this paragraph (b).

Example 7. (i) Plan P is a defined benefit plan that provides for a normal retirement benefit of 40% of a participant's average compensation for the participant's highest 3 consecutive years of compensation, payable in the normal form of a straight life annuity commencing at normal retirement age or the date of actual retirement if later. If a participant separates from service prior to normal retirement age, Plan P provides a benefit equal to an amount that bears the same ratio to 40% of such average compensation as the participant's actual number of years of service bears to the number of years of service the participant would have if the participant's service continued to normal retirement age. As of the end of a plan year, participant D is 45 years old and has completed 20 years of service, and participant E is 41 years old and has completed 1 year of credited service. Thus, D's rate of benefit accrual for the plan year may be determined as 1% of compensation for D's highest 3 consecutive years, and E's rate of benefit accrual for the plan year may be determined as 1.6% of compensation for E's highest 3 consecutive years.

(ii) If D were younger than age 45 (with 20 years of service and the same compensation history), D's rate of benefit accrual for the plan year would not be greater than 1% of compensation for D's highest 3 consecutive years. Thus, there is no reduction in the rate of benefit accrual for D that is directly because of the individual's attainment of any age as provided in paragraph (b)(3)(i) of this section. In addition, there are no facts and circumstances indicating that D's rate of benefit accrual is reduced indirectly because of D's attainment of any age as provided in paragraph (b)(3)(ii) of this section. Likewise, if E were younger than age 41 (with 1 year of service and the same compensation history), E's rate of benefit accrual for the plan year would not be greater than 1.6% of compensation for E's highest 3 consecutive years. Thus, there is no reduction in the rate of benefit accrual for E that is directly because of the individual's attainment of any age as provided in paragraph (b)(3)(i) of this section. In addition, there are no facts and circumstances indicating that E's rate of benefit accrual is reduced indirectly because of E's attainment of any age under paragraph (b)(3)(ii) of this section. These same results would apply for any possible participant in Plan P. Accordingly, Plan P satisfies the requirements of section 411(b)(1)(H) and this paragraph (b).

Example 8. (i) Plan A is a defined benefit plan that provides for an accrued benefit of 2% of a participant's average compensation for the participant's highest 3 consecutive years of compensation for the first 20 years of service, plus 1% of such average compensation for years in excess of 20, payable in the normal form of a straight life annuity

commencing at normal retirement age or the date of actual retirement if later. However, if a participant separates from service prior to normal retirement age, Plan P provides a benefit equal to an amount that bears the same ratio to the total percentage of such average compensation that the participant would have if service continued to normal retirement age as the participant's actual number of years of service bears to the number of years of service the participant would have if the participant's service continued to normal retirement age. For participants who work past normal retirement age, Plan A provides a benefit equal to 2% per year for years of service not in excess of 20, plus the following rate for years of service in excess of 20: the sum of 40% plus the product of 1% times service in excess of 20 years, with that sum divided by total service to the end of the current plan year. As of the beginning of the plan year beginning January 1, 2008, participant N is 64 years old and has completed 20 years of service, and participant O is 70 years old and has completed 20 years of credited service. Thus, N's rate of benefit accrual for that plan year may be determined as 1.95% of compensation for N's highest 3 consecutive years (2% for 20 years, plus 1% for 1 year, with that sum divided by 21 equals 1.95%), and O's rate of benefit accrual for that plan year also may be determined 1.95% of compensation for O's highest 3 consecutive years (40% for the first 20 years, plus 1% for service to the end of 2008, with that sum divided by 21 equals 1.95%).

(ii) If O were younger than age 70 (with 20 years of service and the same compensation history), O's rate of benefit accrual for the plan year would not be greater than 1.95% of compensation for O's highest 3 consecutive years. The same conclusion applies for any other possible participant. Thus, Plan A satisfies paragraph (b)(3)(ii) of this section.

(iii) However, if Plan A were instead to provide a rate of benefit accrual for service after normal retirement age equal to 2% for years of service not in excess of 20, plus 1% for service in excess of 20, Plan A would fail to satisfy paragraph (b)(3)(ii) of this section. For example, O's rate of benefit accrual would be 1% for 2008, whereas N's rate of benefit accrual would be 1.95% for 2008, even though the only difference between O and N is that N is younger.

Example 9. (i) The facts are similar to Example 8, except that the formula is 1% of a participant's average compensation for the participant's highest 3 consecutive years of compensation for the first 20 years, plus 2% of such average compensation for years in excess of 20, payable in the normal form of a straight life annuity commencing at normal retirement age or the date of actual retirement if later. As in Example 8, if a participant separates from service prior to normal retirement age, Plan P provides a benefit equal to an amount that bears the same ratio to the total percentage of such average compensation that the participant would have if service continued to normal retirement age as the participant's actual number of years of service bears to the number of years of service the participant would have if the participant's service continued to normal retirement age.

Further, similar to the facts in Example 8(iii) of this paragraph (b)(3)(iii), for participants who work past normal retirement age, Plan A provides a benefit equal to 1% per year for years of service not in excess of 20, plus 2% per year for years of service in excess of 20. As of the beginning of the plan year beginning January 1, 2008, participant K is 45 years old and has completed 10 years of service, and participant M is 55 years old and has completed 10 years of credited service. Thus, K's rate of benefit accrual for the plan year may be determined as 1.33% of compensation for K's highest 3 consecutive years (1% for 20 years, plus 2% for 10 more years, with the sum divided by 30 equals 1.33%), and M's rate of benefit accrual for the plan year may be determined as 1% of compensation for O's highest 3 consecutive years (1% for 20 years, with that amount divided by 20 equals 1%).

(ii) If M were younger than age 55 (with 10 years of service and the same compensation history), M's rate of benefit accrual for the plan year would be greater than 1% of compensation for M's highest 3 consecutive years. (Plan A also provides for an impermissible reduction in the rate of benefit accrual for a participant whose service continues after normal retirement age in a manner that is comparable to Example 8(iii) of this paragraph (b)(3)(iii).) Thus, Plan A fails to satisfy paragraph (b)(3)(ii) of this section.

Example 10. (i) Employer Z maintains Plan Q, a defined benefit plan that provides an accrued benefit of $40 per month multiplied by a participant's years of credited service. Participant F attains normal retirement age of 65 and continues in the full time service of Z. At age 65, F has 30 years of credited service under the plan and could receive a normal retirement benefit of $1,200 per month ($40 X 30 years) if F retires. The plan suspends benefits for participants who work past normal retirement age, in accordance with section 411(a)(3)(B) and 29 CFR 2530.203-3 of the regulations of the Department of Labor, and does not provide for any actuarial increase for employment past normal retirement age. Accordingly, the plan does not pay F's accrued benefit while F remains in the full time service of Z and does not provide for an actuarial adjustment of F's accrued benefit because of delayed payment. For example, if F retires at age 67, after completing 2 additional years of credited service for Z, F will receive a benefit of $1,280 per month ($40 x 32 years) commencing at age 67.

(ii) Under Plan Q, the rate of accrual for all participants is $40 per month. Thus, there could not be any participant who would have a rate of benefit accrual that is greater than $40 per month if the participant were younger, so that there is no reduction in the rate of benefit accrual that is because of the individual's attainment of any age under paragraph (b)(3)(i) of this section. Accordingly, Plan Q satisfies the requirements of section 411(b)(1)(H) and this paragraph (b).

Example 11. (i) Assume the same facts as in Example 10, except that the plan provides that the amount of F's benefit at normal retirement age will be actuarially increased for delayed retirement (even though the plan suspends benefits for participants who work past normal retirement age), and this actuarially increased benefit will be paid if it exceeds the plan formula, but no actuarial increase is provided for any amount that is

accrued after normal retirement age. The plan takes this actuarial increase into account as part of the rate of benefit accrual in plan years ending after F's attainment of normal retirement age, as provided under paragraph (b)(2)(ii) of this section.

(ii) Under section 411(b)(1)(H) and this paragraph (b), F's employment past normal retirement age cannot cause F's rate of benefit accrual for any year to be less than $40 for the year. Plan Q satisfies this requirement for the first year after normal retirement age because, under the plan, F is entitled to receive, upon retirement at the end of the year when F is age 66, an actuarially increased benefit of $1,344.68 per month, so that the rate of benefit accrual for the year is $144.68 (which is $1,344.68 minus $1,200).

(iii) Further, for the second year past normal retirement age ending when F is age 67, F must be entitled to a rate of benefit accrual of at least $149.50 per month, which is the highest rate of benefit accrual under Plan Q for any younger participant with 32 years of service at the end of the year. (In these facts, all participants have a rate of accrual of $40 until normal retirement age and a participant who is age 66 with 32 years of service at the end of the year would have a rate of benefit accrual of $149.50 due to an actuarial increase on an age 65 benefit of $1,240 per month.) Under the plan, F is entitled to receive, upon retirement at age 67, an actuarially increased benefit of $1,511.39 per month. Plan Q satisfies the requirement that F be entitled to the highest rate of benefit accrual provided to any younger participant because the rate of benefit accrual in that year ($1,511.39 minus $1,344.68 equals $166.71) is not less than what the rate would be for F if F were younger. These same results would apply for any possible participant in Plan Q. Accordingly, Plan Q satisfies the requirements of section 411(b)(1)(H) and this paragraph (b).

Example 12. (i) Employer Z maintains Plan R, a defined benefit plan that provides an accrued benefit of 2% of the average of a participant's high 3 consecutive years of compensation multiplied by the participant's years of credited service under the plan. Participant G, who has attained normal retirement age (age 65) under the plan, continues in the full time service of Z. At normal retirement age, G has average compensation of $40,000 for G's high 3 consecutive years and has 10 years of credited service under the plan. Thus, at normal retirement age, G is entitled to receive an annual normal retirement benefit of $8,000 ($40,000 X .02 X 10 years). Payment of G's retirement benefit is not suspended, and the plan provides that retirement benefits that commence after a participant's normal retirement age are actuarially increased for late retirement. Under the plan provision relating to actuarial increase, the actuarial increase for the plan year is made to the benefit that would have been paid had the participant retired as of the end of the preceding plan year. The plan then provides the greater of this actuarially increased benefit and benefits under the plan formula based on continued service, thereby including the actuarial increase in the rate of benefit accrual in plan years ending after G's attainment of normal retirement age, as provided in paragraph (b)(2)(ii) of this section. The foregoing is illustrated in the following table with respect to certain years of credited service performed by G after attaining normal retirement age 65. (Certain numbers may not total due to rounding.)

Age at start of plan year	Years of service at start of plan year	Average pay for high 3 consecutive years at start of plan year	Plan formula at start of plan year (.02 times column 2 times column 3)	Additional accruals for the plan year under plan formula (column 4 minus column 4 for prior year)	Annual benefit, as actuarially increased (column 8 from prior year actuarially increased)	Actuarial increase on the benefit at prior age (column 6 minus column 8 for prior year)	Annual benefit to which C is entitled at start of year (greater of column 4 or column 6)	Annual benefit as percent of average pay column 8 ÷ column 3)	Rate of benefit accrual (column 9 less column 9 for prior year)
(1)	**(2)**	**(3)**	**(4)**	**(5)**	**(6)**	**(7)**	**(8)**	**(9)**	**(10)**
65	10	$40,000	$8,000	n/a	n/a	n/a	$8,000	20%	2%
66	11	$42,000	$9,240	$1,240	$8,964	$964	$9,240	22%	2%
67	12	$58,000	$13,920	$4,680	$10,386	$1,142	$13,920	24%	2%
68	13	$60,000	$15,600	$1,680	$15,697	$1,777	$15,697	26.16%	2.16%
69	14	$66,000	$18,480	$2,880	$17,762	$2,065	$18,480	28%	1.84%
70	15	$68,000	$20,400	$1,920	$20,989	$2,509	$20,989	30.87%	2.87%

(ii) In the year G is 69 at the beginning of the year, G's rate of benefit accrual (1.84% of the average high 3 consecutive years of compensation) is lower than the rate of benefit accrual that would apply to a younger participant because a participant who is younger than age 65 with the same number of years of credited service and compensation history would have a rate equal to 2% of average high 3 consecutive years of compensation. Accordingly, Plan R fails to satisfy the requirements of section 411(b)(1)(H) and this paragraph (b).

Example 13. (i) The facts are the same as in Example 10, except that, under the plan provisions relating to retirement after normal retirement age, a participant's benefit is equal to the sum of the benefit that would have been paid had the participant retired as of the end of the preceding plan year and the greater of the actuarial increase for the plan year on that amount or the otherwise applicable accrual for the plan year under the plan formula. The foregoing is illustrated in the following table with respect to certain years of credited service performed by G after attaining normal retirement age 65.

Age at start of plan year	Years of service at start of plan year	Average pay for high 3 consecutive years at start of plan year	Plan formula at start of plan year (.02 times column 2 times column 3)	Additional accruals for the plan year under plan formula (column 4 minus column 4 for prior year)	Annual benefit, as actuarially increased (column 8 from prior year actuarially increased)	Actuarial increase on the benefit at prior age (column 6 minus column 8 for prior year)	Annual benefit to which C is entitled at start of year (column 8 at prior age plus the greater of column 5 and column 7)	Annual benefit as percent of average pay column 8 ÷ column 3)	Rate of benefit accrual (column 9 less column 9 for prior year)
(1)	**(2)**	**(3)**	**(4)**	**(5)**	**(6)**	**(7)**	**(8)**	**(9)**	**(10)**
65	10	$40,000	$8,000	n/a	n/a	n/a	$8,000	20%	2%
66	11	$42,000	$9,240	$1,240	$8,964	$964	$9,240	22%	2%
67	12	$58,000	$13,920	$4,680	$10,386	$1,142	$13,920	24%	2%
68	13	$60,000	$15,600	$1,680	$15,697	$1,777	$15,697	26.16%	2.16%
69	14	$66,000	$18,480	$2,880	$17,762	$2,065	$18,577	28.1%	2%
70	15	$68,000	$20,400	$1,920	$21,098	$2,521	$21,098	31.03%	2.93%

(ii) In the year G is 69 at the beginning of the year, G's rate of benefit accrual (2% of the average high 3 consecutive years of compensation) is not lower than the rate that would apply to G if G were younger. For example, if G were age 68 with the same 14 years of credited service and compensation history that G has at age 69, G would have a rate of benefit accrual equal to 2% of average high 3 consecutive years of compensation (in contrast to Example 12 in which the rate is 1.84% for an employee who is age 69 with 14 years of service, but would be 2% for younger employees with the same service and compensation history). Similar results would apply for any other potential younger participant in Plan R. Accordingly, Plan R satisfies the requirements of section 411(b)(1)(H) and this paragraph (b).

(iii) The decrease in G's rate of benefit accrual from 2.16% to 2% from age 68 to age 69 is not an impermissible reduction because of age. Under paragraph (b)(3) of this section, the determination of whether an impermissible reduction occurs because of age is made by comparing any potential participant's rate of benefit accrual to what the rate would be if the participant were younger (but with the same years of service, compensation history, and any other relevant factors taken into account under the plan), not by comparing a participant's rate in one year to that participant's rate in an earlier year. As indicated in paragraph (ii) of this Example 13, the rate of benefit accrual for a participant who is age 69 with 14 years of service at the beginning of the year is compared with the rate for all younger participants with the same service and compensation history. Similarly, the 2.16% rate for a participant who is age 68 with 13 years of service at the beginning of the year is compared with the rate for all younger participants with the same service and compensation history. Thus, for example, if G were age 67 with the same 13 years credited service and high 3 years of compensation equal to $60,000 that G has at age 68, G would have a rate of benefit accrual equal to 2.08% of average high 3 consecutive years of compensation.

(4) Certain adjustments for benefit distributions--(i) In general. Under section 411(b)(1)(H)(iii)(I), a defined benefit plan may provide that the requirement for continued benefit accrual under section 411(b)(1)(H)(i) and this paragraph (b) for a plan year is treated as satisfied to the extent of the actuarial equivalent of benefits distributed, as provided in this paragraph (b)(4). Distributions made before the participant attains normal retirement age or during a period that is not "section 203(a)(3)(B) service," as defined in 29 CFR 2530.203-3(c) of the regulations of the Department of Labor, may not be taken into account under this paragraph (b)(4).

(ii) Amount of the adjustment for benefits distributed. A defined benefit plan does not violate paragraph (b) of this section for a plan year merely because the rate of benefit accrual is reduced (but not below zero) to the extent of the actuarial equivalent of plan benefit distributions made to the participant during the plan year. For this purpose, distributions made during the plan year generally are disregarded for that year to the extent the actuarial value of the distributions exceeds the actuarial value of distributions that would have been made during the plan year had distribution of the participant's accrued benefit commenced at the beginning of the plan year (or, if later, at the participant's normal retirement age) in the normal form of benefit. (But see paragraph (b)(4)(iii) of this section for rules taking this excess into account at the end of the current year and in future years.) In addition, in any case in which the participant's benefits are being distributed in an optional form of benefit under which the amount payable annually is less than the amount payable under the plan's normal form of benefit (for example, a QJSA under which the annual benefit is less than the amount payable annually under a straight life annuity normal form), the plan may treat the participant as receiving payments under an actuarially equivalent normal form of benefit for the plan year and all future plan years.

(iii) Treatment of accelerated benefit payments--(A) Accelerated benefit payments. This paragraph (b)(4)(iii) applies if the actuarial value of the distributions made to the participant during a plan year exceeds the actuarial value of the distributions that would have been made during the plan year had distributions commenced at the beginning of the plan year (or, if later, at the participant's normal retirement age) in the normal form of benefit. In such a case, the excess payments (referred to as accelerated benefit

payments) are converted to an actuarially equivalent stream of annual benefit payments under the plan's normal form of benefit, commencing at the beginning of the next plan year. This conversion must be based on the same actuarial assumptions used under the plan to determine the distributions made to the participant during the plan year. For purposes of this paragraph (b)(4)(iii), the actuarially equivalent stream of annual benefit payments is referred to as the annuity equivalent of accelerated benefit payments.

(B) Credit for annuity equivalent of accelerated benefit payments. For purposes of applying paragraphs (b)(4)(ii) and (iii)(C) of this section, the annuity equivalent of accelerated benefit payments is deemed to be paid to the participant in each plan year that begins after the plan year during which any accelerated benefit payment under paragraph (b)(4)(iii)(A) of this section is made.

(C) Effect of accelerated benefit payments on rate of benefit accrual. If any accelerated benefit payments under paragraph (b)(4)(iii)(A) of this section have been made to a participant, then, in lieu of determining the participant's rate of benefit accrual under paragraph (b)(2)(ii) of this section, the participant's rate of benefit accrual for a plan year is determined as the excess (if any) of--

(1) The sum of the annual benefit to which the participant is entitled at the end of the current plan year, assuming payment commences in the normal form at the end of the current plan year, plus the amount deemed paid in the next plan year under the annuity equivalent of accelerated benefit payments; over

(2) The sum of the annual benefit to which the participant was entitled at the end of the preceding plan year, assuming that payment commences in the normal form at the later

of normal retirement age and the end of the preceding plan year, plus the amount deemed paid during the current plan year under the annuity equivalent of accelerated benefit payments.

(iv) Examples. The provisions of this paragraph (b)(4) may be illustrated by the following examples. In each of the examples, except as otherwise indicated, normal retirement age is 65 and the birthday of each participant is assumed to be January 1. In addition, except as otherwise indicated, the plan contains no limitations on the maximum amount of benefits the plan will pay to any participant (other than the limitations imposed by section 415), on the maximum number of years of credited service taken into account under the plan, or on the compensation used for purposes of determining the amount of any participant's normal retirement benefit (other than the limitation imposed by section 401(a)(17)) and the plan uses the following actuarial assumptions for purposes of determining the amount of any participant's accrued benefit (other than the limitation imposed by section 401(a)(17)), and the plan uses the following actuarial assumptions in determining actuarial equivalence: a 7.5% rate of interest and the 83 GAM (male) mortality table. The examples are as follows:

Example 1. (i) Facts relating to the year in which participant attains age 65. Employer Z maintains Plan Q, a defined benefit plan that provides an accrued benefit of $40 per month multiplied by the participant's years of credited service. Participant F attains normal retirement age of 65 on January 1 and continues in the full time service of Z. At the end of the year in which F attains age 65, F has 30 years of credited service under the plan and could receive an accrued benefit of $1,200 per month ($40 x 30 years) if F retires. Plan Q does not suspend payment of benefits for participants who work past normal retirement age and F commences benefit payments at normal retirement age. (These are the same facts as in Example 10 of paragraph (b)(3)(iii) of this section, except that the Plan Q does not provide for the suspension of normal retirement benefit payments.) The plan offsets the value of the benefit distributions against benefit accruals in plan years

ending after the participant's attainment of normal retirement age, as permitted by paragraph (b)(4)(ii) of this section. Participant F (who remains in the full time service of Y) receives 12 monthly benefit payments after attainment of age 65 and prior to attainment of age 66. The total monthly benefit payments of $14,400 ($1,200 x 12 payments) have an actuarial value at the end of the year in which F turns 65 of $15,118 (reflecting interest and mortality) which would produce a monthly life annuity benefit of $145 commencing at age 66. The rate of benefit accrual otherwise applicable under the plan formula for the year of credited service F completes after attaining normal retirement age is $40 per month.

(ii) Conclusions relating to the year in which F attains age 65. Because the actuarial value (determined as a monthly benefit of $145) of the benefit payments made during the first year after F's attainment of normal retirement age exceeds the benefit accrual otherwise applicable for the first year after F's attainment of normal retirement age, the plan is not required to accrue benefits on behalf of F for the one year of credited service after F's attainment of normal retirement age and the plan is not required to increase F's monthly benefit payment of $1,200 during the year in which F attains age 65.

(iii) Facts relating to the year in which F attains age 66. Assume F receives 12 additional monthly benefit payments the next year prior to F's retirement at the end of the next year when F attains age 66. The total monthly benefit payments of $14,400 ($1,200 x 12 payments) have an actuarial value at the end of that year of $15,135 (reflecting interest and mortality) which would produce a monthly benefit payment of $149 commencing at age 67. The rate of benefit accrual otherwise applicable under the plan formula for the additional year of credited service F completed that year is $40 per month.

(iv) Conclusions relating to the year in which F attains age 66. Because the actuarial value (determined as a monthly benefit of $149) of the benefit payments made during that year exceeds the benefit accrual otherwise applicable for the additional year of credited service, the plan is not required to accrue benefits on behalf of F for the second year of credited service F completed after attaining normal retirement age and the plan is not required to increase F's monthly benefit payment of $1,200.

Example 2. (i) Facts. Employer Z maintains Plan R, a defined benefit plan that provides an accrued benefit of 2% of the average of a participant's high 3 consecutive years of compensation multiplied by the participant's years of credited service under the plan. Payment of a participant's retirement benefit is not suspended, and the plan provides that retirement benefits that commence after a participant's normal retirement age are actuarially increased for late retirement. Under the plan provision relating to actuarial increase, the actuarial increase for the plan year is made to the benefit that would have been paid had the participant retired as of the end of the preceding plan year. The plan then provides the greater of this actuarially increased benefit and benefits under the plan formula based on continued service, thereby including the actuarial increase in the rate of benefit accrual in plan years ending after attainment of normal retirement age, as provided

in paragraph (b)(2)(ii) of this section. Participant G, who has attained normal retirement age (age 65) under the plan, continues in the full time service of Z. At normal retirement age, G has average compensation of $40,000 for G's high 3 consecutive years and has 10 years of credited service under the plan. Thus, at normal retirement age, G is entitled to receive an annual normal retirement benefit of $8,000 ($40,000 x .02 x 10 years). G continues working after normal retirement age, with G's average compensation increasing to $68,000 at age 70. (The facts in this Example 2 are the same as Example 13 of paragraph (b)(3)(ii) of this section, except that the employee does not retire at age 70, but continues in the full time service of Z.) Upon G's attainment of age 70, the plan commences benefit payments to G. The annual benefit paid to G in the first plan year is $21,098. In determining the annual benefit payable to G in each subsequent plan year, the plan offsets the value of benefit distributions made to the participant by the close of the prior plan year against benefit accruals otherwise applicable in plan years during which such distributions were made, as permitted by paragraph (b)(4)(ii)(B) of this section.

(ii) Conclusion. Accordingly, for each subsequent plan year, G is entitled under the plan to receive benefit payments based on G's benefit at the close of the prior plan year, plus the excess (if any) of the benefit for the plan year determined under the plan formula otherwise applicable over the value of total benefit distributions made to G during the plan year. The foregoing is illustrated in the following table with respect to certain years of credited service performed by G while benefits were being distributed to G.

Age at start of plan year	Years of service at start of plan year	Average pay for high 3 consecutiv e years at start of plan year	Plan formula at start of plan year (.02 times column 2 times column 3)	Additional accruals for the plan year under plan formula (column 4 minus column 4 for prior year)	Benefit distributio ns made during the prior year	Annual benefit that is actuarial equivalent of column 6	Annual benefit to which G is entitled at end of the year (column 8 for prior year, plus the excess, if any of column 5 for the current year, over column 7 for current year)
(1)	**(2)**	**(3)**	**(4)**	**(5)**	**(6)**	**(7)**	**(8)**
70	15	$68,000	$20,400	$1,920	none	none	$21,098
71	16	$70,000	$22,400	$2,000	$21,098	$2,799	$21,098
72	17	$90,000	$30,600	$8,200	$21,098	$2,891	$26,407
73	18	$100,000	$36,000	$5,400	$26,407	$3,743	$28,065

Example 3. (i) Facts relating to the year in which a participant attains age 65. Plan X provides an accrued benefit equal to 1% of the average of a participant's highest 3 consecutive years of compensation times the participant's years of service, payable in the normal form of a straight life annuity commencing at normal retirement age or at the date of actual retirement if later. Plan X permits a participant who is an employee to commence distributions after attainment of normal retirement age (age 65) and provides for benefits otherwise accrued after normal retirement age to be offset by the actuarial equivalent of any benefit distributions made to the participant. Plan X provides for a participant who does not commence distributions to receive an actuarial increase for the year from the amount payable at the end of the preceding year (if greater than the amount otherwise accrued for H during the year under X's formula). Participant H attains age 65 on the first day of a plan year when Participant H's average highest 3 consecutive years of compensation is $60,000 and H has 20 years of service. Accordingly, Participant H's accrued benefit at the beginning of the year is equal to a straight life annuity of $1,000 per month (20% times $60,000 divided by 12) commencing at the beginning of the year. Participant H elects to receive a single-sum distribution of $130,389 at the beginning of the year, which is equal to the present value of H's accrued benefit under section 417(e) at that time. Participant H continues to work through the end of the plan year and at the end of the year has average compensation of $60,000 for the year. Plan X uses the actuarial assumptions specified in section 417(e) for purposes of determining actuarial equivalence. For purposes of this Example 3, the applicable interest rate under section 417(e) is assumed to be 6%, and the applicable mortality table under section 417(e) is the mortality table in effect on January 1, 2003.

(ii) Conclusion relating to effect of distributions made in the year H attains age 65. Under this paragraph (b)(4), H would otherwise accrue an additional monthly benefit of $50 for the additional year of service under the plan's formula (21% times $60,000 minus 20% times $60,000, divided by 12). The plan is permitted under section 411(b)(1)(H)(iii)(I) to offset additional accruals otherwise applicable after normal retirement age by the actuarial value of distributions made during the year. However, under paragraph (b)(4)(ii) of this section, distributions made during a plan year are disregarded to the extent that the actuarial value of the distributions exceeds the actuarial value of distributions that would have been made during the plan year had distribution of the participant's accrued benefit commenced at the beginning of the plan year under the plan's normal form.

(iii) Conclusion relating to calculations for distribution made in the year H attains age 65. At the end of the year, the actuarial value of the distribution made to H ($130,389 plus interest and mortality for the year equals $139,812) is greater than the year end actuarial value of distributions that would have been made during the plan year had distribution of the participant's accrued benefit at the beginning of the plan year commenced in the normal form at the beginning of the plan year (which is $12,470, based on the plan's actuarial assumptions). Accordingly, the $127,342 excess (referred to as an

accelerated benefit payment) is disregarded in the current year. (However, as described below, the annuity equivalent of the $127,342 is deemed to be paid to H commencing at the beginning of the first plan year after the plan year during which the accelerated benefit payment is made.)

(iv) Conclusion relating to rate of benefit accrual for the year H attains age 65. To determine the rate of benefit accrual for the year in which H attains age 65, the annuity equivalent of accelerated benefit payments is calculated and, under paragraph (b)(4)(iii)(C) of this section, this amount is treated as part of the benefit payable at the end of the year in calculating the rate of benefit accrual for the year. In this Example 3, the annuity equivalent of the $127,342 accelerated benefit payment equals a straight life annuity of $1,000 per month commencing at the beginning of the next plan year. Thus, for purposes of applying paragraph (b)(4)(iii) of this section to determine the rate of benefit accrual for the plan year in which H attains age 65, paragraph (b)(4)(iii)(C)(1) of this section is an annual straight life annuity commencing at end of the year equal to $1,000 (the sum of the annual benefit to which the H is entitled at the end of the plan year, which is zero in this case, plus the amount deemed paid in the next plan year under the annuity equivalent of accelerated benefit payments, which is $1,000 in this case) and the amount in paragraph (b)(4)(iii)(C)(2) of this section is an annual straight life annuity commencing at end of the preceding plan year equal to $1,000. Thus, H's rate of benefit accrual for the year is zero.

(v) Conclusion relating to whether rate of benefit accrual for year H attains age 65 satisfies section 411(b)(1)(H). Under paragraph (b)(4)(ii) of this section, a plan may reduce the rate of benefit accrual otherwise applicable to the extent of distributions made during the year. The actuarial equivalent of $12,470 (the actuarial value of the 12 $1,000 monthly payments deemed paid to H during the plan year under paragraph (b)(4)(ii) of this section) is a straight life annuity commencing at the end of the plan year equal to $98 per month. Thus, the otherwise applicable accrual for the year may be reduced (but not below zero) by $98 per month. The highest rate of benefit accrual for any participant with H's service and compensation history who is younger is an annual straight life annuity of $50 per month. Because the permissible reduction of $98 per month is not less than the otherwise applicable accrual of $50 per month, Plan X is not required by this paragraph (b) for the year and section 411(b)(1)(H) to provide H with any additional accruals for the year.

(vi) Conclusion relating to rate of benefit accrual for year H attains age 65 if no distribution were made. If Participant H had not elected to receive any distribution during the plan year, then H's accrued benefit at the end of the year would be a straight life annuity of $1,098 per month commencing at the end of the year (which is actuarially equivalent to a straight life annuity of $1,000 per month commencing at the beginning of the year). Thus, H's rate of benefit accrual for that year would be $98 (but no adjustments for any distribution would apply).

(vii) Facts relating to next year in which H attains age 66. Participant H works another year and H's average compensation becomes $70,000. Under this paragraph (b)(4), H would otherwise accrue an additional monthly benefit of $233 for the additional year of service under the plan's formula (22% times $70,000, minus 21% times $60,000, divided by 12). However, the plan is permitted under section 411(b)(1)(H)(iii)(I) to offset additional accruals after normal retirement age by the actuarial value of distributions made during the year. Under paragraph (b)(4)(iii)(B) of this section, the $1,000 annuity equivalent of accelerated benefit payments is deemed to be paid to H during this second year when H attains age 66. These deemed payments are actuarially equivalent to an accrual of $100 per month payable at the end of that year. Accordingly, the plan reduces the otherwise applicable accrual of $233 to the extent of the accrual of $100 per month payable at the end of the year in which H attains age 66. Thus, the $233 accrual during the year in which H becomes 66 is reduced by $100 to $133. Under the plan X, H's accrued benefit at the end of the year is $133 per month.

(viii) Conclusion relating to rate of benefit accrual for year H attains age 66. To determine the rate of benefit accrual for the second year when H attains age 66, the annuity equivalent of accelerated benefit payments is calculated and, under paragraph (b)(4)(iii)(C) of this section, this amount is treated as part of the benefit payable at the end of the year in calculating the rate of benefit accrual for the second year. In this Example 3, the annuity equivalent of the $127,342 accelerated benefit payment that was made in the year in which H attained age 65 equals a straight life annuity of $1,000 per month commencing at the beginning of the next plan year. Thus, for purposes of applying paragraph (b)(4)(iii) of this section to determine the rate of benefit accrual for the second plan year, the amount in paragraph (b)(4)(iii)(C)(1) of this section is an annual straight life annuity commencing at end of the year equal to $1,133 (the sum of the annual benefit to which the H is entitled at the end of the plan year, which is $133 in this case, plus the amount deemed paid in the next plan year under the annuity equivalent of accelerated benefit payments, which is $1,000 in this case) and the amount in paragraph (b)(4)(iii)(C)(2) of this section is an annual straight life annuity commencing at end of the preceding plan year equal to $1,000. Thus, H's rate of benefit accrual for the year in which H becomes age 66 is $133.

(ix) Conclusion relating to whether rate of benefit accrual for year H becomes 66 satisfies section 411(b)(1)(H). Under paragraph (b)(4))(ii) of this section, a plan may reduce the rate of benefit accrual to the extent of distributions made during the year. The actuarial equivalent of $12,480 (the actuarial value of the 12 $1,000 monthly payments deemed made to H during the plan year) is a straight life annuity commencing at the end of the plan year equal to $100 per month. Thus, the otherwise applicable accrual for the year may be reduced (but not below zero) by $100 per month. The highest rate of benefit accrual for any participant with H's service and compensation history who is younger is an annual straight life annuity of $233 per month. Thus, because the sum of $133 and $100 is

not less than the otherwise applicable accrual of $233 per month, Plan X satisfies this paragraph (b) and section 411(b)(1)(H) for the year.

(c) Defined contribution plans--(1) In general. A defined contribution plan (including a target benefit plan described in §1.410(a)-4(a)(1)) does not satisfy the requirements of section 411(b)(2) if the rate of allocation made to the account of a participant is reduced, either directly or indirectly, because of the participant's attainment of any age. A reduction in the rate of allocation includes any discontinuance in the allocation of employer contributions or forfeitures to the account of the participant or cessation of participation in the plan.

(2) Rate of allocation--(i) Aggregate allocations. For purposes of this paragraph (c), a participant's rate of allocation for any plan year is the aggregate allocations taken into account for the plan year under §1.401(a)(4)-2(c)(2).

(ii) Determination of rate of allocation. A participant's rate of allocation for a plan year can be determined as a dollar amount. Alternatively, if a plan's formula bases a participant's allocations solely on compensation for the plan year and compensation is determined without regard to attainment of any age, then a participant's rate of allocation can be determined as a percentage of the participant's compensation for the plan year.

(3) Reduction that is directly or indirectly because of a participant's attainment of any age--(i) Reduction in rate of allocation that is directly because of a participant's attainment of any age. A plan provides for a reduction in the rate of allocation that is directly because of a participant's attainment of any age for any plan year if, under the terms of the plan, any participant's rate of allocation for the plan year would be higher if the

participant were younger. Thus, a plan fails to satisfy section 411(b)(2) and this paragraph (c) if, under the terms of the plan, the rate of allocation for any individual who is or could be a participant under the plan would be lower solely as a result of such individual being older.

(ii) Reduction in rate of allocation that is indirectly because of a participant's attainment of any age--(A) In general. A plan provides for a reduction in the rate of allocation that is indirectly because of a participant's attainment of any age for any plan year if any participant's rate of allocation for the plan year would be higher if the participant were to have a characteristic that is a proxy for being younger, based on all of the relevant facts and circumstances. Thus, a plan fails to satisfy section 411(b)(2) and this paragraph (c) if the rate of allocation for any individual who is or could be a participant under the plan would be lower solely as a result of such individual having a different characteristic which is a proxy for being older, based on applicable facts and circumstances.

(B) Treatment of limitations. A reduction in a participant's rate of allocation is not indirectly because of the attainment of any age in violation of section 411(b)(2) solely because of a positive correlation between attainment of any age and a reduction in the rate of allocation. Thus, a defined contribution plan (including a target benefit plan described in §1.410(a)-4(a)(1)) does not fail to satisfy the minimum vesting standards of section 411(a) solely because the plan limits the total amount of employer contributions and forfeitures that may be allocated to a participant's account (for a particular plan year or for the participant's total years of credited service under the plan), solely because the plan limits the total number of years of credited service for which a participant's account may receive allocations of employer contributions and forfeitures, or solely because the plan limits the

number of years of credited service that may be taken into account for purposes of determining the amount of, or the rate at which, employer contributions and forfeitures are allocated to a participant's account for a particular plan year.

(iii) Special rule for target benefit plans. A defined contribution plan that is a target benefit plan, as defined in §1.410(a)-4(a)(1), satisfies section 411(b)(2) only if the defined benefit formula used to determine allocations would satisfy section 411(b)(1)(H) without regard to section 411(b)(1)(H)(iii). Such a target benefit plan does not fail to satisfy this paragraph (c) with respect to allocations after normal retirement age merely because the allocation for a plan year is reduced to reflect shorter longevity using a reasonable actuarial assumption regarding mortality.

(iv) Additional rules. The Commissioner may prescribe additional guidance, published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*) of this chapter), with respect to the application of section 411(b)(2) and this section to target benefit plans.

(d) Benefits and forms of benefits subject to requirements--(1) General rule. Except as provided in paragraph (d)(2) or (3) of this section, sections 411(b)(1)(H) and 411(b)(2) and paragraphs (b) and (c) of this section apply to all benefits (and forms of benefits) provided under the plan, including accrued benefits, benefits described in section 411(d)(6), ancillary benefits, and other rights and features provided under the plan. Accordingly, except as provided in paragraph (d)(2) or (3) of this section, a participant's rate of benefit accrual under a defined benefit plan and a participant's allocations under a defined contribution plan are considered to be reduced because of the participant's attainment of any age if optional forms of benefits, ancillary benefits, or other rights or

features under the plan provided with respect to benefits or allocations attributable to credited service prior to the attainment of the participant's age are not provided on at least as favorable a basis with respect to benefits or allocations attributable to credited service after attainment of the participant's age. Thus, for example, a plan may not provide a single-sum payment only with respect to benefits attributable to years of credited service before the attainment of a specified age. Similarly, except as provided in paragraph (d)(2) or (3) of this section, if an optional form of benefit is available under the plan at a specified age, the availability of that form of benefit, or the method for determining the manner in which that form of benefit is paid, may not, directly or indirectly, be denied or provided on terms less favorable to participants because of the attainment of any age. Similarly, if the method for determining the amount or the rate of the subsidized portion of a joint and survivor annuity or the subsidized portion of a preretirement survivor annuity is less favorable with respect to participants who have attained a specified age than with respect to participants who have not attained such age, benefit accruals or account allocations under the plan will be considered to be reduced because of the attainment of such age.

(2) Special rule for actuarial assumptions regarding mortality. A plan does not fail to satisfy section 411(b)(1)(H) or this paragraph (d) merely because the plan makes actuarial adjustments using a reasonable assumption regarding mortality to calculate optional forms of benefit or to calculate the cost of providing a qualified preretirement survivor annuity, as defined in section 417(c).

(3) Special rule for certain benefits. A plan does not fail to satisfy section 411(b)(1)(H) or this paragraph (d) merely because the following benefits, or the manner in

which such benefits are provided under the plan, vary because of the attainment of any higher age--

(i) The subsidized portion of an early retirement benefit (whether provided on a temporary or permanent basis);

(ii) A qualified disability benefit (as defined in §1.411(a)-7(c)(3)); or

(iii) A social security supplement (as defined in §1.411(a)-7(c)(4)(ii)).

(e) Coordination with certain provisions. Notwithstanding section 411(b)(1)(H), section 411(b)(2), and paragraphs (a) through (d) of this section, the following rules apply--

(1) Section 415 limitations. No benefit accrual with respect to a participant in a defined benefit plan is required for a plan year by section 411(b)(1)(H)(i) and no allocation to the account of a participant in a defined contribution plan (including a target benefit plan described in §1.410(a)-4(a)(1)) is required for a plan year by section 411(b)(2) to the extent that the allocation or accrual would cause the plan to exceed the limitations of section 415.

(2) Prohibited discrimination--(i) No benefit accrual on behalf of a highly compensated employee in a defined benefit plan is required for a plan year by section 411(b)(1)(H)(i) to the extent such benefit accrual would cause the plan to discriminate in favor of highly compensated employees within the meaning of section 401(a)(4).

(ii) No allocation to the account of a highly compensated employee in a defined contribution plan (including a target benefit plan) is required for a plan year by section 411(b)(2) to the extent the allocation would cause the plan to discriminate in favor of highly compensated employees within the meaning of section 401(a)(4).

(iii) The Commissioner may provide additional guidance, published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*) of this chapter), relating to prohibited discrimination in favor of highly compensated employees.

(3) Permitted disparity. A defined benefit plan does not fail to satisfy section 411(b)(1)(H) for a plan year and a defined contribution plan does not fail to satisfy 411(b)(2) for a plan year merely because accruals or allocations under the plan are reduced to satisfy the uniformity requirements of §1.401(*l*)-2(c) or 1.401(*l*)-3(c) for the plan year.

(4) Distribution rights under section 411. A defined benefit plan does not fail to satisfy section 411(b)(1)(H) for a plan year and a defined contribution plan does not fail to satisfy 411(b)(2) for a plan year merely because of the right to defer distributions provided under section 411(a)(11) or a plan provision consistent with section 411(a)(11).

(f) Effective dates--(1) Effective date of sections 411(b)(1)(H) and 411(b)(2) for noncollectively bargained plans--(i) In general. Except as otherwise provided in paragraph (f)(2) of this section, sections 411(b)(1)(H) and 411(b)(2) are applicable for plan years beginning on or after January 1, 1988, with respect to a participant who is credited with at least 1 hour of service in a plan year beginning on or after January 1, 1988. Neither section 411(b)(1)(H) nor section 411(b)(2) is applicable with respect to a participant who is not credited with at least 1 hour of service in a plan year beginning on or after January 1, 1988.

(ii) Defined benefit plans. In the case of a participant who is credited with at least 1 hour of service in a plan year beginning on or after January 1, 1988, section 411(b)(1)(H) is

applicable with respect to all years of service completed by the participant other than plan years beginning before January 1, 1988.

(iii) Defined contribution plans. Section 411(b)(2) does not apply with respect to allocations of employer contributions or forfeitures to the accounts of participants under a defined contribution plan for a plan year beginning before January 1, 1988.

(iv) Hour of service. For purposes of this paragraph (f)(1), 1 hour of service means 1 hour of service recognized under the plan or required to be recognized under the plan by section 410 (relating to minimum participation standards) or section 411 (relating to minimum vesting standards). In the case of a plan that does not determine service on the basis of hours of service, 1 hour of service means any service recognized under the plan or required to be recognized under the plan by section 410 (relating to minimum participation standards) or section 411 (relating to minimum vesting standards).

(2) Effective date of sections 411(b)(1)(H) and 411(b)(2) for collectively bargained plans--(i) In the case of a plan maintained pursuant to 1 or more collective bargaining agreements between employee representatives and 1 or more employers, ratified before March 1, 1986, sections 411(b)(1)(H) and 411(b)(2) are applicable for benefits provided under, and employees covered by, any such agreement with respect to plan years beginning on or after the later of--

(A) January 1, 1988; or

(B) The earlier of January 1, 1990, or the date on which the last of such collective bargaining agreements terminates (determined without regard to any extension of any such agreement occurring on or after March 1, 1986).

(ii) The applicability date provisions of paragraph (f)(1) of this section shall apply in the same manner to plans described in paragraph (f)(2)(i) of this section, except that the applicable date determined under paragraph (f)(2)(i) of this section shall be substituted for the effective date determined under paragraph (f)(1) of this section.

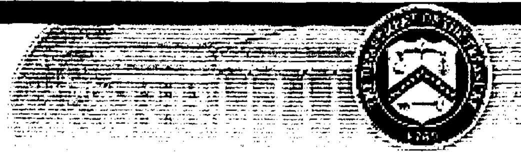
(iii) In accordance with the provisions of paragraph (f)(2)(i) of this section, a plan described therein may be subject to different applicability dates under sections 411(b)(1)(H) and 411(b)(2) for employees who are covered by a collective bargaining agreement and employees who are not covered by a collective bargaining agreement.

(iv) For purposes of paragraph (f)(2)(i) of this section, the service crediting rules of paragraph (f)(1) of this section shall apply to a plan described in paragraph (f)(2)(i) of this section, except that in applying such rules the applicability date determined under paragraph (f)(2)(i) of this section shall be substituted for the applicability date determined under paragraph (f)(1) of this section. See paragraph (f)(1)(iv) of this section for rules relating to the recognition of an hour of service.

(3) Regulatory effective date. Paragraphs (a) through (e) of this section are applicable with respect to plan years beginning on or after the date of publication of final regulations in the **Federal Register**.

David A. Mader

Assistant Deputy Commissioner of Internal Revenue.



PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

December 10, 2002
PO-3677

"The U.S.-EU Positive Economic Agenda on Financial Markets Issues"
Remarks by U.S. Assistant Secretary of the Treasury for International Affairs
Randal K. Quarles
The European Institute Transatlantic Seminar on Trade and Investment
Washington, DC
December 10, 2002

Thank you.

At the conclusion of the U.S.-EU Summit early last May, the White House and the European Commission issued a FACT SHEET describing a Positive Economic Agenda going forward, and the U.S.-EU financial markets dialogue was mentioned as one of a number of initiatives. You may recall that the predominant theme of press reports at that juncture was that the U.S. and the EU were engaged in a transatlantic trade war and that there was little that was positive happening in the relationship. The facts, however, portrayed a more balanced picture and it was in that light that Presidents Bush and Prodi decided to put forth the Positive Economic Agenda.

What is the dialogue all about?

The financial markets dialogue was launched in March 2002 to give U.S. and EU officials an opportunity to discuss a range of financial and regulatory issues of interest to both sides. It is led by the U.S. Department of Treasury and the European Commission, with active participation of U.S. and EU member state financial services regulators. A number of informal financial market dialogue meetings have been held in Brussels and in Washington, both at the policy level and at the technical level, and further discussions will take place in the weeks ahead.

U.S. interests in the dialogue center on the EU's efforts to develop a single European capital market by 2005, which the U.S. supports. The Financial Services Action Plan is the center piece of this effort with measures aimed at the retail and wholesale markets as well as supervision. There are other important initiatives at the EU level that will help underpin a more integrated financial market. For example, in response to increased concerns generated by corporate scandals in the US and Europe, activity at the EU level also encompasses issues such as corporate governance and auditing issues. Another example is the new rule-making procedures.

To ensure that measures can be modified to reflect changes in the dynamic world of finance, the European Commission has been given the authority to adopt implementing regulations. In the securities areas the Commission is advised by the newly created Committee of European Securities Regulators (CESR) representing supervisors and the European Securities Committee representing policy officials. European Finance Ministers have recently endorsed a similar approach for the banking and insurance area. These provide a broad range of issues for discussion in the dialogue.

As part of the dialogue, interested financial sector officials on both sides have been consulting with U.S. and EU government officials, financial regulators and relevant leaders in the Congress and in the European Parliament. The purpose of these

exchanges is to help make the process of integration of Europe's capital markets as transparent as possible and more generally to ensure that the views and expertise of private sector players are taken into account.

Financial Services Action Plan

The EU's Financial Services Action Plan (FSAP) is a collection of 42 measures designed to further integrate European capital markets. As of the end of November 31 measures have been completed, demonstrating that the Plan has momentum, aided by the political backing of European Heads of State.

Well-managed, the FSAP offers a clear "win-win" opportunity for Europe, the United States, the world economy and U.S. financial institutions. A recent study undertaken for the Commission suggested that the reduced financing costs associated with a more integrated European financial market could lift EU-wide GDP 1.1% by 2012, rising business investment, employment and per capita incomes. The US clearly supports such an effort.

To gain such benefits elements of the plan need to be consistent with the reality of an open, global financial system – working "with the grain of the market." Efficient, innovative firms operating in the European market, both domestic and foreign, should be able to reap rewards through healthy competition. This is the ideal.

To secure agreement among member states, we have the sense that sometimes consensus is achieved that is inconsistent with existing market practices in some member states, which means that the process of integration is moving away from the market. We have raised such concerns with respect to the Prospectuses Directive in which new rules would have been imposed that could have fragmented an already existing pan EU bond market.

We also have urged the Commission to work with market participants and investors in an open, transparent manner. Such an approach can help ensure that proposed legislation addresses legitimate issues and that the "answer is right," that is consistent with the operation of highly sophisticated financial markets.

After a false start with Prospectuses, the Commission undertook an extensive consultation process in putting together a draft proposed Investment Services Directive. This Directive is the foundation for securities market rules. The Commission deservedly received good marks for its efforts -- both on process and substance. However, recent text modifications appeared to step back from the goal of working with the grain of the market, which was being achieved through the transparent consultation process.

Under the FSAP, the Commission will be assuming an increasingly important role in adopting regulations to implement the plan. Therefore, it should take extra care to issue the best draft technically possible and ensure that the draft regulations reflect market realities and will solidly and seamlessly anchor a unified European financial market in the global capital market. We discuss these issues and others in an informal, two-way U.S.-EU financial markets dialogue.

Managing "Spillover" Effects

The dialogue serves as an important venue to raise issues that arise on both sides of the Atlantic. In particular, it can help manage "spillover" effects that regulatory action in one jurisdiction may have in another. Such spillovers are likely to be increasingly the case in today's more tightly connected global capital markets. European Commission officials have raised concerns about the effect of the Sarbanes-Oxley Act provisions on EU firms since the Act makes no distinction between domestic and foreign private issuers and auditing firms. If foreign issuers and auditing firms are subject to robust measures in their home markets, then double regulation imposes an unnecessary burden and cost.

Going in the other direction, one element of the FSAP, the Financial Conglomerates

Directive, raises issues with U.S. investment banks. Under the directive, U.S.-based investment banks operating in Europe would be subject to supervision at the holding company level. In the United States, however, investment banks are supervised by the SEC at the broker-dealer level – not at the holding company level. Therefore, absent a finding of "equivalent" oversight by EU authorities, U.S.-based investment banks operating in Europe may face higher compliance and operating costs.

We are using the informal financial markets dialogue to work on such cases of regulatory "spillover" and to guard against others that could arise. We believe we can successfully manage such issues because both sides share the same objectives: sound financial market supervision and regulation, and efficient capital markets that generate real benefits to firms and investors on both sides of the Atlantic.

Conclusion

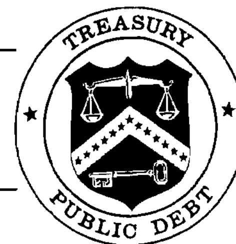
While conflicts are inevitable given our varied experiences and attitudes toward financial regulation and oversight, the financial markets dialogue has been a successful forum for openly airing concerns on both sides. Both sides share the same objectives: sound financial market supervision and regulation, and efficient capital markets that generate real benefits to firms and investors on both sides of the Atlantic.

I know that President Bush and Secretary O'Neill have been impressed by the depth and professionalism of the talks thus far, and we are committed to continuing our discussions in the weeks and months ahead and to assist our regulators in developing "win-win" solutions to issues at hand that will benefit both sides. Such efforts make the dialogue a positive exercise in cooperation and distinguish it from a negotiation of trade issues, which is normally a zero-sum game.

Thank you.

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239



TREASURY SECURITY AUCTION RESULTS
BUREAU OF THE PUBLIC DEBT - WASHINGTON DC

'OR IMMEDIATE RELEASE
)ecember 09, 2002

CONTACT: Office of Financing
202-691-3550

RESULTS OF TREASURY'S AUCTION OF 6-DAY BILLS

Term:	6-Day Bill
Issue Date:	December 10, 2002
Maturity Date:	December 16, 2002
CUSIP Number:	912795MW8

High Rate: 1.235% Investment Rate 1/: 1.278% Price: 99.979

All noncompetitive and successful competitive bidders were awarded ecurities at the high rate. Tenders at the high discount rate were llotted 31.81%. All tenders at lower rates were accepted in full.

AMOUNTS TENDERED AND ACCEPTED (in thousands)

Tender Type	Tendered	Accepted
Competitive	$ 47,119,000	$ 13,001,053
Noncompetitive	0	0
FIMA (noncompetitive)	0	0
SUBTOTAL	47,119,000	13,001,053
Federal Reserve	0	0
TOTAL	$ 47,119,000	$ 13,001,053

Median rate 1.220%: 50% of the amount of accepted competitive tenders ıs tendered at or below that rate. Low rate 1.200%: 5% of the amount : accepted competitive tenders was tendered at or below that rate.

.d-to-Cover Ratio = 47,119,000 / 13,001,053 = 3.62

Equivalent coupon-issue yield.

PO - 3678

DEPARTMENT OF THE TREASURY

TREASURY NEWS

OFFICE OF PUBLIC AFFAIRS • 1500 PENNSYLVANIA AVENUE, N.W. • WASHINGTON, D.C. • 20220 • (202) 622-2960

EMBARGOED UNTIL 11:00 A.M.
December 9, 2002

Contact: Office of Financing
202/691-3550

TREASURY OFFERS 4-WEEK BILLS

The Treasury will auction 4-week Treasury bills totaling $16,000 million to refund an estimated $20,000 million of publicly held 4-week Treasury bills maturing December 12, 2002, and to pay down approximately $4,000 million.

Tenders for 4-week Treasury bills to be held on the book-entry records of *TreasuryDirect* will not be accepted.

The Federal Reserve System holds $13,213 million of the Treasury bills maturing on December 12, 2002, in the System Open Market Account (SOMA). This amount may be refunded at the highest discount rate of accepted competitive tenders in this auction up to the balance of the amount not awarded in today's 13-week and 26-week Treasury bill auctions. Amounts awarded to SOMA will be in addition to the offering amount.

Up to $1,000 million in noncompetitive bids from Foreign and International Monetary Authority (FIMA) accounts bidding through the Federal Reserve Bank of New York will be included within the offering amount of the auction. These noncompetitive bids will have a limit of $100 million per account and will be accepted in the order of smallest to largest, up to the aggregate award limit of $1,000 million.

The allocation percentage applied to bids awarded at the highest discount rate will be rounded up to the next hundredth of a whole percentage point, e.g., 17.13%.

This offering of Treasury securities is governed by the terms and conditions set forth in the Uniform Offering Circular for the Sale and Issue of Marketable Book-Entry Treasury Bills, Notes, and Bonds (31 CFR Part 356, as amended).

Details about the new security are given in the attached offering highlights.

oOo

Attachment

PO-3679

HIGHLIGHTS OF TREASURY OFFERING
OF 4-WEEK BILLS TO BE ISSUED DECEMBER 12, 2002

December 9, 2002

Offering Amount....................$16,000 million
Public Offering....................$16,000 million
NLP Exclusion Amount...............$10,600 million

Description of Offering:
Term and type of security..........28-day bill
CUSIP number.......................912795 LT 6
Auction date.......................December 10, 2002
Issue date.........................December 12, 2002
Maturity date......................January 9, 2003
Original issue date................July 11, 2002
Currently outstanding..............$41,431 million
Minimum bid amount and multiples....$1,000

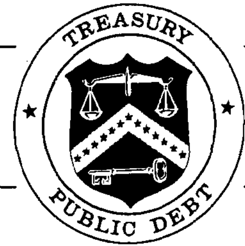
Submission of Bids:
Noncompetitive bids: Accepted in full up to $1 million at the highest discount rate of accepted competitive bids.
Foreign and International Monetary Authority (FIMA) bids: Noncompetitive bids submitted through the Federal Reserve Banks as agents for FIMA accounts. Accepted in order of size from smallest to largest with no more than $100 million awarded per account. The total noncompetitive amount awarded to Federal Reserve Banks as agents for FIMA accounts will not exceed $1,000 million. A single bid that would cause the limit to be exceeded will be partially accepted in the amount that brings the aggregate award total to the $1,000 million limit. However, if there are two or more bids of equal amounts that would cause the limit to be exceeded, each will be prorated to avoid exceeding the limit.
Competitive bids:
(1) Must be expressed as a discount rate with three decimals in increments of .005%, e.g., 4.215%.
(2) Net long position (NLP) for each bidder must be reported when the sum of the total bid amount, at all discount rates, and the net long position is $1 billion or greater.
(3) Net long position must be determined as of one half-hour prior to the closing time for receipt of competitive tenders.

Maximum Recognized Bid at a Single Rate...35% of public offering
Maximum Award..........................35% of public offering

Receipt of Tenders:
Noncompetitive tenders:
Prior to 12:00 noon eastern standard time on auction day
Competitive tenders:
Prior to 1:00 p.m. eastern standard time on auction day

Payment Terms: By charge to a funds account at a Federal Reserve Bank on issue date.

PUBLIC DEBT NEWS



Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

TREASURY SECURITY AUCTION RESULTS
BUREAU OF THE PUBLIC DEBT - WASHINGTON DC

'OR IMMEDIATE RELEASE
ecember 09, 2002

CONTACT: Office of Financing
202-691-3550

RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Term: 91-Day Bill
Issue Date: December 12, 2002
Maturity Date: March 13, 2003
CUSIP Number: 912795MC2

High Rate: 1.195% Investment Rate 1/: 1.215% Price: 99.698

All noncompetitive and successful competitive bidders were awarded ecurities at the high rate. Tenders at the high discount rate were llotted 11.30%. All tenders at lower rates were accepted in full.

AMOUNTS TENDERED AND ACCEPTED (in thousands)

Tender Type	Tendered	Accepted
Competitive	$ 28,029,830	$ 12,433,830
Noncompetitive	1,441,188	1,441,188
FIMA (noncompetitive)	125,000	125,000
SUBTOTAL	29,596,018	14,000,018 2/
Federal Reserve	5,215,013	5,215,013
TOTAL	$ 34,811,031	$ 19,215,031

Median rate 1.185%: 50% of the amount of accepted competitive tenders ıs tendered at or below that rate. Low rate 1.165%: 5% of the amount accepted competitive tenders was tendered at or below that rate.

d-to-Cover Ratio = 29,596,018 / 14,000,018 = 2.11

Equivalent coupon-issue yield.
Awards to TREASURY DIRECT = $1,135,014,000

http://www.publicdebt.treas.gov

PO-3680

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

TREASURY SECURITY AUCTION RESULTS
BUREAU OF THE PUBLIC DEBT - WASHINGTON DC

'OR IMMEDIATE RELEASE
ɪecember 09, 2002

CONTACT: Office of Financing
202-691-3550

RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Term: 182-Day Bill
Issue Date: December 12, 2002
Maturity Date: June 12, 2003
CUSIP Number: 912795MR9

High Rate: 1.245% Investment Rate 1/: 1.269% Price: 99.371

All noncompetitive and successful competitive bidders were awarded ecurities at the high rate. Tenders at the high discount rate were llotted 61.22%. All tenders at lower rates were accepted in full.

AMOUNTS TENDERED AND ACCEPTED (in thousands)

Tender Type	Tendered	Accepted
Competitive	$ 27,195,420	$ 14,042,270
Noncompetitive	882,773	882,773
FIMA (noncompetitive)	75,000	75,000
SUBTOTAL	28,153,193	15,000,043 2/
Federal Reserve	5,617,696	5,617,696
TOTAL	$ 33,770,889	$ 20,617,739

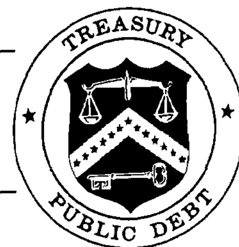
Median rate 1.235%: 50% of the amount of accepted competitive tenders ɩs tendered at or below that rate. Low rate 1.200%: 5% of the amount accepted competitive tenders was tendered at or below that rate.

d-to-Cover Ratio = 28,153,193 / 15,000,043 = 1.88

Equivalent coupon-issue yield.
Awards to TREASURY DIRECT = $662,839,000

?0 -3681

PUBLIC DEBT NEWS



Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

TREASURY SECURITY AUCTION RESULTS
BUREAU OF THE PUBLIC DEBT - WASHINGTON DC

'OR IMMEDIATE RELEASE
'ecember 10, 2002

CONTACT: Office of Financing
202-691-3550

RESULTS OF TREASURY'S AUCTION OF 4-WEEK BILLS

Term:	28-Day Bill
Issue Date:	December 12, 2002
Maturity Date:	January 09, 2003
CUSIP Number:	912795LT6

High Rate: 1.205% Investment Rate 1/: 1.227% Price: 99.906

All noncompetitive and successful competitive bidders were awarded ecurities at the high rate. Tenders at the high discount rate were llotted 46.64%. All tenders at lower rates were accepted in full.

AMOUNTS TENDERED AND ACCEPTED (in thousands)

Tender Type	Tendered	Accepted
Competitive	$ 43,201,300	$ 15,950,580
Noncompetitive	50,203	50,203
FIMA (noncompetitive)	0	0
SUBTOTAL	43,251,503	16,000,783
Federal Reserve	2,380,729	2,380,729
TOTAL	$ 45,632,232	$ 18,381,512

Median rate 1.200%: 50% of the amount of accepted competitive tenders s tendered at or below that rate. Low rate 1.180%: 5% of the amount accepted competitive tenders was tendered at or below that rate.

d-to-Cover Ratio = 43,251,503 / 16,000,783 = 2.70

Equivalent coupon-issue yield.

http://www.publicdebt.treas.gov

PO-3682

FROM THE OFFICE OF PUBLIC AFFAIRS

December 10, 2002
PO-3683

Media Advisory
Treasury Department and U.S. Postal Service Hold Wednesday News Conference

The Treasury Department and the U.S. Postal Service tomorrow will hold a joint news conference on the U.S. Postal Service.

Treasury Under Secretary for Domestic Finance Peter R. Fisher and Postmaster General John E. Potter will host the news conference at 10:30 a.m. EST on Wednesday, Dec. 11, 2002, in the Media Room (Room 4121) at the Treasury Department, 1500 Pennsylvania Ave., N.W., Washington, DC. They will be joined by Robert F. Rider, Chairman of the Board of Governors of the U.S. Postal Service.

The news conference will be web cast live at www.treasury.gov.

The room will be available for pre-set at 9:00 a.m. on Wednesday. Media without Treasury or White House press credentials planning to attend should contact Frances Anderson at Treasury's Office of Public Affairs at (202) 622-2960 by 9:00 a.m. on Wednesday with the following information: name, media organization, social security number and date of birth. This information also may be faxed to (202) 622-1999.

For Immediate Release
December 11, 2002

Contact: Betsy Holahan
202-622-2960

Statement of
Treasury Under Secretary for Domestic Finance Peter R. Fisher
on Presidential Commission on U.S. Postal Service

Good morning. We are here to announce that President Bush is establishing a Commission on the U.S. Postal Service. At the request of the President, Jim Johnson and Harry Pearce will serve as Co-Chairs of the Commission. I will introduce Mr. Johnson in a minute, Mr. Pearce tried to be here this morning but because of the weather was unable to fly in. Postmaster General Jack Potter and Postal Service Board Chairman Bob Rider are also here with us and will each say a few words after my remarks.

The U.S. Postal Service is the linchpin of our domestic mailing industry. This industry as a whole represents 8 percent of our Gross Domestic Product and nine million workers. As business communications, bills and payments move increasingly to the Internet, the business model of the Postal Service is increasingly at risk. For the last four years, the annual volume of individual first-class letters declined from 54.3 billion to 49.3 billion, even as the cost structure of the Postal Service has been expanding as more than a million and half new delivery addresses are added each year. New technology, declining volume, and continued expansion of the delivery cost base, combined with competition from the private sector, pose a fundamental challenge to the Postal Service.

President Bush recognizes that now is the time to re-assess how the Postal Service should adapt to pressure from customers, competitors and technology, and best fulfill its mission in the 21st century. The Commission will be an invaluable tool to develop strategies to meet the operational challenges that the Postal Service faces and to chart a course that will build a healthy financial foundation. It will help us learn how the Postal Service can execute its mission more efficiently and cost-effectively. The Postal Service needs to press on with its own Transformation Plan; nothing should hold back these efforts. The Commission will consider the potential need for further steps that should be taken to secure the future of our entire system of mail delivery. Inaction is unacceptable - for taxpayers, for mailers, and for current and former Postal Service workers.

PO-3684

The way I think of this, there are just two things that are out of bounds. We don't want to Commission to come back and suggest that the existing business model should be left in place and the costs all rolled up on the taxpayer. We also don't want them to come back and say that all of the existing costs should be rolled up on the rate payer. Everything else is on the table and we hope they come back with their best ideas.

You know there are billions of dollars of postal operations that today are outsourced - from planes and transportation to rural delivery routes. That said, our goal is not to privatize the postal service. We do want the Commission to give us the best ideas they can to make our mail delivery system viable in the 21st century. This is about ensuring the long-term viability of the postal service, for mailers and for taxpayers. Nothing more and nothing less.

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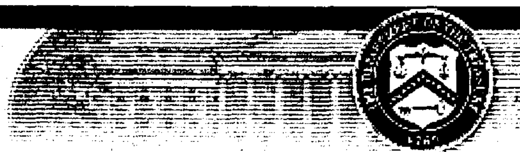
PRESS ROOM



FROM THE OFFICE OF PUBLIC AFFAIRS

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To view or print the Microsoft Word content on this page, download the free Microsoft Word Viewer.

December 11, 2002
PO-3685

Bush Administration Announces Presidential Commission on U.S. Postal Service
James A. Johnson and Harry Pearce Named as Commission Co-Chairs

Treasury Under Secretary for Domestic Finance Peter R. Fisher and Postmaster General John E. Potter today announced that President George W. Bush is establishing a Commission on the U.S. Postal Service. At the request of the President, James A. Johnson, Vice Chairman of Perseus, L.L.C., and Harry Pearce, Chairman of Hughes Electronics Corporation, will serve as Co-Chairs of the Commission.

The nine-member bipartisan Commission will identify the operational, structural, and financial challenges facing the Postal Service; examine potential solutions; and recommend legislative and administrative steps to ensure the long-term viability of postal service in the United States. The Commission will submit its report to the President by July 31, 2003.

"The President recognizes that now is the time to re-assess how the Postal Service should adapt to pressure from customers, competitors, and technology, and best fulfill its mission in the 21st century," said Under Secretary Fisher. "The Commission will be an invaluable tool to develop strategies to meet the operational challenges that the Postal Service faces and to chart a course that will build a healthy financial foundation. It will help us learn how the Postal Service can execute its mission more efficiently and cost-effectively. Inaction is unacceptable - for taxpayers, for mailers, and for current and former Postal Service workers."

"We remain committed to implementing the Transformation Plan that the Postal Service submitted to Congress earlier this year," said Postmaster General Potter. "Consistent with our Transformation Plan, we expect that the findings and recommendations of the Commission will reaffirm our commitment to ensuring that the Postal Service can maintain reliable and affordable mail service to all communities across the country."

The U.S. Postal Service is the linchpin of a $900 billion domestic mailing industry. The domestic mailing industry represents eight percent of Gross Domestic Product and employs nine million workers. The fundamental challenge for the Postal Service is that its business model is at great risk. Last reorganized in 1971, the Postal Service has succeeded in reducing federal subsidies and, with other improvements, has constrained cumulative losses to $6 billion since 1972.

However, at the end of their most recent fiscal year, the Postal Service owed the Federal government, and ultimately the American taxpayer, $11 billion (cumulative losses plus borrowings for capital and operational expenses).

One of the greatest challenges for the Postal Service is decreasing volume as business communications, bills and payments, move increasingly to the Internet. For the last four years, the annual volume of individual first-class letters has

declined from 54.3 billion to 49.3 billion, even though the Postal Service adds about 1.7 million new delivery addresses per year. That decline, coupled with competition from the private sector, has brought about a substantially different business environment. These developments require a responsible federal government review of government-provided mail service.

In addition to Co-Chairs Johnson and Pearce, Commission members include Dionel Aviles, President of Aviles Engineering Corporation, Texas; Don Cogman, Chairman, CC Investments, Arizona; Carolyn Gallagher, former President and CEO, Texwood Furniture, Texas; Richard Levin, President, Yale University, Connecticut; Norman Seabrook, President, New York City Correction Officers' Benevolent Association, New York; Robert Walker, Chairman and CEO, Wexler Group, Washington, DC; and Joseph Wright, President and CEO, PanAmSat, Connecticut.

Related Documents:

- Executive Order
- Statement of John Potter
- Statement of Rober Rider
- Johnson biography
- Pearce biography
- Statement of Peter Fisher

THE WHITE HOUSE

Office of the Press Secretary

For Immediate Release December 11, 2002

EXECUTIVE ORDER

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PRESIDENT'S COMMISSION ON THE UNITED STATES POSTAL SERVICE

By the authority vested in me as President by the Constitution and the laws of the United States of America, and to ensure the efficient operation of the United States Postal Service while minimizing the financial exposure of the American taxpayers, it is hereby ordered as follows:

Section 1. Establishment. There is established the President's Commission on the United States Postal Service (Commission).

Sec. 2. Membership. The Commission shall be composed of nine members appointed by the President. The President shall designate two members of the Commission to serve as Co-Chairs.

Sec. 3. Mission. (a) The mission of the Commission shall be to examine the state of the United States Postal Service, and to prepare and submit to the President a report articulating a proposed vision for the future of the United States Postal Service and recommending the legislative and administrative reforms needed to ensure the viability of postal services.

(b) In fulfilling its mission, the Commission shall consider the following issues and such other issues relating to the Postal Service as the Commission determines appropriate:

(i) the role of the Postal Service in the 21st century and beyond;

(ii) the flexibility that the Postal Service should have to change prices, control costs, and adjust service in response to financial, competitive, or market pressures;

(iii) the rigidities in cost or service that limit the efficiency of the postal system;

(iv) the ability of the Postal Service, over the long term, to maintain universal mail delivery at affordable rates and cover its unfunded liabilities with minimum exposure to the American taxpayers;

(v) the extent to which postal monopoly restrictions continue to advance the public interest under evolving market conditions, and the extent to which the Postal Service competes with private sector services; and
(vi) the most appropriate governance and oversight structure for the Postal Service.

Sec. 4. Administration. (a) The Department of the Treasury or any organizational entity subject to the direction of the Secretary of the Treasury shall, to the extent permitted by law, provide administrative support and funding for the Commission. The Commission is established within the Department of the Treasury for administrative purposes only.

(b) Members of the Commission shall serve without any compensation for their work on the Commission. Members appointed from among private citizens of the United States, however, while engaged in the work of the Commission, may be allowed travel expenses, including per diem in lieu of subsistence, as authorized by law for persons serving intermittently in Government service (5 U.S.C. 5701-5707), to the extent funds are available.

(c) The Commission shall have a staff headed by an Executive Director.

(d) The Commission, with the concurrence of the Secretary of the Treasury, may establish subcommittees, consisting of Commission members, as appropriate, to aid in its work.

(e) Consistent with such guidance as the President or, on the President's behalf, the Secretary of the Treasury, may provide, the Commission shall exchange information with and obtain advice from Members of Congress; Federal, State, local, and tribal officials; commercial, nonprofit, and residential users of the United States Postal Service; and others, as appropriate, including through public hearings.

(f) Insofar as the Federal Advisory Committee Act, as amended, may apply to the Commission, any functions of the President under that Act, except for those in section 6 of that Act, shall be performed by the Secretary of the Treasury, in accordance with the guidelines that have been issued by the Administrator of General Services.

(g) Nothing in this order shall be construed to impair or otherwise affect the functions of the Director of the Office of Management and Budget relating to budget, administrative, or legislative proposals.

Sec. 5. Report. The Commission shall submit its report, consistent with its mission set forth in section 3 of this order, to the President, through the Secretary of the Treasury, not later than July 31, 2003.

Sec. 6. General Provisions. (a) This order is intended only to improve the internal management of the Federal Government and it is not intended to, and does not create, any right or benefit, substantive or procedural, enforceable at law or in equity by a party against the United States, its departments, agencies, instrumentalities or entities, its officers or employees, or any other person.

(b) The Commission shall terminate 30 days after submitting its report and in no event later than August 30, 2003.

GEORGE W. BUSH

THE WHITE HOUSE,
December 11, 2002.

# # #

Statement of Postmaster General John E. Potter on the Establishment of a Postal Presidential Commission

I want to thank the President and Under Secretary Fisher for their hard work and foresight in creating this commission. I would also note the impressive qualifications of those who have been selected to serve. Individually and collectively, they will bring a valuable new perspective to the challenging and complex issue of postal reform. The Postal Service welcomes the Commission's consideration of the future of America's postal system.

This action is consistent with—and complementary to—the Postal Service's Transformation Plan. Our Plan, which defines the actions the strategies being followed by the Postal Service to protect affordable, universal service for everyone in America, also acknowledges the very real need for legislative reform.

A similar Commission resulted in the establishment of today's Postal Service 30 years ago. That critical modernization opened the door to an innovative business model that produced unprecedented improvements in service and efficiency for America's mail users- from businesses to consumers. And since 1982, we have done so without requiring taxpayer subsidies for our daily operations.

The Postal Reorganization Act of 1970 has served the nation well. Since the creation of the Postal Service in 1971, mail volume has more than doubled. Delivery addresses have increased by more than 74 percent. And the price of the First-Class stamp, adjusted for inflation, is the same as it was in 1971.

But the basic economic assumption of the business model—that continuing growth in mail volume and revenue would support continued infrastructure growth—is no longer valid. In fact, volume growth is at risk from competition and technology, while the number of delivery points is increasing. Without postal reform, the widening divergence of volume growth and delivery point expansion will make it impossible to continue the long-term successes that have been achieved since postal reorganization.

This Commission has a historic opportunity to offer recommendations guaranteeing a postal system as effective and dependable as today's—for many years to come. In the meantime, the Postal Service will continue to aggressively manage the business by implementing the strategies in our Transformation Plan. In fact, in the last fiscal year, the Postal Service has reduced operating expenses by $2.8 billion and, at the same time, achieved record levels of service. We will continue our focused efforts to control costs, improve service and efficiency, and add value to our products. These actions are critical to fulfilling our long-standing mission of serving the nation. We look forward to the Commission's recommendations for a strong mail system for our nation.

The Commission is good news coming at the right time. The Commission has the opportunity to build on the achievements made possible by the Postal Reorganization Act of 1970 before America faces a postal crisis.

The nation cannot afford a postal crisis. The mail is simply too important to the life of our nation. The Postal Service is the foundation of a $900 billion dollar industry that employs 9 million people. American business relies on the Postal Service, an entire advertising and direct mail industry has evolved and matured during the past 25 years and, even in this day of high speed computer technology, the local post office provides a fundamental and low-cost communication link for every American - from Alaska to Florida, from our soldiers serving in the Gulf to families on Guam.

Let me close by again thanking the President for establishing the Commission. I also want to congratulate co-chairs James Johnson and Harry Pearce and all of the members. Today's action will have a long-term effect on the public policy of this nation. I look forward to working with the Commission as it shapes that policy.

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Statement of Robert F. Rider
Chairman of the Board of Governors of the U.S. Postal Service

On behalf of the Board of Governors of the United States Postal Service, I want to express my gratitude to the President and Under Secretary Fisher for establishing a Presidential Commission to examine the challenges facing the Postal Service and recommend solutions that will ensure the long-term viability of America's postal system.

In their oversight of the nation's postal system, the Governors of the Postal Service are chosen to represent the public interest.

This Board recognizes that the public interest requires fundamental change of the 33-year-old statute that created a self-supporting United States Postal Service.

Acting on that conviction, the Board has been a united and vocal advocate of legislative action to protect the right of everyone in America. From the smallest, most remote towns to the largest of cities, to affordable, dependable mail service.

We are gratified that our efforts, and the efforts of so many others in the mailing community, in Congress, and in the Administration, have resulted in the creation of this Commission.

As Governors acting in the public interest, we are committed to maintaining the fundamental principal and vision that delivery of mail is an important and vital government service, regardless of where one lives or what one's station in life might be.

We offer our full support to the Commission in its efforts to achieve this goal.

I offer my personal congratulations to co-chairs James Johnson and Harry Pearce and to all the members of the Commission.

Along with all of the Governors, I look forward to working with them to assure a strong postal system for America.

Thank you.

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Biography

JAMES A. JOHNSON

James A. Johnson is Vice Chairman of Perseus, L.L.C., a merchant banking and private equity firm based in Washington, DC and New York City.

Beginning in January of 1990 and continuing through December 1999 he was employed by Fannie Mae. He served as Vice Chairman (1990), Chairman and CEO (1991-1998), and Chairman of the Executive Committee (1999).

Prior to joining Fannie Mae, Johnson was a managing director in corporate finance at Lehman Brothers. Before joining Lehman, he was the president of Public Strategies, a Washington-based consulting firm he founded to advise corporations on strategic issues.

From 1977 to 1981, he served as executive assistant to Vice President Walter F. Mondale, where he advised the Vice President on domestic and foreign policy and political matters. Earlier, he was employed by the Target Corporation, worked as a staff member in the U.S. Senate, and was on the faculty at Princeton University.

Johnson serves as chairman of The John F. Kennedy Center for the Performing Arts and is chairman of the board of trustees of The Brookings Institution.

He also serves on the board of the following organizations: The Enterprise Foundation; Gannett, Inc.; The Goldman Sachs Group, Inc.; KB Home; National Association on Fetal Alcohol Syndrome; National Housing Endowment; Target Corporation; Temple-Inland, Inc.; and UnitedHealth Group. He is also a member of The American Friends of Bilderberg, The Business Council, the Council on Foreign Relations, the Trilateral Commission, and he is Chairman of the Advisory Council for Public Strategies Incorporated. In March 1994, Johnson was named "CEO of the Year" by The George Washington University School of Business and Public Management. He also was named a 1998 "Washingtonian of the Year" by Washingtonian Magazine. In May 2001, he was elected to the American Academy of Arts and Sciences.

Johnson received a B.A. degree in political science from the University of Minnesota and a Masters Degree in public affairs from the Woodrow Wilson School at Princeton. In 1997, Mr. Johnson received an Honorary Doctor of Laws Degree from Colby College, in 1999 he received an Honorary Doctor of Humane Letters Degree from Howard University, and in 2002, he received a Doctor of Laws Degree from Skidmore College.

Mr. Johnson lives in Washington with his wife and their son.

December 2002

HARRY J. PEARCE

Harry J. Pearce was elected chairman of the Hughes Electronics Corporation Board of Directors, a subsidiary of General Motors Corporation, in May 2001. Pearce has served on the HUGHES Board since November 1992. He had been vice chairman and a director of the General Motors Corporation Board of Directors since 1996 until his retirement from General Motors in May 2001.

Pearce had been an executive vice president since 1992 and was vice president and general counsel with responsibility for GM's Legal Staff from May 1987 to August 1994. Pearce joined General Motors as associate general counsel in October 1985, assuming responsibility for all product litigation and product safety matters worldwide. Previously, he had been a senior partner in the law firm of Pearce & Durick in Bismarck, N.D. In that capacity, he represented GM and other industrial companies nationwide in a variety of product liability cases over a period of 15 years.

Pearce is Chairman of the United States Air Force Academy's Board of Visitors, Chairman of the U.S. Air Force Academy's Sabre Society, and a lifetime member of the U.S. Air Force Academy's Association of Graduates. He was the recipient of the U.S. Marine Corps Scholarship Foundation's Colonel I. Robert Kriendler Memorial Award in 1998 and is also serving his fifth year as co-chairman of the U.S. Marine Corps Scholarship Foundation's Annual Leatherneck Ball. In 2001, he was selected as a recipient of the first U.S. Air Force Academy's Distinguished Graduate Award.

During his service career, Pearce served as a Staff Judge Advocate in the Air Force and was certified as a military judge. On his return to civilian life, he joined a law firm in Bismarck. He was a municipal judge in Bismarck from 1970 to 1976 and also served as United States Commissioner and U.S. Magistrate.

Pearce is also a member of the board of directors of Marriott International, Inc., MDU Resources Group, Inc., National Defense University Foundation, Air Force Academy Association of Graduates, the Detroit Investment Fund, The Bone Marrow Foundation, The National Bone Marrow Transplant Link, the Lauri Strauss Leukemia Foundation, the Stewart Francke Leukemia Foundation, Sabriya's Castle of Fun Foundation, Chairman of the GM Cancer Research Foundation and The Marrow Foundation's Board of Directors, president and board member of The Leukemia & Lymphoma Society Research Foundation, and a member of Wayne State University's School of Medicine's board of visitors. He also serves as a member of the Mothers Against Drunk Driving (MADD) board of advisors.

Pearce is a fellow in the American College of Trial Lawyers and a fellow in the International Society of Barristers. He is chairman of the Product Liability Advisory Council Foundation and a founding member of the Minority Counsel Demonstration Program of the American Bar Association's Commission on Opportunities for Minorities in the Profession.

Pearce is a member of World Business Council for Sustainable Development (including co-chair of the global mobility initiative on sustainability), The National Academies' Panel on Science, Technology and Law, The Mentor Group's Forum for U.S.-EU (European Union) Legal-Economic Affairs, and The Conference Board. He also serves as a trustee of Northwestern University, Howard University, United States Council for International Business, and New Detroit Inc.

Pearce was born on Aug. 20, 1942, in Bismarck, N.D. He received a bachelor's degree in engineering sciences from the United States Air Force Academy in 1964, where he was a member of the Honor Committee, the Dean's List, the Commandant's List, and the Superintendent's List and a recipient of the Major General Fechet Award. He earned his juris doctor degree from Northwestern University's School of Law in 1967 where he was a Hardy Scholar, on the Dean's List, and a member of the National Moot Court Team. He received an honorary degree of Doctor of Engineering from Rose-Hulman Institute of Technology in 1997, and an honorary degree of Doctor of Laws from Northwestern University in 1998 and an Alumni Merit Award in 1991.

Furthermore, in 2001 he received the International Association of Organ Donation's Corporate Benefactor Award and The American Jewish Committee's National Human Relations Award; the National Conference for Community & Justice Humanitarian Award and The Black Patriots Foundation Leadership Award in 2000; *Parents* magazine's "As They Grow" Award in 1999; *The Detroit News* "Michiganian of the Year" Award in 1998; and the ABA's Commission on Opportunities for Minorities in the Profession's "Spirit of Excellence" Award in 1997.

# # #

Revised 3/19/02

For Immediate Release
December 11, 2002

Contact: Betsy Holahan
202-622-2960

Statement of
Treasury Under Secretary for Domestic Finance Peter R. Fisher
on Presidential Commission on U.S. Postal Service

Good morning. We are here to announce that President Bush is establishing a Commission on the U.S. Postal Service. At the request of the President, Jim Johnson and Harry Pearce will serve as Co-Chairs of the Commission. I will introduce Mr. Johnson in a minute, Mr. Pearce tried to be here this morning but because of the weather was unable to fly in. Postmaster General Jack Potter and Postal Service Board Chairman Bob Rider are also here with us and will each say a few words after my remarks.

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The way I think of this, there are just two things that are out of bounds. We don't want to Commission to come back and suggest that the existing business model should be left in place and the costs all rolled up on the taxpayer. We also don't want them to come back and say that all of the existing costs should be rolled up on the rate payer. Everything else is on the table and we hope they come back with their best ideas.

You know there are billions of dollars of postal operations that today are outsourced - from planes and transportation to rural delivery routes. That said, our goal is not to privatize the postal service. We do want the Commission to give us the best ideas they can to make our mail delivery system viable in the 21st century. This is about ensuring the long-term viability of the postal service, for mailers and for taxpayers. Nothing more and nothing less.

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FROM THE OFFICE OF PUBLIC AFFAIRS

ecember 11, 2002
O-3686

U.S. International Reserve Position

ne Treasury Department today released U.S. reserve assets data for the latest week. As indicated in this table, U.S. reserve assets taled $75,938 million as of the end of that week, compared to $75,737 million as of the end of the prior week.

I. Official U.S. Reserve Assets *(in US millions)*

	November 29, 2002			December 6, 2002		
TOTAL	75,737			75,938		
. Foreign Currency Reserves [1]	Euro	Yen	TOTAL	Euro	Yen	TOTAL
. Securities	6,407	12,817	19,225	6,515	12,717	19,232
)f which, issuer headquartered in the U.S.			0			0
. Total deposits with:						
.i. Other central banks and BIS	10,579	2,573	13,152	10,744	2,553	13,297
.ii. Banks headquartered in the U.S.			0			0
.ii. Of which, banks located abroad			0			0
iii. Banks headquartered outside the U.S.			0			0
iii. Of which, banks located in the U.S.			0			0
IMF Reserve Position [2]			20,469			20,500
Special Drawing Rights (SDRs) [2]			11,849			11,867
Gold Stock [3]			11,042			11,042
Other Reserve Assets			0			0

II. Predetermined Short-Term Drains on Foreign Currency Assets

	November 29, 2002			December 6, 2002		
	Euro	Yen	TOTAL	Euro	Yen	TOTAL
⁼oreign currency loans and securities			0			0
ᴬggregate short and long positions in forwards and futures in foreign currencies vis-à-vis the U.S. dollar:						

2.a. Short positions	0	0
2.b. Long positions	0	0
3. Other	0	0

III. Contingent Short-Term Net Drains on Foreign Currency Assets

	November 29, 2002			December 6, 2002		
	Euro	**Yen**	**TOTAL**	**Euro**	**Yen**	**TOTAL**
. Contingent liabilities in foreign currency			0			0
.a. Collateral guarantees on debt due within 1 'ear						
.b. Other contingent liabilities						
. Foreign currency securities with embedded ptions			0			0
. Undrawn, unconditional credit lines			0			0
.a. With other central banks						
.b. With banks and other financial institutions						
'eadquartered in the U.S.						
c. With banks and other financial institutions						
'eadquartered outside the U.S.						
Aggregate short and long positions of ɔtions in foreign						
urrencies vis-à-vis the U.S. dollar			0			0
a. Short positions						
a.1. Bought puts						
a.2. Written calls						
b. Long positions						
ɔ.1. Bought calls						
ɔ.2. Written puts						

Notes:

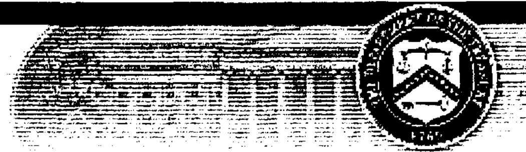
ɪcludes holdings of the Treasury's Exchange Stabilization Fund (ESF) and the Federal Reserve's System Open Market Account MA), valued at current market exchange rates. Foreign currency holdings listed as securities reflect marked-to-market values, and ɔsits reflect carrying values. Foreign Currency Reserves for the latest week may be subject to revision. Foreign Currency

:eserves for the prior week are final.

/ The items, "2. IMF Reserve Position" and "3. Special Drawing Rights (SDRs)," are based on data provided by the IMF and are alued in dollar terms at the official SDR/dollar exchange rate for the reporting date. The entries for the latest week reflect any ecessary adjustments, including revaluation, by the U.S. Treasury to the prior week's IMF data. IMF data for the latest week may be ıbject to revision. IMF data for the prior week are final.

' Gold stock is valued monthly at $42.2222 per fine troy ounce.

PRESS ROOM



FROM THE OFFICE OF PUBLIC AFFAIRS

December 12, 2002
PO-3687

Statement of Treasury Assistant Secretary for Financial Markets
Brian C. Roseboro at The Bond Market Association's
Repo and Securities Lending Conference
New York City
The Resilience of the U.S. Financial Markets, and Keeping It That Way

It would be an honor for anyone to speak to this distinguished gathering. It is especially an honor for me as a Treasury official, because you play the central role in the theme I'd like to examine today.

My theme is the remarkable resilience of the U.S. financial markets – and how you in the private sector, and we in the public sector, need to work to keep it that way.

I begin with a scenario with which many of you may be familiar. Imagine that the stock market has fallen, say a third, since its peak two years before. The economy is in the doldrums. And to top it off, an enemy has attacked the United States, slaying thousands of U.S. citizens. The stock market tanks even further.

The year? No, not 2001. It was 1941. And the story of the financial markets then, as now, was one of bouncing back to meet the challenge. Has it been the financial regulators, the government, that explains this resilience? I'd say no. While the government may help (putting aside the military, which had a little to do with defeating the Axis in the 1940s and Al-Qaeda and other terrorist threats today), the real leadership has come from the private sector.

Take the corporate scandals of the past year or so. Of course, Sarbanes-Oxley and the reforms the Securities and Exchange Commission has implemented have helped. But the main reason calm has more or less returned to the equity markets is that investors have forced a new discipline on corporate issuers, forcing them to right their internal governance after an age of excess.

The same goes for the clarity of firms' financial reporting. As a number of leading financial firms have discovered, investors now charge a premium for financial disclosures as murky as a muddy pool.

And the private sector – that's you – also has a much richer appreciation now, as do we all, of infrastructure resiliency. Before September 11, most of the financial industry, certainly its high-flying leaders, saw back-up systems and sites – the emergency plumbing of Wall Street – as the province of back-office worry-warts. Important, maybe, but bothersome. But what those back-office guys knew is that the deal isn't done until it's fully cleared and settled; and a Wall Street with cracked pipes smells as rosy and functions as well as a stopped-up bathroom plumbing. It turns out that all those Y2K preparations proved more useful than we had thought. And going forward we won't make the same mistakes.

Admittedly, the effort to improve the resiliency of our financial markets involves costs, but these are insurance premia. The costs of being unprepared would be much higher to both you and the economy than the costs of improving financial market resiliency.

I'd like to discuss three ongoing projects or issues concerning financial markets of interest to all of us. Your interest in these issues is due to your roles as financial market participants. The Treasury's interest in the efficiency and resiliency of our financial markets stems from our responsibilities for financial market policy. We are also vitally interested in the secondary as well as primary government securities markets. As this audience appreciates, the Treasury relies heavily on the primary market to meet our financing needs and issues new securities every week of the year. The primary market in turn relies on its backbone, the secondary market, to attract consistent and deep interest.

First is the Federal Reserve's initiative to explore how to improve the arrangements for payment and settlement of and related services for government security transactions. The Federal Reserve is concerned about what happens if one of the two major clearing banks for government securities is unable to provide services to the dealer community. This concern, which we at the Treasury share, has received greater attention because of the aftermath of September 11. However, we are not just concerned about what happens as a result of a physical attack or natural disaster, since there are other reasons that a clearing bank might be unable to function. Some scenarios for an involuntary exit of a clearing bank from the business may be unlikely, but are not impossible.

The first major step in the project was the Federal Reserve's and the SEC's white paper in May – "Structural Change in the Settlement of Government Securities: Issues and Options." Treasury staff were involved in the discussions with interested parties prior to the release of the white paper and assisted in its preparation.

In response to the comments on the white paper, the Federal Reserve last month established a private-sector working group on government securities clearance and settlement. That group is charged with preparing for the Federal Reserve a report discussing possible mechanisms by which if one functional clearing bank for whatever reason has to cease serving customers, the other could step in.

The working group includes representatives of the two clearing banks, the dealer and broker community, the mutual fund industry, and other interested parties. Staff from the Treasury, as well as from the Federal Reserve and the SEC, are attending meetings of the working group as observers and technical advisers.

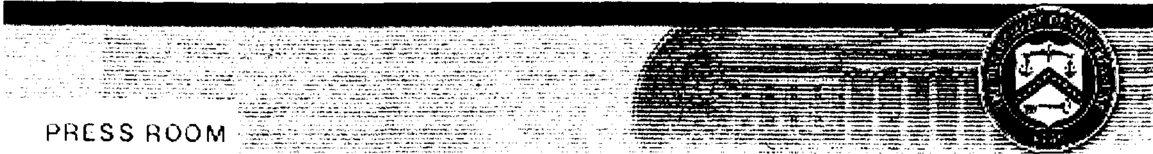
Many of the issues before the working group are far from easy, such as those posed by triparty repos, and the group's task is important. The Treasury will accordingly keep a close eye on developments in this area. Let me be clear, however. We do not at this time prefer a particular solution for mitigating these risks. We believe that the best solutions will come from a cooperative effort with the private sector, as with the Federal Reserve's working group. I challenge you, and ask you, to make the most of this project. Only if you provide the technical expertise and analysis of those who work in the markets every day, and only if you propose practical options that the various industry segments can accept, will this working group lead the industry and us to a robust solution.

A second issue is the concerns that have been raised about General Collateral Financing (GCF) repos cleared through the Government Securities Clearing Corporation. The concerns center on the settlement practices for this product and on the net debt cap limits on payments made through the Federal Reserve System. We at the Treasury are monitoring this discussion with care. This product, which has shown enormous growth in the last several years, provides important benefits to participants in the government securities market. We hope that the parties involved can devise creative solutions to the concerns raised. We have not taken a position, but will continue to talk to interested parties and intend to be as helpful as we can in assisting the effort to come up with solutions.

The last project of note is the draft white paper on "Sound Practices to Strengthen Resilience of the U.S. Financial System," which the Federal Reserve, the Office of the Comptroller of the Currency, and the SEC issued in August. We understand that there is some controversy about aspects of this paper. How to improve

resiliency of our financial system in the event of catastrophic events and how best to achieve and implement these mechanisms are and should be topics of legitimate debate. We believe, however, that it is vitally important that we improve the resiliency of the financial system because of its indispensable role in our economy.

Let me return to my overall theme: that the primary responsibility and capability for improving the resiliency of our financial markets lies, as a dictate of reality, with the private sector. We are ready to do our part. But without your initiative, creativity, expertise, and leadership, we cannot make our financial markets as robust as they must be for the challenges ahead.



FROM THE OFFICE OF PUBLIC AFFAIRS

December 12, 2002
PO-3688

Remarks of Randal K. Quarles
Assistant Secretary of the Treasury for International Affairs
Bretton Woods Committee Symposium
"Turmoil in Latin America – What is Happening and Why?"

It is a pleasure to join the Bretton Woods Committee for a timely discussion about events in Latin America and prospects for the future.

I appreciate today's perspectives on Latin America and want to begin by noting the diversity and promise in the region. Countries range from extremely poor nations confronting difficult development challenges to economies with sophisticated financial markets. Some states in Latin America are performing well economically. Others are just beginning to implement good policies, and have much to look forward to. Still others have recently experienced crises and stresses.

Since taking office, this administration has sought to promote both growth and stability in Latin America and throughout the world. The high costs of macroeconomic policy failures are particularly evident in this region at this time, arguing for renewed efforts to prevent and address financial crises so that they do not wipe out hard-won gains. It is critical, though, that the region be equally focused on growth strategies. While it is easy to see how a crisis can set back growth, it is also important to recognize how a sustained, day-in and day-out commitment to policies that achieve higher growth can reduce vulnerability to crisis. With even slightly faster economic expansion, debt burdens become more manageable, fiscal adjustment is less painful, and investor confidence increases.

The evolution of economic prospects in Latin America this year calls for steps to accelerate growth and highlights the need to do a better job of preventing and managing financial crises. Conditions throughout the region became more difficult this year with economic growth likely to be zero at best. This is in contrast to other developing and emerging market regions where growth is positive this year – about 6% in Asia, 3% in Eastern Europe, and 3% in Africa.

Clearly raising economic growth in the region must remain a high priority.
The United States has emphasized three pillars that should underlie growth and development strategies: ruling justly, investing in people, and promoting free markets. These pillars are very much relevant for Latin America and shortcomings in these areas help to explain erratic growth performance.

As we look at the region, it is important to keep in mind that geography is not destiny in Latin America. For example, Chile – which enjoyed 6.8% average annual growth throughout the 1990s – has distinguished itself by pursuing strong macroeconomic and structural policies and has performed well despite turmoil elsewhere in Latin America.

Promoting Trade and Financial Links

Raising living standards and expanding support for democratic institutions in Latin America depend critically on achieving higher levels of productivity growth – a key concern in a region where one-third of the people live on less than two dollars per day.

Increased trade is one of the most important ways to raise productivity and growth. The United States is committed to comprehensive trade liberalization in the region through the Free Trade Area of the Americas (FTAA). Indeed, with recently approved Trade Promotion Authority, the United States has outlined an ambitious agenda of trade opening initiatives. These include the recently finalized free trade agreement with Chile, the Andean Trade Promotion and Drug Eradication Act, negotiation of a Central American free trade area, and the United States proposal to eliminate agricultural subsidies and lower agricultural tariffs as one element of the Doha global trade negotiations.

At the bilateral level, the United States and Mexico have worked together through the Partnership for Prosperity initiative to strengthen Mexico's economy through a number of measures to improve access to capital, build capacity, and stimulate private investment in areas that do not yet fully benefit from NAFTA. One key element of the Partnership for Prosperity that could greatly facilitate the flow of capital to Latin American countries involves a project to reduce the cost of remittances sent from abroad. The Inter-American Development Bank estimates that Latin Americans living in the United States send an average of $200 to their native countries an average of seven to eight times per year. These remittances surpassed $23 billion last year – about one fifth of total worldwide remittances – and represent an enormous resource transfer to families and businesses that can make direct use of the funds. Although remittance charges are declining, they still range from 6-15% of the remitted amount plus an exchange margin that ranges from 3-5%. Increased competition as more and more traditional financial institutions offer remittance products should help to lower costs.

We are also seeking to boost private sector activity and enable businesses to take full advantage of opportunities for trade by working with the IDB to facilitate access to trade finance. Recent crises have made clear that once reliable sources of finance for private firms may be less certain in times of financial stress. Facilitating access to trade finance should help reduce the depth of crises and improve country resilience in the wake of economic turbulence.

Promoting Stability and Preventing Crises

In recent years, a marked increase in the frequency and severity of financial crises in emerging markets has contributed to deep recessions, instances of high unemployment, volatile exchange rates, and high interest rates that cause real hardships for people. The uncertainty caused by economic instability reduces foreign and domestic investment – there have been steep declines in net private capital flows to emerging markets – and has negative implications for productivity and growth.

It almost goes without saying that the best way to deal with crises is to prevent them from happening in the first place. This requires close monitoring of country vulnerabilities, and taking appropriate action to reduce those vulnerabilities. At the U.S. Treasury, for example, we have developed a "Blue Chip" index based on numerical crisis indicators from a variety of public and private sources. We are also asking that the IMF pay more attention to vulnerability in emerging market economies to help detect potential trouble earlier. The multilateral development banks are contributing to crisis prevention efforts by helping countries strengthen financial sectors and institutions, thereby making their economies more resilient.

The emerging market countries themselves, of course, have the primary responsibility to help prevent crises through strong policy actions. These policies include credible and sustainable fiscal, monetary, and exchange rate policies, responsible debt management, reforms to strengthen financial sectors, and greater transparency.

In cases where difficulties cannot be avoided and countries turn to the official sector for assistance, experience has shown that lending programs that lack strong ownership by a country's leaders are likely to fail; we should not support such programs. We must lend to countries whose leaders are willing and even eager to take responsibility for making policy decisions that will have a long lasting positive impact on economic development.

This Administration also has emphasized that contagion should not be considered "automatic" and that support for large scale financing through the IMF would not be based on claims of contagion without evidence that there were fundamental links between countries. We have worked to distinguish between direct links from one country to another – which clearly exist in neighboring countries like the United States and Mexico – and unfounded claims of an automatic spread of bad market events from one country to another without such links.

While working to discourage unjustified contagion, the United States has supported assistance for countries that are following good policies but are negatively affected by a nearby crisis. We saw this when the United States welcomed an IMF program for Brazil in August 2001 as a cushion against increasing difficulties in Argentina. Similarly, United States support for Uruguay early this year was aimed at limiting the impact of the Argentina crisis due to the direct or fundamental interdependence between the two countries. In contrast, the alternative of supporting bad policies in a crisis country due to fear of contagion effects undermines incentives to follow good policies.

At the same time, we are working to increase discipline in terms of access to IMF resources to reduce the size of IMF packages and thereby reduce the risk of moral hazard – i.e., the belief that in a crisis, large-scale IMF assistance will protect investors from the consequences of their decisions. The United States has refrained from providing longer-term bilateral loan assistance in recent crisis cases, as was done in the past, and has emphasized that the IMF must be the key source of emergency support, thereby limiting official assistance to IMF resources. The United States has moved gradually in implementing limits on financing – accepting a waiver in Argentina in the spring 2001, and then agreeing to an augmentation – so that investor expectations can adjust smoothly to new official sector policies.

In terms of program design, the IMF should work to structure international financial packages so that strong incentives for good policy performance are maintained. Prior actions that must be completed before a lending program begins, for instance, can sometimes be a useful means for a country to demonstrate its commitment before international funds are disbursed. The United States is encouraging the IMF to concentrate more on the areas most central to its expertise: monetary, fiscal, exchange rate, financial, and debt management policies. Narrowing the range of conditionality in this direction should help achieve more focused programs with increased country ownership. "Backloading" financial assistance, with smaller amounts of money provided initially and larger amounts provided later on, can help to ensure that a country's performance does not weaken over time.

In addition, we are working to create a more orderly and predictable process for debt restructuring for cases where debts are unsustainable. The aim is not to reduce the incentives for sovereign governments to pay their debts in full and on time. Rather the aim is to reduce the great deal of existing uncertainty about restructuring processes that currently exists and that complicates decision-making. A more predictable sovereign debt restructuring process for countries that reach unsustainable debt positions would help reduce this uncertainty, thereby leading to better, more timely decisions, reducing the frequency and severity of crises.

As has been discussed in other fora, two approaches have been outlined: a decentralized approach that would incorporate collective action clauses into bond contracts and a more centralized approach that would address sovereign bankruptcy through an amendment to the IMF Articles or through another international treaty. We are seeking the most effective mechanism through full consideration of both of these approaches and, possibly, a combination of the two.

If there is convincing evidence that the decentralized approach does a better job of preventing crises and strengthening capital flows than the centralized or the combined approaches, then the decentralized approach will be the choice supported by the Bush Administration. Similarly, if one of the other approaches can be shown to work better, then that option will be the one supported. In terms of collective action clauses, given support from the private sector, from the official sector, and from key emerging market countries, the time is ripe for moving ahead and actually putting such clauses in new issues. This would be a tremendous step

forward to creating a more orderly sovereign debt restructuring process.

Through these measures, we hope to reduce the frequency and harm of crises in Latin America and other regions, increase private sector capital flows, and thereby foster stability among emerging markets.

How then do these broad policy principles translate into specific policy actions for countries experiencing difficulties? Let me now provide a brief update on three of the key countries in the region that have received particular attention in recent months – Uruguay, Brazil, and Argentina.

Uruguay is an example of getting the incentives right. The United States and the international financial institutions made an extraordinary effort for Uruguay because it was: 1) a victim of external shocks; 2) willing to pursue real financial sector reform as well as fiscal adjustment; and 3) rightly focused on preventing the collapse of its banking system.

Brazil's government's has demonstrated a sustained commitment to responsible macroeconomic policy and this proven track record justified a strong response from the international community. Official financing was rightly used to build confidence in conjunction with good policy.

For Argentina, the U.S. has strongly supported efforts to provide Argentina breathing room as it works with the IMF to develop a plan to strengthen its monetary and fiscal framework.

Fighting Poverty, Strengthening the Rule of Law, and Improving the Environment

The United States is working on a range of efforts to help increase productivity and overall economic growth in Latin America, reduce poverty, and protect the environment.

At the World Bank and Inter-American Development Bank, the United States is supporting development projects and programs that address the basic causes of low productivity, including projects to raise health and education levels, increase access to clean water and sanitation, and improve the climate for private sector development. Higher quality education and training is particularly important to equip people and countries to take advantage of the opportunities presented by market liberalization. We believe these and other multilateral development bank efforts will benefit from a renewed emphasis on measuring for results in order to maximize development effectiveness. Particularly important will be efforts to improve transparency and public expenditure tracking so that resources are used well.

Beginning in 2004, the Millennium Challenge Account initiative will dramatically increase assistance from the United States to poor countries that demonstrate strong performance – those that govern justly and uphold the rule of law, invest in their own people, and create a favorable climate for private enterprise. The total increase will reach $5 billion per year starting in 2006. These funds provide a powerful incentive for countries to create an environment conducive to growth.

One specific area in which the United States has pushed for progress to raise living standards and productivity is access to clean water. The United States strongly supports efforts toward achievement of the objective for water under the Millennium Development Goals, which call for reduction by half of the proportion of people without sustainable access to clean drinking water. The IDB has estimated that there is potential for about three-quarters of Latin American countries to reach this goal by 2015. However, we must work together to ensure that all of Latin America can achieve and even surpass this target more quickly. This will mean a strong commitment by the countries themselves to provide an enabling environment conducive to sustainable water services for cities and rural populations alike.

Through the HIPC initiative, the United States has joined with other countries and the international financial institutions in a comprehensive effort to provide debt relief to the Heavily Indebted Poor Countries, including Bolivia, Guyana, Honduras, and Nicaragua. The HIPC initiative is addressing the unsustainable debt burdens in these countries, and helping to increase investments to spur greater productivity, economic growth, and poverty reduction.

Through the multilateral development banks and other efforts, the United States has encouraged lending to small businesses as an effective tool to provide credit to the independent entrepreneurs who help drive growth in Latin America.

For a number of Latin American countries, illicit drug cultivation and production rivals the legitimate economy, deprives the state of potential revenue, and undermines government stability. Bilateral assistance and preferential trade access from the United States are geared toward drug eradication and the promotion of alternative development strategies – critical steps toward putting countries on a path of rising growth.

The United States also has sought to link debt relief for developing countries to environmental conservation. Building on the Enterprise for the Americas Initiative, the Tropical Forest Conservation Act offers eligible developing countries reduction on concessional debt in exchange for a commitment to fund tropical forest conservation activities.

Conclusion

In spite of recent turbulence, there is good reason to be confident about the region's prospects. First, the current economic cycle of slow or negative growth will improve, especially as the U.S. economy continues to gain strength. At roughly 38% of GDP, exports comprise a large percentage of income for the Latin American region as a whole.

Many countries within the region have made important progress over the past decade in strengthening the economic institutions and policies that will improve their growth prospects. In a number of countries, for instance, central banks have focused more on keeping inflation low. And many countries have abandoned soft exchange rate pegs and maintained floating exchange rate regimes, helping them to adjust more easily when faced with economic shocks. Others, such as El Salvador, have been successful with full dollarization.

Across the region, the private sector now contributes a larger percentage of GDP than it did during the 1980s, which will help Latin American economies regain their dynamism more quickly. Many countries now have more extensive trade and financial linkages among themselves and with developed economies – such as the United States and Europe – than they did in the past. This is a factor that will help to accelerate their recovery once conditions improve. Latin America also has a strong human capital and resource base that provides a solid underlying foundation for future growth.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

December 12, 2002
PO-3689

Today the Treasury Department released the following update on the financial war on terrorism:

Total amount of terrorist assets blocked worldwide since September 11, 2001 (in millions) - $123

Within the United States (in millions) 36.2
Other countries (in millions) 86.8

DEPARTMENT OF THE TREASURY

TREASURY NEWS

OFFICE OF PUBLIC AFFAIRS • 1500 PENNSYLVANIA AVENUE, N.W. • WASHINGTON, D.C. • 20220 • (202) 622-2960

EMBARGOED UNTIL 11:00 A.M.
December 12, 2002

CONTACT: Office of Financing
202/691-3550

TREASURY OFFERS 13-WEEK AND 26-WEEK BILLS

The Treasury will auction 13-week and 26-week Treasury bills totaling $30,000 million to refund an estimated $31,005 million of publicly held 13-week and 26-week Treasury bills maturing December 19, 2002, and to pay down approximately $1,005 million. Also maturing is an estimated $20,000 million of publicly held 4-week Treasury bills, the disposition of which will be announced December 16, 2002.

The Federal Reserve System holds $13,582 million of the Treasury bills maturing on December 19, 2002, in the System Open Market Account (SOMA). This amount may be refunded at the highest discount rate of accepted competitive tenders either in these auctions or the 4-week Treasury bill auction to be held December 17, 2002. Amounts awarded to SOMA will be in addition to the offering amount.

Up to $1,000 million in noncompetitive bids from Foreign and International Monetary Authority (FIMA) accounts bidding through the Federal Reserve Bank of New York will be included within the offering amount of each auction. These noncompetitive bids will have a limit of $100 million per account and will be accepted in the order of smallest to largest, up to the aggregate award limit of $1,000 million.

TreasuryDirect customers have requested that we reinvest their maturing holdings of approximately $1,042 million into the 13-week bill and $787 million into the 26-week bill.

Beginning with these auctions, a bidder must report its net long position if, in the security being auctioned, the bidder's net long position plus its bids in the auction meet or exceed a specific dollar-amount threshold. That threshold amount, equivalent to 35% of the offering amount of the security, will be stated in the highlights of the security's auction announcement.

The allocation percentage applied to bids awarded at the highest discount rate will be rounded up to the next hundredth of a whole percentage point, e.g., 17.13%.

This offering of Treasury securities is governed by the terms and conditions set forth in the Uniform Offering Circular for the Sale and Issue of Marketable Book-Entry Treasury Bills, Notes, and Bonds (31 CFR Part 356, as amended).

Details about each of the new securities are given in the attached offering highlights.

oOo

Attachment

For press releases, speeches, public schedules and official biographies, call our 24-hour fax line at (202) 622-2040

PO-3696

HIGHLIGHTS OF TREASURY OFFERINGS OF BILLS
TO BE ISSUED DECEMBER 19, 2002

December 12, 2002

Offering Amount	$14,000 million	$16,000 million
Maximum Award (35% of Offering Amount)	$ 4,900 million	$ 5,600 million
Maximum Recognized Bid at a Single Rate	$ 4,900 million	$ 5,600 million
NLP Reporting Threshold	$ 4,900 million	$ 5,600 million
NLP Exclusion Amount	$ 4,600 million	None

Description of Offering:

Term and type of security	91-day bill	182-day bill
CUSIP number	912795 MD 0	912795 MS 7
Auction date	December 16, 2002	December 16, 2002
Issue date	December 19, 2002	December 19, 2002
Maturity date	March 20, 2003	June 19, 2003
Original issue date	September 19, 2002	December 19, 2002
Currently outstanding	$17,916 million	---
Minimum bid amount and multiples	$1,000	$1,000

The following rules apply to all securities mentioned above:

Submission of Bids:

Noncompetitive bids: Accepted in full up to $1 million at the highest discount rate of accepted competitive bids.

Foreign and International Monetary Authority (FIMA) bids: Noncompetitive bids submitted through the Federal Reserve Banks as agents for FIMA accounts. Accepted in order of size from smallest to largest with no more than $100 million awarded per account. The total noncompetitive amount awarded to Federal Reserve Banks as agents for FIMA accounts will not exceed $1,000 million. A single bid that would cause the limit to be exceeded will be partially accepted in the amount that brings the aggregate award total to the $1,000 million limit. However, if there are two or more bids of equal amounts that would cause the limit to be exceeded, each will be prorated to avoid exceeding the limit.

Competitive bids:

(1) Must be expressed as a discount rate with three decimals in increments of .005%, e.g., 7.100%, 7.105%.

(2) Net long position (NLP) for each bidder must be reported when the sum of the total bid amount, at all discount rates, and the net long position equals or exceeds the NLP reporting threshold stated above.

(3) Net long position must be determined as of one half-hour prior to the closing time for receipt of competitive tenders.

Receipt of Tenders:

Noncompetitive tenders..... Prior to 12:00 noon eastern standard time on auction day

Competitive tenders........ Prior to 1:00 p.m. eastern standard time on auction day

Payment Terms: By charge to a funds account at a Federal Reserve Bank on issue date, or payment of full par amount with tender. *TreasuryDirect* customers can use the Pay Direct feature, which authorizes a charge to their account of record at their financial institution on issue date.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

December 12, 2002
PO-3691

Remarks of Pam Olson Assistant Secretary for Tax Policy Before the IRS/George Washington, University 15th Annual Institute on Current Issues in International Taxation

Globalization and the U.S. International Tax Rules

Remarks today on hot topics for an international tax conference offer a wealth of options. There are novel enforcement actions, new tax information exchange agreements with countries once thought of as havens for those seeking to hide assets or income - countries now proudly adopting the best practices of developed nations for transparency and information exchange, significant developments in tax treaties aimed at reducing barriers to the free flow of capital, the World Trade Organization's decision that our extraterritorial income exclusion rule constitutes a prohibited export subsidy, U.S. citizens expatriating, U.S. companies inverting, and the list goes on. Of course, a list like that would probably prompt our colleagues outside of the tax world to tell us we need to get out more! And so we do. Instead of any of these hot topics, I want to talk today about an area where one might say we need to get out more. That area is the fundamentals of our international tax rules.

Viewed from the vantage point of an increasingly global marketplace, our tax rules appear outmoded, at best, and punitive of U.S. economic interests, at worst. Most other developed countries of the world are concerned with setting a competitiveness policy that permits their workers to benefit from globalization. As Deputy Secretary Dam observed recently, however, our international tax policy seems to have been based on the principle that if we have a competitive advantage, we should tax it!

Let's start with the basics. Our income tax system as a whole dates back to shortly after the turn of the last century, a time when cars were called horseless carriages and buggy whip makers had just gone out of business. A bit has happened since then. Of course, significant changes have been made to the tax code as well. In the international area, we added the subpart F rules back in 1962.

I would say that they haven't aged as well as a lot of the 40 somethings in this room. In fact, they are showing their age. We also made fairly significant changes to the international tax rules in 1986. That would make those rules teenagers now, and they have the characteristics of the average teenager. They're hard to understand, messy, inconsistent, and display little regard for the real world.

The global economy looked very different when the subpart F rules were put in place than it does today. The same is true of the U.S. role in the global economy. Forty years ago the U.S. was dominant and accounted for over half of all multinational investment in the world. We could make decisions about our tax system essentially on the basis of a closed economy, and we could generally count on our trade partners to follow our lead in tax policy.

The world has changed in the last 40 years. The globalization of the U.S. economy puts ever more pressure on our international tax rules. When the rules were first developed, they affected relatively few taxpayers and relatively few transactions.

Today, there is hardly a U.S.-based company that is not faced with applying the U.S. international tax rules to some aspect of its business.

What does globalization mean? This audience needs no explanation, but it is useful to think about it for a minute. It means the growing interdependence of countries resulting from increasing integration of trade, finance, investment, people and ideas in one global marketplace. Globalization results in increased cross-border trade, and the establishment of production facilities and distribution networks around the globe. Technology is a key driving force behind globalization. Advances in communications, information technology, and transport have slashed the cost and time taken to move goods, capital, people, and information. Firms in this global marketplace differentiate themselves by being smarter: applying more cost efficient technologies or innovating faster than their competitors. The returns to being smarter are much higher than they once were as the benefits can be marketed worldwide.

The significance of globalization to the U.S. economy since the enactment of subpart F is apparent from the statistics on international trade and investment. In 1960, trade in goods to and from the U.S. represented just over six percent of GDP. Today, trade in goods to and from the U.S. represents over 20 percent of GDP, more than three times larger than in 1960, while trade in goods and services represents more than 25 percent of GDP today. It is worth noting that numerous studies confirm a strong link between trade and economic growth. Trade appears to raise income by spurring the accumulation of physical and human capital and by increasing output for given levels of capital.

Cross border investment, both inflows and outflows, also has grown dramatically in the last 40 years. In 1960, cross border investment represented just over one percent of GDP. In 2000, it was nearly 16% of GDP, representing annual cross-border flows of more than $1.5 trillion. The aggregate cross border ownership of capital is valued at $15 trillion. In addition, U.S. multinational corporations are now responsible for more than one-quarter of U.S. output and about 15 percent of U.S. employment.

At the same time companies are competing for sales, they are also competing for capital: U.S.-managed firms may have foreign investors, and foreign-managed firms may have U.S. investors. Portfolio investment accounts for approximately two-thirds of US investment abroad and a similar fraction of foreign investment in the U.S.

The U.S. tax rules have important effects on international competitiveness both because of the integration of domestic activities of U.S. multinational companies with their foreign activities and because repatriated foreign earnings of foreign investments are subject to U.S. domestic tax. Increasingly, the flow of goods and services is not through purchases between exporters and importers, but through transfers between affiliates of multinational corporations. The rules governing transfer pricing, interest allocation, withholding rates, foreign tax credits, and the taxation of actual or deemed dividends impacts these flows.

The U.S. tax system should not distort trade or investment relative to what would occur in a world without taxes. The difficulty is that every country makes sovereign decisions about its own tax system, so it is impossible for the U.S. to level all playing fields simultaneously for each of the different forms competition might take in every country.

The question we must answer is what should we do to increase the competitiveness of U.S. businesses and workers. Professor Michael Graetz observed in his book, The Decline (and Fall?) of the Income Tax:

The internationalization of the world economy has made it far more difficult for the United States, or any other country for that matter, to enact a tax system radically different from those in place elsewhere in the world. In today's worldwide economy, we can no longer look solely to our own navels to answer questions of tax policy.

To date, our attempts to address one of the perceived competitive disadvantages created by our laws have been repeatedly ruled inconsistent with the World Trade Organization's rules. Earlier this year, a WTO appellate panel held that the extraterritorial income exclusion regime of our tax law constituted a prohibited export subsidy under the WTO rules. Just two years before, a WTO appellate panel held that the foreign sales corporation provisions constituted a similar, prohibited subsidy. President Bush has made clear that the U.S. must comply with the WTO rulings. That result should be obvious because - let's face it - no one has a greater stake in the WTO and in free trade than the U.S. Despite the WTO decisions against our foreign sales corporation and extraterritorial income regimes, the WTO rules serve the economic interests of American businesses and workers by opening markets and ensuring fair play.

In addition to making clear that the U.S. must comply, the President made two further decisions. He said that any response to the ruling must increase the competitiveness of U.S. businesses. He also pledged to work with the Congress to create the solution. Treasury is working closely with the tax-writing committees of Congress to develop legislation that makes meaningful changes to our tax law to satisfy the twin goals of honoring our WTO obligations and preserving the competitiveness of U.S. businesses operating in the global marketplace.

We must consider the ways in which our tax system differs from that of our major trading partners to identify aspects that may hinder the competitiveness of U.S. companies and workers. About half of the OECD countries employ a worldwide tax system as does the U.S. However, even limiting comparison of competition among multinational companies established in countries using a worldwide tax system, U.S. multinationals can be disadvantaged when competing abroad. This is because the United States employs a worldwide tax system that, unlike other worldwide systems, may tax active forms of business income earned abroad before it has been repatriated and may more strictly limit the use of the foreign tax credits that prevent double taxation of income earned abroad.

The Accelerator—Subpart F. The focus of the subpart F rules is on passive, investment-type income that is earned abroad through a foreign subsidiary. However, the reach of the subpart F rules extends well beyond passive income to encompass some forms of income from active foreign business operations. No other country has rules for the immediate taxation of foreign-source income that are comparable to the U.S. rules in terms of breadth and complexity.

For example, under subpart F, a U.S. company that uses a centralized foreign distribution company to handle sales of its products in foreign markets is subject to current U.S. tax on the income earned abroad by that foreign distribution subsidiary. In contrast, a local competitor making sales in that market is subject only to the tax imposed by that country. Similarly, a foreign competitor that uses a centralized distribution company to make sales into the same markets generally will be subject only to the tax imposed by the local country. U.S. companies that centralize their foreign distribution facilities therefore face a tax penalty not imposed on their foreign competitors.

The subpart F rules also impose current U.S. taxation on income from certain services transactions, shipping activities and oil related activities performed abroad. In contrast, a foreign competitor engaged in the same activities generally will not be subject to current home-country tax on its income from these activities. While the purpose of these rules is to differentiate passive or mobile income from active business income, they operate to currently tax some classes of income arising from active business operations structured and located in a particular country for business reasons wholly unrelated to tax considerations.

Limitations on Foreign Tax Credits. The rules for determining and applying the foreign tax credit are detailed and complex and can have the effect of subjecting U.S.-based companies to double taxation on their income earned abroad. For example, the foreign tax credit may be used only to offset U.S. tax on net foreign-source income and not to offset U.S. tax on U.S.-source income. Net foreign-source income is determined by reducing foreign-source income by U.S. expenses allocated to such income. Under the current rules, the interest expense of a U.S.

affiliated group is allocated between U.S. and foreign-source income based on the group's total U.S. and foreign assets. These rules treat the interest expense of a U.S. parent as relating to its foreign subsidiaries even where those subsidiaries are equally or more leveraged than the U.S. parent. This over-allocation of interest expense to foreign income inappropriately reduces the foreign tax credit limitation because it understates foreign income. The effect can be to subject U.S. companies to double taxation. Other countries do not have expense allocation rules that are nearly as extensive as ours.

The U.S. foreign tax credit rules are further complicated by the need to calculate foreign and domestic source income, allocable expenses, and foreign tax credits separately for different categories or "baskets" of income. Foreign taxes paid with respect to income in a particular category may be used only to offset the U.S. tax on income from that same category.

Under the current U.S. rules, if a U.S. company has an overall foreign loss in a particular taxable year, that loss reduces the company's total income and therefore reduces its U.S. tax liability for the year. Special overall foreign loss rules apply to recharacterize foreign-source income earned in subsequent years as U.S.-source income until the entire overall foreign loss from the prior year is recaptured. This recharacterization has the effect of limiting the U.S. company's ability to claim foreign tax credits in those subsequent years. No comparable recharacterization rules apply in the case of an overall domestic loss. However, a net loss in the U.S. would offset income earned from foreign operations, income on which foreign taxes have been paid. The net U.S. loss thus would reduce the U.S. company's ability to claim foreign tax credits for those foreign taxes paid. This gives rise to the potential for double taxation when the U.S. company's business cycle for its U.S. operations does not match the business cycle for its foreign operations.

Double Tax on Equity-Financed Investments. The U.S. is one of the few OECD countries that does not provide for some form of integration between taxes paid at the corporate level and taxes paid by individuals on distributions from corporations.

Under U.S. law, $100 of corporate profits is first taxed at a 35% corporate tax rate. The remaining $65 is then available for distribution to shareholders or for reinvestment. If distributed to shareholders, it is subject to tax at the shareholders tax rate – ranging from 0% for investments in qualified pension savings to 38.6% at the top individual rate. If dividend tax rates paid by individuals average 25%, then only 75% of the $65 distribution is left after individual taxes are paid, or less than $50 of the original $100 in corporate profit.

The present U.S. system, by taxing income at the corporate level and dividends at the individual level, increases the hurdle rate of return (i.e., the minimum rate of return required on a prospective investment) undertaken by corporations. Whether competing at home against foreign imports or competing abroad through exports from the U.S. or through foreign production, the double tax makes it less likely that the U.S. company can compete successfully against a foreign competitor. Most OECD countries alleviate this problem by reducing personal income tax payments on corporate distributions.

Time for reform. We have a tax code that has not kept pace with the globalization that has transpired over the last 40 years. It is time for us to review our rules based on the world in which we live today and the world we imagine for the future.

We must design rules that equip us to compete in the global economy – not fearfully, but hopefully. The fact of the matter is that we – all of us - benefit significantly from vigorous participation in the global economy.
Over the past 20 years, U.S. companies that invest abroad exported more (exporting between one-half and three-quarters of all U.S. exports), paid their workers more, and spent more on R&D and physical capital than companies not engaged globally.

While 80 percent of U.S. investment abroad is located in high-income countries, it is

useful to say a word about the investment that goes into developing countries. These countries recognize U.S. investment as important to achieving sustainable poverty-reducing growth and development. I'm asking you to look at this altruistically, but if you can't, then look at it selfishly. Poker games are revenue neutral, but international trade and investment are not poker games. Healthy foreign economies mean more markets for our products. They mean more opportunities for us to profitably invest. But, I have to return the altruistic point. Foreign investment means sharing our ideas, our knowledge, our values, and our capital. That is not a zero sum game. I hope you will engage with us in a discussion of what the future might bring.

IRS Voluntary Disclosure Practice

Before I conclude, I would like to briefly mention the IRS announcement this week that it has revised and updated a key practice that assists agency investigators in determining whether a case is recommended for criminal prosecution. A taxpayer's timely, voluntary disclosure of a substantial unreported tax liability has long been an important factor in deciding whether the taxpayer's case should ultimately be referred for criminal prosecution. The IRS has modernized this practice to allow more taxpayers to voluntarily comply with their obligations and to reduce the uncertainty over what constitutes a "timely" disclosure. This is an important step in helping taxpayers and their advisers understand the steps they can take and the circumstances in which they can get back into compliance with the tax laws without fear of prosecution. With these practices in place, we hope that more taxpayers will do the right thing and voluntarily disclose their outstanding tax liabilities.

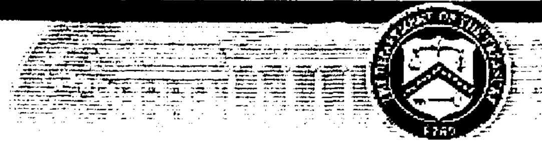
Public dialogue

Let me close by noting that we are committed to a better and more open dialogue with the public. The discussion we are having on international tax reform is one illustration of that dialogue. The recent release of our promised quarterly update of the business plan which reflects our continued conversation with you about the issues we need to address is another illustration. Still another illustration is the issuance in proposed form of section 302, consolidated return, and tax shelter regulations. All of these are the opening in a dialogue with the public about what the rules should be. We will work diligently to propose sound rules and to do so rapidly enough to meet your needs.

Unfortunately, no immortals have yet been hired to work at IRS or Treasury. We're all human. We will make mistakes. We will also have differences of opinion from time to time. But have no doubt about it. While we much appreciate your praise, we especially value your criticism. It helps us stay on track.

Thank you.

PRESS ROOM



FROM THE OFFICE OF PUBLIC AFFAIRS

December 13, 2002
PO-3692

SECRETARY O'NEILL ANNOUNCES DAVIS' PLANS TO LEAVE TREASURY

The Treasury Department today announced that Michele Davis, Assistant Secretary of the Treasury for Public Affairs, will leave government service at the end of the year.

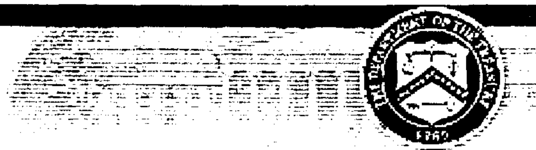
Davis plans to join Fannie Mae, as Vice President for Regulatory Policy.

"Michele has done an outstanding job communicating President Bush's efforts to keep America's economy strong and to spread prosperity around the world," said Treasury Secretary Paul O'Neill.

Davis played an essential role at the Treasury Department over the last two years. She led the Department's efforts to inform the nation of the benefits of President Bush's tax relief program, the state of the government's finances, the need for better results from international development assistance and the Secretary's understanding of the American economy. Davis' tenure at Treasury included tumultuous times for the nation, and she worked to ensure that the Treasury's actions in the wake of September 11 were well understood – from implementation of the PATRIOT act to improvements in border security to the opening of the financial front in the war on terrorism.

"Michele brought invaluable experience to her position and with that background and perspective, she played an important role in shaping many of the public policy debates within the Administration and on Capitol Hill," O'Neill concluded.

PRESS ROOM



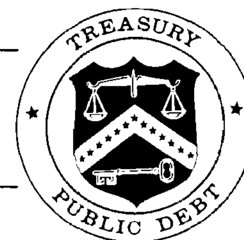
FROM THE OFFICE OF PUBLIC AFFAIRS

December 13, 2002
PO-3693

TREASURY DEPARTMENT STATEMENT NAMING NICHOLS ACTING ASSISTANT SECRETARY FOR PUBLIC AFFAIRS

The White House has asked Rob Nichols to serve as Acting Assistant Secretary for Public Affairs until the President makes a decision on a permanent replacement.

PUBLIC DEBT NEWS



Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

TREASURY SECURITY AUCTION RESULTS
BUREAU OF THE PUBLIC DEBT - WASHINGTON DC

FOR IMMEDIATE RELEASE
December 16, 2002

CONTACT: Office of Financing
202-691-3550

RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Term:	91-Day Bill
Issue Date:	December 19, 2002
Maturity Date:	March 20, 2003
CUSIP Number:	912795MD0

High Rate: 1.200% Investment Rate 1/: 1.219% Price: 99.697

All noncompetitive and successful competitive bidders were awarded securities at the high rate. Tenders at the high discount rate were allotted 92.68%. All tenders at lower rates were accepted in full.

AMOUNTS TENDERED AND ACCEPTED (in thousands)

Tender Type	Tendered	Accepted
Competitive	$ 33,989,343	$ 12,441,961
Noncompetitive	1,408,080	1,408,080
FIMA (noncompetitive)	150,000	150,000
SUBTOTAL	35,547,423	14,000,041 2/
Federal Reserve	5,064,079	5,064,079
TOTAL	$ 40,611,502	$ 19,064,120

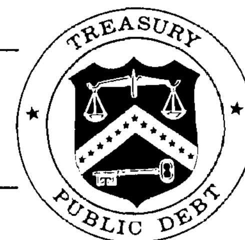
Median rate 1.190%: 50% of the amount of accepted competitive tenders was tendered at or below that rate. Low rate 1.175%: 5% of the amount of accepted competitive tenders was tendered at or below that rate.

Bid-to-Cover Ratio = 35,547,423 / 14,000,041 = 2.54

1/ Equivalent coupon-issue yield.
2/ Awards to TREASURY DIRECT = $1,143,464,000

PO-3694

PUBLIC DEBT NEWS



Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

TREASURY SECURITY AUCTION RESULTS
BUREAU OF THE PUBLIC DEBT - WASHINGTON DC

FOR IMMEDIATE RELEASE
December 16, 2002

CONTACT: Office of Financing
202-691-3550

RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Term:	182-Day Bill
Issue Date:	December 19, 2002
Maturity Date:	June 19, 2003
CUSIP Number:	912795MS7

High Rate: 1.260% Investment Rate 1/: 1.286% Price: 99.363

All noncompetitive and successful competitive bidders were awarded securities at the high rate. Tenders at the high discount rate were allotted 41.83%. All tenders at lower rates were accepted in full.

AMOUNTS TENDERED AND ACCEPTED (in thousands)

Tender Type	Tendered	Accepted
Competitive	$ 33,621,125	$ 14,896,489
Noncompetitive	1,053,731	1,053,731
FIMA (noncompetitive)	50,000	50,000
SUBTOTAL	34,724,856	16,000,220 2/
Federal Reserve	5,910,919	5,910,919
TOTAL	$ 40,635,775	$ 21,911,139

Median rate 1.245%: 50% of the amount of accepted competitive tenders was tendered at or below that rate. Low rate 1.200%: 5% of the amount of accepted competitive tenders was tendered at or below that rate.

Bid-to-Cover Ratio = 34,724,856 / 16,000,220 = 2.17

1/ Equivalent coupon-issue yield.
2/ Awards to TREASURY DIRECT = $839,443,000

PO-3695

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

TREASURY SECURITY AUCTION RESULTS
BUREAU OF THE PUBLIC DEBT - WASHINGTON DC

FOR IMMEDIATE RELEASE
December 16, 2002

CONTACT: Office of Financing
202-691-3550

RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Term:	91-Day Bill
Issue Date:	December 19, 2002
Maturity Date:	March 20, 2003
CUSIP Number:	912795MD0

High Rate: 1.200% Investment Rate 1/: 1.219% Price: 99.697

All noncompetitive and successful competitive bidders were awarded securities at the high rate. Tenders at the high discount rate were allotted 92.68%. All tenders at lower rates were accepted in full.

AMOUNTS TENDERED AND ACCEPTED (in thousands)

Tender Type	Tendered	Accepted
Competitive	$ 33,989,343	$ 12,441,961
Noncompetitive	1,408,080	1,408,080
FIMA (noncompetitive)	150,000	150,000
SUBTOTAL	35,547,423	14,000,041 2/
Federal Reserve	5,064,079	5,064,079
TOTAL	$ 40,611,502	$ 19,064,120

Median rate 1.190%: 50% of the amount of accepted competitive tenders was tendered at or below that rate. Low rate 1.175%: 5% of the amount of accepted competitive tenders was tendered at or below that rate.

Bid-to-Cover Ratio = 35,547,423 / 14,000,041 = 2.54

1/ Equivalent coupon-issue yield.
2/ Awards to TREASURY DIRECT = $1,143,464,000

DEPARTMENT OF THE TREASURY

OFFICE OF PUBLIC AFFAIRS • 1500 PENNSYLVANIA AVENUE, N.W. • WASHINGTON, D.C. • 20220 • (202) 622-2960

EMBARGOED UNTIL 11:00 A.M.
December 16, 2002

Contact: Office of Financing
202/691-3550

TREASURY OFFERS 4-WEEK BILLS

The Treasury will auction 4-week Treasury bills totaling $16,000 million to refund an estimated $20,000 million of publicly held 4-week Treasury bills maturing December 19, 2002, and to pay down approximately $4,000 million.

Tenders for 4-week Treasury bills to be held on the book-entry records of *TreasuryDirect* will not be accepted.

The Federal Reserve System holds $13,582 million of the Treasury bills maturing on December 19, 2002, in the System Open Market Account (SOMA). This amount may be refunded at the highest discount rate of accepted competitive tenders in this auction up to the balance of the amount not awarded in today's 13-week and 26-week Treasury bill auctions. Amounts awarded to SOMA will be in addition to the offering amount.

Up to $1,000 million in noncompetitive bids from Foreign and International Monetary Authority (FIMA) accounts bidding through the Federal Reserve Bank of New York will be included within the offering amount of the auction. These noncompetitive bids will have a limit of $100 million per account and will be accepted in the order of smallest to largest, up to the aggregate award limit of $1,000 million.

A bidder must report its net long position if, in the security being auctioned, the bidder's net long position plus its bids in the auction meet or exceed a specific dollar-amount threshold. That threshold amount, equivalent to 35% of the offering amount of the security, will be stated in the highlights of the security's auction announcement.

The allocation percentage applied to bids awarded at the highest discount rate will be rounded up to the next hundredth of a whole percentage point, e.g., 17.13%.

This offering of Treasury securities is governed by the terms and conditions set forth in the Uniform Offering Circular for the Sale and Issue of Marketable Book-Entry Treasury Bills, Notes, and Bonds (31 CFR Part 356, as amended).

Details about the new security are given in the attached offering highlights.

oOo

Attachment

PO-3697

HIGHLIGHTS OF TREASURY OFFERING
OF 4-WEEK BILLS TO BE ISSUED DECEMBER 19, 2002

December 16, 2002

Offering Amount.......................... $16,000 million
Maximum Award (35% of Offering Amount)... $ 5,600 million
Maximum Recognized Bid at a Single Rate.. $ 5,600 million
NLP Reporting Threshold.................. $ 5,600 million
NLP Exclusion Amount..................... $11,300 million

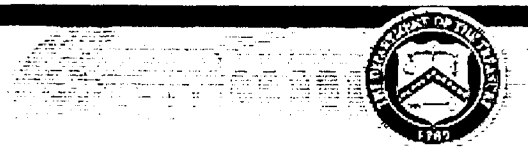
Description of Offering:
Term and type of security................ 28-day bill
CUSIP number............................. 912795 LU 3
Auction date............................. December 17, 2002
Issue date............................... December 19, 2002
Maturity date............................ January 16, 2003
Original issue date...................... July 18, 2002
Currently outstanding.................... $43,961 million
Minimum bid amount and multiples......... $1,000

Submission of Bids:
Noncompetitive bids: Accepted in full up to $1 million at the highest discount rate of accepted competitive bids.
Foreign and International Monetary Authority (FIMA) bids: Noncompetitive bids submitted through the Federal Reserve Banks as agents for FIMA accounts. Accepted in order of size from smallest to largest with no more than $100 million awarded per account. The total noncompetitive amount awarded to Federal Reserve Banks as agents for FIMA accounts will not exceed $1,000 million. A single bid that would cause the limit to be exceeded will be partially accepted in the amount that brings the aggregate award total to the $1,000 million limit. However, if there are two or more bids of equal amounts that would cause the limit to be exceeded, each will be prorated to avoid exceeding the limit.
Competitive bids:
(1) Must be expressed as a discount rate with three decimals in increments of .005%, e.g., 4.215%.
(2) Net long position (NLP) for each bidder must be reported when the sum of the total bid amount, at all discount rates, and the net long position equals or exceeds the NLP reporting threshold stated above.
(3) Net long position must be determined as of one half-hour prior to the closing time for receipt of competitive tenders.

Receipt of Tenders:
Noncompetitive tenders:
Prior to 12:00 noon eastern standard time on auction day
Competitive tenders:
Prior to 1:00 p.m. eastern standard time on auction day

Payment Terms: By charge to a funds account at a Federal Reserve Bank on issue date.

PRESS ROOM



FROM THE OFFICE OF PUBLIC AFFAIRS

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December 17, 2002
PO-3698

TREASURY ISSUES FINAL REGULATIONS REGARDING THIRD-PARTY CONTACTS

Today the Treasury Department issued final regulations regarding the requirement in section 7602(c) that the IRS notify a taxpayer both before the IRS contacts third parties in connection with an examination or collection of the taxpayer's tax liability and after such third-party contacts are made (i.e., a report generally containing the names of the persons actually contacted by the IRS).

"The final regulations clarify the rules under which the IRS will notify taxpayers of third-party contacts," stated Treasury Assistant Secretary for Tax Policy Pam Olson.

This requirement, enacted as part of RRA 1998, is intended to help protect a taxpayer's reputation and business interests by giving the taxpayer notice that third parties might be contacted. At the same time, Congress recognized the privacy interests of third parties and the IRS' responsibility to administer the internal revenue laws effectively. The final regulations balance these important considerations.

Related Documents:

- The Text of the Final Regulations

[4830-01-u]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 301

[REG-104906-99]

RIN 1545-AX04

Third Party Contacts

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations providing guidance on third-party contacts made with respect to the determination or collection of tax liabilities. The regulations reflect changes to section 7602 of the Internal Revenue Code made by section 3417 of the Internal Revenue Service Restructuring and Reform Act of 1998. The regulations potentially affect all taxpayers whose Federal tax liabilities are being determined or collected by the IRS.

DATES: Effective Dates: These regulations are effective on [the date final regulations are published in the Federal Register].

Applicability Dates: For the date of applicability, see section 301.7602-2(g).

FOR FURTHER INFORMATION CONTACT: Robert A. Miller, 202-622-3630 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

Section 3417 of the IRS Restructuring and Reform Act of 1998 (RRA 1998), Pub. L. No. 105-206 (112 Stat. 685), amended section 7602 by adding section 7602(c). This provision prohibits IRS officers and employees from contacting any person, other than the taxpayer, with respect to the determination or collection of the taxpayer's liability without giving the taxpayer reasonable advance notice that contacts with persons other than the taxpayer may be made.

On January 2, 2001, the IRS published in the Federal Register a notice of proposed rulemaking (66 FR 32479) to interpret and implement I.R.C. § 7602(c). Two written comments were received but a public hearing was not held. The proposed regulations, as revised by this Treasury decision, are substantially adopted.

As described more fully in the preamble to the proposed regulations, the final regulations balance a taxpayer's business and reputational interests with third parties' privacy interests and the IRS' responsibility to administer the internal revenue laws effectively. By providing general pre-contact notice followed by post-contact identification, these final regulations enable a taxpayer to come forward with information required by the IRS before third parties are contacted. The taxpayer's business and reputational interests therefore can be addressed without impeding the IRS' ability to make those third-party contacts that are necessary to administer the internal revenue laws.

These final regulations do not finalize the provisions in the proposed regulations regarding periodic reports. Subsequent to the issuance of the proposed regulations, the IRS determined that the issuance of periodic reports may result in harm to third parties and, accordingly, has determined that periodic reports should not be issued. Taxpayers will continue to receive pre-contact notice and may specifically request from the IRS reports of persons contacted.

Comments on the Proposed Regulations

Section 301.7602-2(e)(3)(ii)–Post Contact Reports–The proposed regulations provided that for contacts with the employees, officers, or fiduciaries of any entity who are acting within the scope of their employment or relationship, it is sufficient to record the entity as the person contacted.

One commentator noted that there may be situations where the name of a specific employee of a business should be recorded and made available to the taxpayer. The commentator suggests adopting a "safe harbor" rule that requires that the name of the party contacted be recorded whenever there is any doubt about how the contact should be recorded. The commentator stated that whenever an employee of a business is contacted due to his or her personal knowledge or business relationship with the taxpayer, the name of the specific employee contacted should be recorded in the contact record rather than (or in addition to) the name of the business entity.

This comment has not been adopted in the final regulations. The final regulations do not prevent IRS employees from providing more than the name of the entity in the record of contact when an employee of a business is contacted. Because the information being

sought typically is that of the entity, and not of any specific employee outside of their capacity as an employee, requiring the identification of the specific employees contacted is not required to provide notice to the taxpayer of the contact made and may impede the IRS' ability to obtain information from the entity.

Section 301.7602-2(f)(3)–Reprisal Exception–The proposed regulations provided that a statement by the person contacted that harm may occur is good cause for the IRS to believe that reprisal may occur. Such contacts are not reported by the IRS to the taxpayer.

One commentator asserted that the proposed regulations are inconsistent with the statute's origin and purpose because the proposed regulations (i) subordinate the rights given to taxpayers to the rights of third parties and the IRS; (ii) provide an insufficient threshold for determining whether good cause exists to conclude that reprisal may occur; (iii) permit a third party to express concerns that providing notice to the taxpayer may result in reprisal against another person; (iv) permit the IRS to make a reprisal determination based upon information obtained from any source; and (v) permit the IRS to make a reprisal determination without peer or supervisory review. In brief, the commentator argued that the scope of what would be considered reprisal is too broad and that the determination of when reprisal would be considered to exist is too lenient. The commentator claimed that the adoption of the proposed regulations would render the requirement in section 7602(c) to provide taxpayers with a record of persons contacted a nullity.

The Treasury Department and the IRS do not agree that the proposed regulations are either too broad with respect to what will be considered reprisal or too permissive with respect to the determination of whether the potential for reprisal exists. As a general

matter, by including a reprisal exception to the notice requirements of section 7602(c), Congress recognized that the rights of taxpayers to receive notice of third-party contacts must be balanced with the rights of third parties to be free from adverse consequences that may result from the IRS providing such notice. The reprisal exception reflects Congress' determination that a taxpayer's right to know whom the IRS has contacted is outweighed by a third party's right to be free from any reprisal. Moreover, since the statute's effective date, the IRS has been operating under reprisal procedures consistent with the proposed regulations. Based upon the small number of reprisal concerns expressed to date, the Treasury Department and the IRS believe that the final regulations, which make no change to the proposed regulations with respect to this issue, appropriately balance the competing interests reflected in the statute and will not render section 7602(c)(2) a nullity.

More specifically, the Treasury Department and the IRS believe that a third party is in the best position to evaluate its relationship with a taxpayer and the potential for reprisal if a contact with that third party is reported by the IRS to the taxpayer. Requiring the IRS to investigate each claim of potential reprisal, including supervisory review of a reprisal determination, would place a heavy administrative burden on the IRS and, more importantly, would intrude into the third party's affairs and require IRS employees to make judgments that they are not well positioned to make. For these reasons, the final regulations do not adopt the "probable cause" standard suggested by the commentator. In addition, the rights provided to a taxpayer under section 7602(c) (i.e., prior notice that contacts with third parties may be made and a record of persons contacted) cannot be

equated with a person's Fourth Amendment right to be free from unreasonable searches and seizures.

In addition, the statute clearly contemplates that the reprisal exception is not limited to concerns of reprisal against the third party contacted. The reprisal exception applies when providing notice to the taxpayer "may involve reprisal against any person." I.R.C. § 7602(c)(3)(B) (emphasis added). The statutory exception also does not restrict the source of information that can be used in making a reprisal determination. In certain cases, an IRS employee may be in possession of information that is unknown to the third party contacted but which suggests that reprisal may occur against another person if the contact with the third party is reported to the taxpayer.

Finally, limiting the reprisal exception to physical harm would be inconsistent with the statute and Congress' clear concern that third parties be free from adverse consequences as a result of being contacted by the IRS regarding a taxpayer's liability. Congress did not define or limit the kind of reprisal situations with which it was concerned. Excluding economic, emotional, or other types of harm would significantly diminish the third-party protections provided by the reprisal exception.

Modifications of Proposed Regulations

Section 301.7602-2(c)(1)(i)–The proposed regulations stated that for purposes of section 7602(c), an IRS employee includes, inter alia, a person who, through a written agreement with the IRS, is subject to disclosure restrictions consistent with section 6103. The final regulations provide that an IRS employee includes a person described in section 6103(n), an officer or employee of such person, and a person who is subject to disclosure

restrictions pursuant to a written agreement in connection with the solicitation of an agreement described in section 6103(n) and its implementing regulations. This change was made to provide a legally precise statement of the rule and to clarify that persons who provide tax administration services to the IRS and who enter into nondisclosure agreements with the IRS, as well as prospective bidders who enter into nondisclosure agreements, are treated as IRS employees for purposes of section 7602(c).

Section 301.7602-2(c)(1)(ii) Example 3–The regulations provide that returning unsolicited telephone calls or speaking with persons other than the taxpayer as part of an attempt to speak to the taxpayer are not initiations of third-party contacts. This provision is illustrated by Example 3, where a revenue agent trying to contact the taxpayer to discuss the taxpayer's pending examination twice calls the taxpayer's place of business. The first call is answered by a receptionist, and the second call is answered by the office answering machine. The example in the regulations states that in both situations the employee leaves a message "stating only his name, telephone number, that he is with the IRS, and asks that the taxpayer call him." The phrase "that he is with the IRS" has been deleted from the example in the final regulations because there may be situations where it would be inappropriate for an IRS employee to identify his or her employer in a telephone conversation or message that can be seen or heard by persons other than the taxpayer. See I.R.C. § 6304(b)(4).

Section 301.7602-2(c)(3)(ii)–The final regulations add Examples 6(a) and 6(b) to illustrate the application of the third-party contact rules to audits of TEFRA partnerships. Section 30

another statute, regulation or administrative procedure. The proposed regulations provide

that the Collection Due Process (CDP) notice furnished under section 6330 and its regulations is an example of a situation where the pre-contact notice requirement is fulfilled by another notice. The final regulations modify the proposed regulations to clarify that CDP notices sent to taxpayers pursuant to section 6330 and its regulations constitute reasonable advance notice that contacts with third parties may be made for purposes of effectuating a levy.

Section 301.7602-2(f)(7)–The final regulations add examples to illustrate the application of the nonadministrative contacts exception.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. Likewise, section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to this regulation, 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, the notice of proposed rulemaking was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Charles B. Christopher of the Office of Associate Chief Counsel, Procedure & Administration (Collection, Bankruptcy & Summonses Division).

List of Subjects in 26 CFR Part 301

Employment taxes, Estate taxes, Excise taxes, Gift taxes, Income taxes, Penalties, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 301 is amended as follows:

PART 301--PROCEDURES AND ADMINISTRATION

Par. 1. The authority citation for part 301 continues to read in part as follows:

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

Par. 2. Section 301.7602-2 is added to read as follows:

§301.7602-2 Third party contacts.

(a) In general. Subject to the exceptions in paragraph (f) of this section, no officer or employee of the Internal Revenue Service may contact any person other than the taxpayer with respect to the determination or collection of such taxpayer's tax liability without giving the taxpayer reasonable notice in advance that such contacts may be made. A record of persons so contacted must be made and given to the taxpayer upon the taxpayer's request.

(b) Third-party contact defined. Contacts subject to section 7602(c) and this regulation shall be called "third-party contacts." A third-party contact is a communication which--

(1) Is initiated by an IRS employee;

(2) Is made to a person other than the taxpayer;

(3) Is made with respect to the determination or collection of the tax liability of such taxpayer;

(4) Discloses the identity of the taxpayer being investigated; and

(5) Discloses the association of the IRS employee with the IRS.

(c) Elements of third-party contact explained. (1) Initiation by an IRS employee-- (i) Explanation. (A) Initiation. An IRS employee initiates a communication whenever it is the employee who first tries to communicate with a person other than the taxpayer. Returning unsolicited telephone calls or speaking with persons other than the taxpayer as part of an attempt to speak to the taxpayer are not initiations of third-party contacts.

(B) IRS employee. For purposes of this section, an IRS employee includes all officers and employees of the IRS, the Chief Counsel of the IRS and the National Taxpayer Advocate, as well as a person described in section 6103(n), an officer or employee of such person, or a person who is subject to disclosure restrictions pursuant to a written agreement in connection with the solicitation of an agreement described in section 6103(n) and its implementing regulations. No inference about the employment or contractual relationship of such other persons with the IRS may be drawn from this regulation for any purpose other than the requirements of section 7602(c).

(ii) Examples. The following examples illustrate this paragraph (c)(1):

Example 1. An IRS employee receives a message to return an unsolicited call. The employee returns the call and speaks with a person who reports information about a taxpayer who is not meeting his tax responsibilities. Later, the employee makes a second call to the person and asks for more information. The first call is not a contact initiated by an IRS employee. Just because the employee must return the call does not change the fact that it is the other person, and not the employee, who initiated the contact. The second call, however, is initiated by the employee and so meets the first element.

Example 2. An IRS employee wants to hire an appraiser to help determine the value of a taxpayer's oil and gas business. At the initial interview, the appraiser signs an agreement that prohibits him from disclosing return information of the taxpayer except as

allowed by the agreement. Once hired, the appraiser initiates a contact by calling an industry expert in Houston and discusses the taxpayer's business. The IRS employee's contact with the appraiser does not meet the first element of a third-party contact because the appraiser is treated, for section 7602(c) purposes only, as an employee of the IRS. For the same reason, however, the appraiser's call to the industry expert does meet the first element of a third-party contact.

Example 3. A revenue agent trying to contact the taxpayer to discuss the taxpayer's pending examination twice calls the taxpayer's place of business. The first call is answered by a receptionist who states that the taxpayer is not available. The IRS employee leaves a message with the receptionist stating only his name and telephone number, and asks that the taxpayer call him. The second call is answered by the office answering machine, on which the IRS employee leaves the same message. Neither of these phone calls meets the first element of a third-party contact because the IRS employee is trying to initiate a communication with the taxpayer and not a person other than the taxpayer. The fact that the IRS employee must either speak with a third party (the receptionist) or leave a message on the answering machine, which may be heard by a third party, does not mean that the employee is initiating a communication with a person other than the taxpayer. Both the receptionist and the answering machine are only intermediaries in the process of reaching the taxpayer.

(2) Person other than the taxpayer--(i) Explanation. The phrases "person other than the taxpayer" and "third party" are used interchangeably in this section, and do not include--

(A) An officer or employee of the IRS, as defined in paragraph (c)(1)(i)(B) of this section, acting within the scope of his or her employment;

(B) Any computer database or web site regardless of where located and by whom maintained, including databases or web sites maintained on the Internet or in county courthouses, libraries, or any other real or virtual site; or

(C) A current employee, officer, or fiduciary of a taxpayer when acting within the scope of his or her employment or relationship with the taxpayer. Such employee, officer, or fiduciary shall be conclusively presumed to be acting within the scope of his or her employment or relationship during business hours on business premises.

(ii) Examples: The following examples illustrate this paragraph (c)(2):

Example 1. A revenue agent examining a taxpayer's return speaks with another revenue agent who has previously examined the same taxpayer about a recurring issue. The revenue agent has not contacted a "person other than the taxpayer" within the meaning of section 7602(c).

Example 2. A revenue agent examining a taxpayer's return speaks with one of the taxpayer's employees on business premises during business hours. The employee is conclusively presumed to be acting within the scope of his employment and is therefore not a "person other than the taxpayer" for section 7602(c) purposes.

Example 3. A revenue agent examining a corporate taxpayer's return uses a commercial online research service to research the corporate structure of the taxpayer. The revenue agent uses an IRS account, logs on with her IRS user name and password, and uses the name of the corporate taxpayer in her search terms. The revenue agent later explores several Internet web sites that may have information relevant to the examination. The searches on the commercial online research service and Internet web sites are not contacts with "persons other than the taxpayer."

(3) With respect to the determination or collection of the tax liability of such taxpayer--(i) Explanation. (A) With respect to. A contact is "with respect to" the determination or collection of the tax liability of such taxpayer when made for the purpose of either determining or collecting a particular tax liability and when directly connected to that purpose. While a contact made for the purpose of determining a particular taxpayer's tax liability may also affect the tax liability of one or more other taxpayers, such contact is not for that reason alone a contact "with respect to" the determination or collection of those other taxpayers' tax liabilities. Contacts to determine the tax status of a pension plan under Chapter 1, Subchapter D (Deferred Compensation), are not "with respect to" the determination of plan participants' tax liabilities. Contacts to determine the tax status of a bond issue under Chapter 1, Subchapter B, Part IV (Tax Exemption Requirements for State and Local Bonds), are not "with respect to" the determination of the bondholders' tax

liabilities. Contacts to determine the tax status of an organization under Chapter 1, Subchapter F (Exempt Organizations), are not "with respect to" the determination of the contributors' liabilities, nor are any similar determinations "with respect to" any persons with similar relationships to the taxpayer whose tax liability is being determined or collected.

(B) Determination or collection. A contact is with respect to the "determination or collection" of the tax liability of such taxpayer when made during the administrative determination or collection process. For purposes of this paragraph (c) only, the administrative determination or collection process may include any administrative action to ascertain the correctness of a return, make a return when none has been filed, or determine or collect the tax liability of any person as a transferee or fiduciary under Chapter 71 of title 26.

(C) Tax liability. A "tax liability" means the liability for any tax imposed by Title 26 of the United States Code (including any interest, additional amount, addition to the tax, or penalty) and does not include the liability for any tax imposed by any other jurisdiction nor any liability imposed by other federal statutes.

(D) Such taxpayer. A contact is with respect to the determination or collection of the tax liability of "such taxpayer" when made while determining or collecting the tax liability of a particular, identified taxpayer. Contacts made during an investigation of a particular, identified taxpayer are third-party contacts only as to the particular, identified taxpayer under investigation and not as to any other taxpayer whose tax liabilities might be affected by such contacts.

(ii) Examples. The following examples illustrate the operation of this paragraph (c)(3):

Example 1. As part of a compliance check on a return preparer, an IRS employee visits the preparer's office and reviews the preparer's client files to ensure that the proper forms and records have been created and maintained. This contact is not a third-party contact "with respect to" the preparer's clients because it is not for the purpose of determining the tax liability of the preparer's clients, even though the agent might discover information that would lead the agent to recommend an examination of one or more of the preparer's clients.

Example 2. A revenue agent is assigned to examine a taxpayer's return, which was prepared by a return preparer. As in all such examinations, the revenue agent asks the taxpayer routine questions about what information the taxpayer gave the preparer and what advice the preparer gave the taxpayer. As a result of the examination, the revenue agent recommends that the preparer be investigated for penalties under section 6694 or 6695. Neither the examination of the taxpayer's return nor the questions asked of the taxpayer are "with respect to" the determination of the preparer's tax liabilities within the meaning of section 7602(c) because the purpose of the contacts was to determine the taxpayer's tax liability, even though the agent discovered information that may result in a later investigation of the preparer.

Example 3. To help identify taxpayers in the florist industry who may not have filed proper returns, an IRS employee contacts a company that supplies equipment to florists and asks for a list of its customers in the past year in order to cross-check the list against filed returns. The employee later contacts the supplier for more information about one particular florist who the employee believes did not file a proper return. The first contact is not a contact with respect to the determination of the tax liability of "such taxpayer" because no particular taxpayer has been identified for investigation at the time the contact is made. The later contact, however, is with respect to the determination of the tax liability of "such taxpayer" because a particular taxpayer has been identified. The later contact is also "with respect to" the determination of that taxpayer's liability because, even though no examination has been opened on the taxpayer, the information sought could lead to an examination.

Example 4. A revenue officer, trying to collect the trust fund portion of unpaid employment taxes of a corporation, begins to investigate the liability of two corporate officers for the section 6672 Trust Fund Recovery Penalty (TFRP). The revenue officer obtains the signature cards for the corporation's bank accounts from the corporation's bank. The contact with the bank to obtain the signature cards is a contact with respect to the determination of the two identified corporate officers' tax liabilities because it is directly connected to the purpose of determining a tax liability of two identified taxpayers. It is not,

however, a contact with respect to any other person not already under investigation for TFRP liability, even though the signature cards might identify other potentially liable persons.

Example 5. The IRS is asked to rule on whether a certain pension plan qualifies under section 401 so that contributions to the pension plan are excludable from the employees' incomes under section 402 and are also deductible from the employer's income under section 404. Contacts made with the plan sponsor (and with persons other than the plan sponsor) are not contacts "with respect to" the determination of the tax liabilities of the pension plan participants because the purpose of the contacts is to determine the status of the plan, even though that determination may affect the participants' tax liabilities.

Example 6(a). The IRS audits a TEFRA partnership at the partnership (entity) level pursuant to sections 6221 through 6233. The tax treatment of partnership items is at issue, but the respective tax liabilities of the partners may be affected by the results of the TEFRA partnership audit. With respect to the TEFRA partnership, contacts made with employees of the partnership acting within the scope of their duties or any partner are not section 7602(c) contacts because they are considered the equivalent of contacting the partnership. Contacts relating to the tax treatment of partnership items made with persons other than the employees of the partnership who are acting within the scope of their duties or the partners are section 7602(c) contacts with respect to the TEFRA partnership, and reasonable advance notice should be provided by sending the appropriate Letter 3164 to the partnership's tax matters partner (TMP). Individual partners who are merely affected by the partnership audit but who are not identified as subject to examination with respect to their individual tax liabilities need not be sent Letters 3164.

Example 6(b). In the course of an audit of a TEFRA partnership at the partnership (entity) level, the IRS intends to contact third parties regarding transactions between the TEFRA partnership and specific, identified partners. In addition to the partnership's TMP, the specific, identified partners should also be provided advance notice of any third-party contacts relating to such transactions.

(4) Discloses the identity of the taxpayer being investigated--(i) Explanation. An IRS employee discloses the taxpayer's identity whenever the employee knows or should know

that the person being contacted can readily ascertain the taxpayer's identity from the information given by the employee.

(ii) Examples. The following examples illustrate this paragraph (c)(4):

Example 1. A revenue agent seeking to value the taxpayer's condominium calls a real estate agent and asks for a market analysis of the taxpayer's condominium, giving the unit number of the taxpayer's condominium. The revenue agent has revealed the identity of the taxpayer, regardless of whether the revenue agent discloses the name of the taxpayer, because the real estate agent can readily ascertain the taxpayer's identity from the address given.

Example 2. A revenue officer seeking to value the taxpayer's condominium calls a real estate agent and, without identifying the taxpayer's unit, asks for the sales prices of similar units recently sold and listing prices of similar units currently on the market. The revenue officer has not revealed the identity of the taxpayer because the revenue officer has not given any information from which the real estate agent can readily ascertain the taxpayer's identity.

(5) Discloses the association of the IRS employee with the IRS. An IRS employee discloses his association with the IRS whenever the employee knows or should know that the person being contacted can readily ascertain the association from the information given by the employee.

(d) Pre-contact notice--(1) In general. An officer or employee of the IRS may not make third-party contacts without providing reasonable notice in advance to the taxpayer that contacts may be made. The pre-contact notice may be given either orally or in writing. If written notice is given, it may be given in any manner that the IRS employee responsible for giving the notice reasonably believes will be received by the taxpayer in advance of the third-party contact. Written notice is deemed reasonable if it is--

(i) Mailed to the taxpayer's last known address;

(ii) Given in person;

(iii) Left at the taxpayer's dwelling or usual place of business; or

(iv) Actually received by the taxpayer.

(2) Pre-contact notice not required. Pre-contact notice under this section need not be provided to a taxpayer for third-party contacts of which advance notice has otherwise been provided to the taxpayer pursuant to another statute, regulation or administrative procedure. For example, Collection Due Process notices sent to taxpayers pursuant to section 6330 and its regulations constitute reasonable advance notice that contacts with third parties may be made in order to effectuate a levy.

(e) Post-contact reports--(1) Requested reports. A taxpayer may request a record of persons contacted in any manner that the Commissioner reasonably permits. The Commissioner may set reasonable limits on how frequently taxpayer requests need be honored. The requested report may be mailed either to the taxpayer's last known address or such other address as the taxpayer specifies in the request.

(2) Contents of record--(i) In general. The record of persons contacted should contain information, if known to the IRS employee making the contact, which reasonably identifies the person contacted. Providing the name of the person contacted fully satisfies the requirements of this section, but this section does not require IRS employees to solicit identifying information from a person solely for the purpose of the post-contact report. The record need not contain any other information, such as the nature of the inquiry or the content of the third party's response. The record need not report multiple contacts made with the same person during a reporting period.

(ii) Special rule for employees. For contacts with the employees, officers, or fiduciaries of any entity who are acting within the scope of their employment or relationship, it is sufficient to record the entity as the person contacted. A fiduciary, officer or employee shall be conclusively presumed to be acting within the scope of his employment or relationship during business hours on business premises. For purposes of this paragraph (e)(2)(ii), the term "entity" means any business (whether operated as a sole proprietorship, disregarded entity under section 301.7701-2 of the regulations, or otherwise), trust, estate, partnership, association, company, corporation, or similar organization.

(3) Post-contact record not required. A post-contact record under this section need not be made, or provided to a taxpayer, for third-party contacts of which the taxpayer has already been given a similar record pursuant to another statute, regulation, or administrative procedure.

(4) Examples. The following examples illustrate this paragraph (e):

Example 1. An IRS employee trying to find a specific taxpayer's assets in order to collect unpaid taxes talks to the owner of a marina. The employee asks whether the taxpayer has a boat at the marina. The owner gives his name as John Doe. The employee may record the contact as being with John Doe and is not required by this regulation to collect or record any other identifying information.

Example 2. An IRS employee trying to find a specific taxpayer and his assets in order to collect unpaid taxes talks to a person at 502 Fernwood. The employee asks whether the taxpayer lives next door at 500 Fernwood, as well as where the taxpayer works, what kind of car the taxpayer drives and whether the camper parked in front of 500 Fernwood belongs to the taxpayer. The person does not disclose his name. The employee may record the contact as being with a person at 502 Fernwood. If the employee then makes the same inquiries of another person on the street in front of 500 Fernwood, and does not learn that person's name, the latter contact may be reported as being with a person on the street in front of 500 Fernwood.

Example 3. An IRS employee examining a return obtains loan documents from a bank where the taxpayer applied for a loan. After reviewing the documents, the employee talks with the loan officer at the bank who handled the application. The employee has contacted only one "person other than the taxpayer." The bank and not the loan officer is the "person other than the taxpayer" for section 7602(c) purposes. The contact with the loan officer is treated as a contact with the bank because the loan officer was an employee of the bank and was acting within the scope of her employment with the bank.

Example 4. An IRS employee issues a summons to a third party with respect to the determination of a taxpayer's liability and properly follows the procedures for such summonses under section 7609, which requires that a copy of the summons be given to the taxpayer. This third-party contact need not be maintained in a record of contacts available to the taxpayer because providing a copy of the third-party summons to the taxpayer pursuant to section 7609 satisfies the post-contact recording and reporting requirement of this section.

Example 5. An IRS employee serves a levy on a third party with respect to the collection of a taxpayer's liability. The employee provides the taxpayer with a copy of the notice of levy form that shows the identity of the third party. This third-party contact need not be maintained in a record of contacts available to the taxpayer because providing a copy of the notice of levy to the taxpayer satisfies the post-contact recording and reporting requirement of this section.

(f) Exceptions. (1) Authorized by taxpayer--(i) Explanation. Section 7602(c) does not apply to contacts authorized by the taxpayer. A contact is "authorized" within the meaning of this section if--

(A) The contact is with the taxpayer's authorized representative, that is, a person who is authorized to speak or act on behalf of the taxpayer, such as a person holding a power of attorney, a corporate officer, a personal representative, an executor or executrix, or an attorney representing the taxpayer; or

(B) The taxpayer or the taxpayer's authorized representative requests or approves the contact.

(ii) No prevention or delay of contact. This section does not entitle any person to prevent or delay an IRS employee from contacting any individual or entity.

(2) Jeopardy--(i) Explanation. Section 7602(c) does not apply when the IRS employee making a contact has good cause to believe that providing the taxpayer with either a general pre-contact notice or a record of the specific person contacted may jeopardize the collection of any tax. For purposes of this section only, good cause includes a reasonable belief that providing the notice or record will lead to--

(A) Attempts by any person to conceal, remove, destroy, or alter records or assets that may be relevant to any tax examination or collection activity;

(B) Attempts by any person to prevent other persons, through intimidation, bribery, or collusion, from communicating any information that may be relevant to any tax examination or collection activity; or

(C) Attempts by any person to flee, or otherwise avoid testifying or producing records that may be relevant to any tax examination or collection activity.

(ii) Record of contact. If the circumstances described in this paragraph (f)(2) exist, the IRS employee must still make a record of the person contacted, but the taxpayer need not be provided the record until it is no longer reasonable to believe that providing the record would cause the jeopardy described.

(3) Reprisal--(i) In general. Section 7602(c) does not apply when the IRS employee making a contact has good cause to believe that providing the taxpayer with either a general pre-contact notice or a specific record of the person being contacted may cause any person to harm any other person in any way, whether the harm is physical, economic,

emotional or otherwise. A statement by the person contacted that harm may occur against any person is sufficient to constitute good cause for the IRS employee to believe that reprisal may occur. The IRS employee is not required to further question the contacted person about reprisal or otherwise make further inquiries regarding the statement.

(ii) Examples. The following examples illustrate this paragraph (f)(3):

Example 1. An IRS employee seeking to collect unpaid taxes is told by the taxpayer that all the money in his and his brother's joint bank account belongs to the brother. The IRS employee contacts the brother to verify this information. The brother refuses to confirm or deny the taxpayer's statement. He states that he does not believe that reporting the contact to the taxpayer would result in harm to anyone but further states that he does not want his name reported to the taxpayer because it would appear that he gave information. This contact is not excepted from the statute merely because the brother asks that his name be left off the list of contacts.

Example 2. Assume the same facts as in Example 1, except that the brother states that he fears harm from the taxpayer should the taxpayer learn of the contact, even though the brother gave no information. This contact is excepted from the statute because the third party has expressed a fear of reprisal. The IRS employee is not required to make further inquiry into the nature of the brothers' relationship or otherwise question the brother's fear of reprisal.

Example 3. An IRS employee is examining a joint return of a husband and wife, who recently divorced. From reading the court divorce file, the IRS employee learns that the divorce was acrimonious and that the ex-husband once violated a restraining order issued to protect the ex-wife. This information provides good cause for the IRS employee to believe that reporting contacts which might disclose the ex-wife's location may cause reprisal against any person. Therefore, when the IRS employee contacts the ex-wife's new employer to verify salary information provided by the ex-wife, the IRS employee has good cause not to report that contact to the ex-husband, regardless of whether the new employer expresses concern about reprisal against it or its employees.

(4) Pending criminal investigations--(i) IRS criminal investigations. Section 7602(c) does not apply to contacts made during an investigation, or inquiry to determine whether to open an investigation, when the investigation or inquiry is--

(A) Made against a particular, identified taxpayer for the primary purpose of evaluating the potential for criminal prosecution of that taxpayer; and

(B) Made by an IRS employee whose primary duties include either identifying or investigating criminal violations of the law.

(ii) Other criminal investigations. Section 7602(c) does not apply to contacts which, if reported to the taxpayer, could interfere with a known pending criminal investigation being conducted by law enforcement personnel of any local, state, federal, foreign or other governmental entity.

(5) Governmental entities. Section 7602(c) does not apply to any contact with any office of any local, state, federal or foreign governmental entity except for contacts concerning the taxpayer's business with the government office contacted, such as the taxpayer's contracts with or employment by the office. The term "office" includes any agent or contractor of the office acting in such capacity.

(6) Confidential informants. Section 7602(c) does not apply when the employee making the contact has good cause to believe that providing either the pre-contact notice or the record of the person contacted would identify a confidential informant whose identity would be protected under section 6103(h)(4).

(7) Nonadministrative contacts--(i) Explanation. Section 7602(c) does not apply to contacts made in the course of a pending court proceeding.

(ii) Examples. The following examples illustrate this paragraph (f)(7):

Example 1. An attorney for the Office of Chief Counsel needs to contact a potential witness for an upcoming Tax Court proceeding involving the 1997 and 1998 taxable

years of the taxpayer. Section 7602(c) does not apply because the contact is being made in the course of a pending court proceeding.

Example 2. While a Tax Court case is pending with respect to a taxpayer's 1997 and 1998 income tax liabilities, a revenue agent is conducting an examination of the taxpayer's excise tax liabilities for the fiscal year ending 1999. Any third-party contacts made by the revenue agent with respect to the excise tax liabilities would be subject to the requirements of section 7602(c) because the Tax Court proceeding does not involve the excise tax liabilities.

Example 3. A taxpayer files a Chapter 7 bankruptcy petition and receives a discharge. A revenue officer contacts a third party in order to determine whether the taxpayer has any exempt assets against which the IRS may take collection action to enforce its federal tax lien. At the time of the contact, the bankruptcy case has not been closed. Although the bankruptcy proceeding remains pending, the purpose of this contact relates to potential collection action by the IRS, a matter not before or related to the bankruptcy court proceeding.

(g) Effective Date. This section is applicable on the date the final regulations are published in the **Federal Register**.

Assistant Deputy Commissioner of Internal Revenue

Secretary of the Treasury

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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December 18, 2002
PO-3699

Treasury Issues Proposed Capitalization Regs

Today, the Treasury Department issued proposed regulations on capitalizing costs incurred in acquiring, creating or enhancing intangible assets. In January of 2002, the Treasury Department and the IRS released an advance notice of proposed rulemaking requesting comments on rules expected to be contained in the proposed regulations. The proposed regulations generally follow the rules described in the advance notice.

"Uncertainty regarding the proper treatment of amounts spent that result in intangible assets has caused significant controversy between taxpayers and the IRS in recent years," stated Treasury Assistant Secretary for Tax Policy Pam Olson. "The proposed regulations are an important step to clear and administrable rules that will allow taxpayers to compute their tax liability properly and the IRS to administer the law efficiently and fairly. The rules in the proposed regulations will reduce uncertainty and controversy in this area, freeing up both IRS and taxpayer resources for more productive activities."

To clarify the application of section 263(a) of the Internal Revenue Code, the proposed regulations describe specific categories of expenditures incurred in acquiring, creating, or enhancing intangible assets that taxpayers are required to capitalize. Expenditures incurred in acquiring, creating or enhancing intangible assets that are not described in the proposed regulations are not required to be capitalized under section 263(a); however, such expenditures may need to be capitalized under another provision of the Code.

To reduce the administrative and compliance costs associated with section 263(a), the proposed regulations provide safe harbors and simplifying assumptions permitting the current deduction of certain costs and significantly reducing taxpayers' record-keeping burden. They include (i) a "12 month" rule, covering costs for certain intangible assets with relatively short useful lives, (ii) "de minimis" rules, covering certain costs less than a specified dollar amount, (iii) an employee compensation rule, covering salaries, bonuses, and commissions paid to employees, and (iv) an overhead rule, covering fixed and variable overhead costs.

In addition, the regulations propose a 15-year safe harbor amortization period for certain created intangible assets that do not have a readily ascertainable useful life. The proposed regulations also explain how taxpayers may deduct debt issuance costs. Comments are requested from the public regarding all of these rules.

Related Documents:

- Guidance Regarding Deduction and Capitalization of Expenditures

Capital Access Programs

A Summary of Nationwide Performance

Department of the Treasury
(Updated) October 1999

CAPITAL ACCESS PROGRAMS:
A Summary of Nationwide Performance

Department of the Treasury
November 1999

This report is available on-line at http://www.ustreas.gov/reports/cap.pdf.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

November 1, 1999

UNDER SECRETARY

Dear Friend:

Since 1986, when Michigan first developed the Capital Access Program (CAP) as a method to increase the availability of credit to small businesses, many states have gradually enacted CAPs of their own. In fact, by the end of 1998, the nationwide cumulative CAP lending was approximately $1.2 billion.

Under the leadership of former Secretary Robert E. Rubin and now under Secretary Lawrence H. Summers, the Treasury Department has undertaken a series of initiatives to expand access to capital and encourage business investment in economically distressed communities. We compiled this report in order to assess the reach of CAPs and to explore the features that contribute to their success.

This report, Capital Access Programs: Nationwide Financial Performance, reviews the following areas:

- nationwide CAP lending statistics through 1998 from the 19 states and 2 municipalities that operate CAPs;
- CAP lending performance through 1998 to underserved communities;
- lessons learned from states' CAPs.

I hope that this report will contribute to greater understanding of CAPs' performance and their future potential as a tool to foster a vibrant small business financing market.

I'd like to thank Cliff Kellogg, the principal author of this report, and acknowledge the research assistance he received from Jim O'Connor, Alan Berube, and Greg Zucca. If you have any questions, please contact Michael Barr, Deputy Assistant Secretary (Community Development Policy) at (202) 622-0016.

Sincerely,

Gary Gensler
Under Secretary
Domestic Finance

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Executive Summary

In March, 1999, the Treasury Department's Community Development Policy Office compiled this report summarizing the performance of state-level Capital Access Programs (CAPs) based on a survey of the states with such programs. This report is the second national review[1] to compile and assess:

- nationwide CAP lending statistics through 1998 from the 19 states and 2 municipalities that operate CAPs;
- CAP lending performance through 1998 to targeted groups of borrowers such as those in low- and moderate-income communities;
- lessons learned from states' CAPs.

The 13-year track record of state-run CAPs suggests that these programs encourage small business lending in a cost-efficient and simple way. Under CAPs, the bank and the borrower pay an up-front insurance premium, typically between 3% and 7% of the loan amount at the bank's discretion, which goes into a reserve fund held at the originating bank. The state matches the combined bank and borrower contribution with a deposit into the same reserve fund. The CAP reserve fund allows a lending bank to make slightly higher risk loans than conventional underwriting, with the protection of the reserve fund for its entire pool of CAP loans.

CAPs allow banks to use their own underwriting standards for eligible loans, without governmental approval of the loan-making decision. Compared with the staff intensiveness of other credit enhancement programs, CAPs require little administrative cost for banks, borrowers or the government. States report that CAPs are staffed by 1 to 1.5 full-time equivalents. In most states, almost all small businesses are eligible for the CAP, though some states limit maximum loan sizes and eligible industries. A state's up-front payment of 3%-7% of the loan amount into a bank's CAP reserve fund supports a bank loan that is 14 to 33 times larger than that amount.

Currently, 19 states and 2 cities operate CAPs, with total lending since 1986 of approximately $1.2 billion and a cumulative average loan size of $59,151. For three consecutive years, the CAP dollar volume has increased, from $187 million in 1996, to $202 million in 1997 (8% growth), and to $246 million in 1998 (22% growth). Over 315 banks actively originated loans in 1998. Nationally, cumulative CAP loan losses total $37.7 million, or 3.1% of all loan volume; net of these losses, remaining CAP loan loss reserves amount to $51.9 million, equal to 4.3% of cumulative volume.

In 1998, Louisiana and Florida undertook to create CAPs in their states, with implementation to begin in 1999; West Virginia discontinued its CAP program due to state budget constraints. Ohio announced that it will extend its coverage for CAP beyond Akron to encompass the entire state. Once these programs are launched, CAPs will operate in 22 states and one city.

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1 *The Treasury Department published the first report, Capital Access Programs: A Summary of Nationwide Performance, in October, 1998.*

Data on CAPs show that CAP loans reach some groups of borrowers not as well served by other credit enhancement programs:

- CAPs reach minority-owned businesses and low- and moderate-income communities in substantial numbers.
- CAP lending retains and creates a significant number of jobs.
- CAPs reach types of businesses, such as building contractors and wholesale trade companies, that are not typically reached by other small business lending programs.
- In some states, CAPs are used significantly for start-up businesses and for working capital, both of which are often cited as needs unsatisfied by the private market without public support.

The survey also revealed key aspects of the largest CAPs. Active marketing to banks appears to be a central feature of large CAPs. Assuring adequate funding for states' CAPs may also increase the volume of lending; even when funding limits are not hit, states that provide insufficient appropriations may discourage both bank participation and full engagement by the state agency administering the program. Similarly, restrictions on maximum loan size or eligible industries may hinder overall program development without demonstrable advantage.

1. Introduction

The expansion of private sector small business lending under CAPs in the 19 states and 2 municipalities currently operating such programs suggests that CAPs provide an innovative way to encourage banks to make loans to a portfolio of individually risky but cumulatively profitable small business loans. CAPs provide financial backing for a bank to make slightly more risky loans than through conventional methods, while still preserving a bank's motivation to underwrite applications rigorously and avoid high losses. CAPs help banks overcome the risks of small business lending by funding a reserve account to cover losses from loans that have defaulted. The risk of the loan is partially subsidized by the state and spread over the portfolio of all CAP loans. CAP loans are not guaranteed, and therefore lenders still bear the ultimate financial risk. However, CAPs have proven helpful in encouraging banks prudently to extend smaller business loans to new customers and, for existing customers, to offer CAP loans in addition to conventional financing.

This report is an update and extension of the October, 1998 report by the Department of the Treasury that summarized financial statistics on nationwide CAP lending and distilled some of the states' best practices. Many of the initial findings from the 1998 report still hold true. This report offers additional information in several areas, including marketing techniques and administrative support, while providing the most up-to-date information on the key CAP statistics. Policymakers and lenders would benefit from a more comprehensive study of CAP job creation impact and the reach of CAP to communities and individuals out of the financial mainstream as well as to particular industries. This report offers a nationwide overview of CAP lending, and we hope it will stimulate further research and discussion.

1.1 How CAPs Work: Program Mechanics

In a CAP, the borrower obtains a loan and loan approval directly from the bank. There is no governmental role in approving or reviewing the application. When making a CAP loan, the bank and borrower pay an up-front insurance premium that, combined, is generally ranges from 3% to 7% of the loan amount. The exact percentage is at the discretion of the individual bank, and in practice, the bank may pass most of its portion of the premium on to the borrower by financing the premium in the loan proceeds. Banks have the discretion to set interest rates on CAP loans as they see fit. In most states, all small businesses are eligible, although some states restrict maximum loan sizes and eligible industries (discussed in more detail later in this report).

The bank holds all of the CAP premiums in a single, pooled reserve account. The bank enrolls the loan by faxing a one- or two-page form to the state, providing the particulars and certifying that it meets program eligibility requirements. The state then deposits a matching amount, most often a one-to-one match, into the originating bank's CAP reserve account. In this way, each bank creates its own funded loan loss reserve to cover a loss on any of its CAP loans. The bank recovers any CAP loan losses by offsetting against the CAP reserve fund it holds. The bank itself must absorb any losses over its accumulated CAP reserve fund.

The state government provides only the up-front matching premium. A few states do provide a start-up credit line to give banks, in effect, an advance of future CAP premiums. This helps a

bank in the event the bank experiences an early CAP loss before the reserve fund has built up enough to absorb the full loss. A bank would then repay the credit line from future CAP premiums. Some states also increase their match rate for loans to targeted borrowers or areas, such as state-designated Enterprise Zones.

CAPs are designed to encourage banks to underwrite loans to a higher risk threshold than conventional lending criteria. Whereas most banks experience loan losses on their traditional loan portfolio of under 0.5% of loan principal outstanding annually, CAPs allow banks to absorb greater losses with its CAP-funded reserve. CAPs thus serve the risk category just slightly outside the scope of traditional bank lending.

1.2 How CAPs Work: Public Policy

The innovative feature of CAPs is the reserve fund that accumulates at each bank. This fund helps the bank to hold and pool its risk, thereby enabling the bank to make profitable loans to small business owners that would otherwise, on an individual basis, be viewed as too risky.

Capital Access Programs have five notable properties as public policy:

- First, CAP loans generally do not appear to "crowd out" loans that the private sector would otherwise make. Borrowers are always able to shop around to see whether another bank would make the loan without requiring the CAP premium. In choosing a CAP loan, borrowers signal that they are unable to find comparable funding elsewhere. Thus, CAPs do not supplant unsubsidized loans made by the private sector but rather make capital available to otherwise sidelined entrepreneurs.[2]

- Second, individual loan decisions in CAPs are made by those with the best information available -- the private parties involved.

- Third, CAPs align the incentives of the borrower, the bank, and the state in the lending process. Private incentives work to encourage CAP loans up to the loss level provided by the reserve fund. Banks may not use the CAP reserve for any purpose other than backing CAP loans. Banks would be disinclined to set the CAP premium too high and thereby miss the opportunity to approve a greater number of profitable loans. At the same time, banks will underwrite CAP loans rigorously, because they must absorb any losses that exceed the CAP reserve account.

- Fourth, the leveraging effect of public funds is large, and the state's investment is certain at the outset. For example, if the state matches a borrower and bank contribution of 5% of the loan amount, its contribution is backing the bank to make a loan that is 20 times larger than the state investment (5% premium x 20 = 100% loan amount) . Moreover, the state does not carry any contingent liability for potential future losses on CAP loans, as it would for a loan guarantee program.

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2 *An in-depth 1998 study of the Michigan CAP by Roger Hamlin of Michigan State University estimated that only 12% of CAP loans would have occurred in the absence of the program.*

- Fifth, program administration is straightforward, according to the participating states and banks. Once the CAP is designed and enacted, the daily administration involves sending the matching premiums to each bank's reserve fund as new loans are enrolled, marketing the program to banks, and keeping accounts. In contrast, government guarantee programs may require staffing of loan review officers, recordkeeping staff, workout officers, legal staff and supervisory staff. All of the states that reported CAP administrative staffing levels reported from 1.0-1.5 full time equivalents. This level of support is consistent across state survey respondents regardless of size of the total volume of loans.

The states with CAPs as well as the most active CAP lenders report that CAPs provide a comparatively simple tool for banks to increase marginally their risk tolerance and, in so doing, to bring capital to an expanded population of viable small businesses.

2. CAP Performance

The data presented here are the results of a nationwide survey conducted by the Treasury Department during February and March of 1999. Comparisons are made to data collected by the Department of Treasury in its October 1998 CAP Report. The complete data set is presented in the Appendix.

2.1 General Financial Performance

This survey covered 19 states and 2 municipalities with operating CAPs. Two of these states, Texas and Illinois, enacted CAPs and began operating their programs in 1997. Two other states, Louisiana and Florida, are launching CAP programs; however, due to the premature nature of their programs, none of their data is included in this report. Since the last survey in 1998, West Virginia has discontinued its CAP program, which had supported over $2 million in CAP lending, and reallocated its funding for other projects.

Loan Volume and Growth

CAP lending has grown at increasing rates in the last three years. By the end of 1998, total CAP lending volume had increased to $1.2 billion. For three consecutive years, the CAP dollar volume has increased, from $187 million in 1996, to $202 million in 1997 (8% growth), and to $246 million in 1998 (22% growth). Figure 1 shows the rise in both total lending volume and the total number of loans over the last three years, and Figure 2 shows the new loan volume and new number of loans in 1997 and 1998.

CAP growth rates are strong across the country. Of the 19 states surveyed with CAPs, only three state programs grew at less than a 10% rate in 1998, while the growth rates in eight states were in excess of 30%. Illinois grew by 179% (its first full year in operation) while North Carolina and Colorado achieved growth rates above 55% and 51% respectively. Figure 3 shows the distribution of growth rates across states.

CAP lending remains especially pronounced in three states: California, Michigan, and Massachusetts are responsible for nearly 68% of 1998 volume. California represents the largest 1998 volume with $80 million followed by Michigan with $52 million and Massachusetts with $35 million (See Figure 5a).

CAP lending per capita provides another measure of the relative magnitude of states' CAPs. By this measure, New Hampshire has the most far-reaching program in the country, with a cumulative CAP loan volume of $57.23 per resident.[3] Figures 4a and 4 b present the largest programs in both absolute and per capita terms. The fact that some small states operate large CAPs on a per capita basis indicates much greater market penetration.

Another benchmark of CAPs' relative size is CAP lending per firm in a state. Using the 1992 Economic Census to calculate CAP lending per firm produces nearly identical results as the per capita measure since, at the state level, the number of businesses closely correlates with the total population. Cumulatively, Michigan's CAP lending per firm is the largest at $725.33 per firm, followed by New Hampshire at $693.64 and Massachusetts at $305.11. Looking at CAP lending in 1998 only, New Hampshire is the largest at $121.16 per firm, followed by Michigan at $95.03 per firm, and Massachusetts at $78.33 per firm.

The collected data show no evidence that CAP demand is saturated: First, the expansion of existing programs is generating more volume increases than the creation of new programs. Second, examining the largest programs -- those most likely to tap-out demand -- shows that in both absolute terms and per capita terms these programs continued through 1998 to extend the largest volume of new loans (see Figures 5a and 5b).

Average Loan Size

While the cumulative nationwide average size of a CAP loan is $59,151, there is considerable variance across states. Banks in California and Texas originate the largest average loans, at $150,526 and $106,338 respectively. Wisconsin and Vermont banks originate the smallest, at $23,985 and $18,223 respectively. However, three of these four states are relatively large in per capita terms, and analysis of the data for all states shows that there is no evident correlation between loan size and any simple measure of CAPs' performance, such as total loan volume or loan losses.

In particular, examination of the data shows that states with larger average CAP loans do not appear to experience a larger percentage of loan losses. (California, however, is an exception, producing both the largest average loans and loan losses, although well within the limits of its CAP reserve fund.) Figure 6 shows the distribution of average loan size across states.

Financial Products

Different banks use CAPs to make different types of loans. Under CAPs, banks decide how to deploy the risk-protection afforded by the loan loss reserve. For example, some banks use CAPs

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3 *Akron, Ohio reported cumulative CAP lending of $61.91 per resident.*

to target a new customer base of small businesses. Other banks use CAPs for the unsecured portion of a financing package in which the bank will also provide some conventional secured financing.

The small business community often cites the financing of start-up businesses as an important funding need not fully satisfied by the private market. The available data appears to show that CAPs can address some of this need. Oregon reports that in 1998, almost 30% of its CAP loans went to start-up businesses. In Massachusetts and Arkansas, in 1998, almost 19% of CAP loans similarly went to start-ups. This suggests that start-ups are a market niche suitable to the CAP product.

In California, one of the most distinguishing characteristics of CAP lending is its use for working capital, another need often cited by small businesses that is difficult to accommodate under other credit programs. In 1997, California reported that a significant 56% of its CAP lending was for working capital revolving lines of credit, and 30% was for working capital term loans. The concentration in working capital and revolving facilities may be due to CAPs' straightforward loan administration and the banks' desire to limit its forward exposure, since these loans are generally for short maturities.

Loan Losses and Reserve Funds

Through the end of 1998, of those states that reported data for both 1997 and 1998, 506 banks were enrolled in CAPs nationwide and 315 of these were actively originating CAP loans. Many of these banks have large branch networks. State CAP administrators suggest that bank mergers have caused a slight decline in bank participation in some states, notably California, Connecticut, and Michigan.

Through the end of 1998, cumulative CAP loan losses nationwide totaled approximately $38.2 million, or 3.2% of all loan volume extended. Net of these losses, banks nationwide held approximately $52 million in their CAP reserve funds at the end of 1998, equal to 4.3% of the total loan volume extended. CAP reserves as a percentage of loans *currently outstanding* would, of course, be a much higher percentage since much of the cumulative loan volume ($1.2 billion) has been repaid.[4] Adding the cumulative losses and remaining loss reserve indicates that banks' total public and private CAP reserve fund contributions have been 7.5% of cumulative lending, with the state usually contributing half of that amount (some states contribute more than a one-to-one match under certain circumstances). This is a measurable drop from 1997, when the total contributions were 8.8% of cumulative lending, suggesting that the average CAP premium is decreasing.

The data, as well as bank behavior, suggest that current CAP reserves may be adequate to meet future losses, absent unforeseen circumstances. First, in some states, many CAP loans are for short maturities. Since remaining current reserves are 1.4 times as large as cumulative historical

[4] *Data on CAP loans outstanding are unavailable for most states, and therefore CAP reserves as a percentage of loans outstanding -- the usual measure of the adequacy of a loan loss reserve -- cannot be calculated.*

losses and most programs are more than a few years old with presumably a substantial loan volume having been repaid ("runoff"), it appears that the coverage available on outstanding loans is sufficient.[5] Second, banks made a record 3,660 loans totaling $246 million in 1998, so it would appear that those banks believe themselves to be adequately covered. Finally, some banks with CAP experience in one state are expanding CAP lending where new states have enacted programs.

State Leverage

States have varying policies with regard to how much they require banks, borrowers, and the state to contribute to the reserve fund. States typically match private contributions one-to-one (that is, dollar-for-dollar), with many states increasing their match rate for target groups or areas, as is discussed in the next section. All in all, state contributions to the reserve funds typically range from 3% to 7% of the loan amount, implying public leverage of private funding in a range from 33:1 to 14:1.

Some states have special strategies to help banks overcome a start-up dynamic in which the first few loans do not on their own generate enough of a reserve pool to cover a default. For instance, Vermont and Pennsylvania provide an initial $50,000 line of credit to their participating banks. Other programs address this issue by increasing the public match rate for banks' initial loans. For example, Michigan provides a two-to-one match for a bank's initial $2 million in loans and then reduces the match to one-to-one. New York and Oklahoma also match at higher rates up to the $2 million and $3 million thresholds respectively. At the same time, many states -- and some with very large CAPs -- do not use start-up incentives at all.

One might expect to see a relationship between the size of a state's contributions to the reserve funds and the resulting size of its CAP. New Hampshire's experience supports this expectation: The average percentage of the loan contributed by New Hampshire to the loan loss reserve is the second largest in the country, exceeding 9% of the total loan volume, and New Hampshire has the most far-reaching program in the nation on a per-capita basis. However, across all programs, only a weak correlation exists between public contributions and the size of a program. The fact that there is not a stronger correlation suggests that state contributions are only one part of a larger story in determining the relative magnitude of state programs. These factors are discussed in Section 3.

Job Creation and Retention

As stated in the 1998 report, the data for jobs created or retained by CAP lending should be viewed cautiously. While the field would benefit from more studies, the reported data suggest the potential impact of CAP lending. Six states provided data on the number of jobs created or retained through CAP lending. Calculating the amount of CAP loan dollars per job created or

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[5] *Programs with the lowest ratio of current reserves to historical losses tend to be the largest CAPs in the country. One explanation of this correlation is simply that larger CAPs tend to be older programs, so that there has been a longer time frame over which existing loans can go into default. This cannot be the full explanation because not all large CAPs are relatively old. A second explanation for the correlation might be that CAPs are larger in states where banks lend more aggressively -- and hence coverage ratios are lower.*

retained in these six states shows a significant variation, from $28,000 per job in one state to $9,000 per job in another. These job retention and creation numbers are self-reported by the borrower and by the state, and these figures are not independently reviewed. However, with these caveats, applying the average employment effect for the six reporting states across the 19 states with operating CAPs suggests that as many as 84,248 jobs may have been created or retained as a result of CAPs. These jobs created by the CAPs are efficiently generated at very little cost to the government. Of the six states that reported this job creation data, the average state subsidy cost per job created/retained is $777.

2.2 Performance in Lending to Specific Groups

Of the 19 states surveyed, eight states augment their CAP contributions for targeted groups. Table 1 shows that four states target state-designated Enterprise Zones, while two target on the basis of other geographical areas. Four states augment their contributions for minority-owned businesses and one for female-owned businesses, disabled-owned businesses, and "welfare-graduate-owned" businesses.

Most states target by increasing their matching contribution to a bank's reserve fund, usually by 1.5 or 2 times their ordinary match. For example, California adds another 50% to its loan loss reserve contribution for loans in severely affected communities, areas around closed military bases, and for loans made by banks just entering the program. Thus, for these loans, California contributes 150% of the combined premium payments made by the lender and borrower. For example, if the lender and the borrower each contribute 2% to the loan loss reserve account, California will contribute 6% instead of its usual 4%. Other states such as Illinois, Indiana, and Pennsylvania increase their match rates if the loans are made to minorities. Connecticut targets by providing a 20% supplemental loan guarantee for certain urban areas. This "first-loss" guarantee reduces the lender's exposure and creates an additional incentive for banks to invest in the targeted communities.

While data were limited, some states reported data showing that -- whether the state targets specific groups or not -- significant percentages of CAP loans are reaching low and moderate income areas as well as minority and female borrowers. In addition, CAPs appear to reach a broad spectrum of industries.

Table 1: Targeted State Programs

	State-Designated Zones	Other Geographic Zones	Minority Owned Businesses	Female Owned Businesses	Disabled Owned Businesses	Welfare Graduates	Industry Targeting
Arizona						✓	
California	✓	✓					
Connecticut		✓					
Illinois	✓		✓	✓	✓		
Indiana	✓		✓				
Pennsylvania			✓				
Texas			✓				
Utah	✓						✓

1) *Low- and Moderate-Income Areas / Geographic Targeting.* According to its own definition of "distressed areas," Connecticut data showed that 34% of 1998 CAP loans by volume were to businesses in low and moderate income areas. Wells Fargo Bank, which continues to originate approximately 85% of all CAP loan volume in California, reported in 1997 that 28% of its CAP loans went to businesses in census tracts with median incomes at the low to moderate level. In Connecticut, the average loan size for low and moderate income areas is 20% larger than the state average, while Wells Fargo loans in these census tracts were 7% larger on average.

2) *Minority-Owned Businesses.* In Illinois' first full year of CAP operations, 26% of all loans have gone to minority entrepreneurs. In New York City, 36% of all loans have gone to minority entrepreneurs while in Wisconsin, this number remains high at 26% (down slightly from 29% in 1997). Comparing these figures with the percentage of businesses which are minority-owned in these states shows that CAP lending reaches a higher proportion of these businesses. In Illinois, 9.3% of businesses are minority owned compared to 2.5% in Wisconsin. Notably, Wisconsin's CAP does not specifically target minority-owned businesses. Across seven states that reported data, the average loan size for minority borrowers is $50,275, which is slightly larger than the average loan for these same seven states (though still below the overall nationwide average CAP loan size of $59,151).

3) *Female-Owned Businesses.* Of the five programs that reported lending data for female-owned businesses, the percentage of female borrowers ranges from a low of 14% in Texas to a high of 37% in Wisconsin. The average loan size for females ranges from 42% to 210% of the state average. Vermont and New York City both exceed 100% of the overall average loan size at 113% and 210% respectively.

4) *Lending by Industry.* Sixteen states provided industry-specific loan information, and the data show that CAP loans are able to cover a broad spectrum of business types. CAP loans in these states are made most often to service businesses, construction, and manufacturing, while also reaching wholesale and transportation firms with significant frequency. Notably, CAPs are reaching certain industries, such as building contractors and wholesale trade companies, that are typically not well served by other types of credit enhancement programs. The available data also indicate that CAP lenders adapt the program to the needs of particular states. For example, for nine of the thirteen states reporting, agribusiness loans represent only 1-3% of the state total, but in Arkansas agribusiness lending comprises 53% of all CAP loans. Also, for nine of the thirteen states reporting, 19% of all loans went to manufacturing businesses, with Indiana reporting a high of 57% of its CAP loans to manufacturers.

3. Key Program Features of Large CAPs

Follow-up conversations with CAP agencies have suggested that there are several other elements that are important to the growth of CAPs:

1) Active marketing of the CAP

Many of the largest programs report that regular marketing is extremely important, particularly in the initial stages of the program. Marketing to banks appears to be most important, while marketing to borrowers is less important in developing a high-volume CAP. Massachusetts, Illinois, and New Hampshire and others emphasize the importance of reaching out to banks individually. Such one-on-one marketing, beyond informing banks of the CAP's existence, provides an opportunity to answer questions about the program. States point out that CAPs should be understood as a tool for expanding business lending parameters and should be offered by banks on a careful and deliberate business basis. State officials in California, Vermont and Virginia said that reaching directly to banks through calls and seminars was an effective means of marketing their CAP programs. Texas, which started its CAP in 1997, noted that press releases were one of the most effective means of marketing their CAP. Texas's success using press releases may be attributable to the fact that some Texas banks had CAP experience in other states and simply needed to know that Texas was offering a similar product. Some states, including Michigan, have chosen not to market their CAP at all, preferring to rely on banks to market the program themselves through their own in-house marketing efforts.

Table 2: CAP Marketing Programs

	Marketing Channels					
	Seminars/ Meetings with Lending Institutions	Brochures/ Mailings Sent to Lending Institutions	Direct Calls to Lending Institutions	Newsletters/ Quarterly Reports Produced and Distributed to Public and Lending Institution	Bank Marketing/ Advertising the CAP Program	Press Releases Sent To Public and Lending Institutions
Number of States Utilizing Marketing Channel	14	8	6	4	3	2

2) Adequate state appropriations for the CAP

Eight state CAPs receive only limited appropriations, either through a one-time appropriation or through an annual ceiling. Colorado and Oregon actually hit their limits in 1997, and Colorado suspended its program until new funding was obtained. Oregon kept its program operating uninterrupted by transferring funds from other budget sources. West Virginia faced similar budget hurdles and has recently suspended its program, choosing instead to allocate funding for other state credit enhancement programs. Even if a state is not hitting its funding limit, low funding may discourage banks from joining the program given lenders' need to originate a volume of loans sufficient to build an adequate loss reserve. Some banks reported that they chose not to participate in a state's CAP because it was funded at too low a level for them to offer the CAP product throughout their entire state branch network or to build up a sufficient reserve account. Interestingly, three of the four states that reported no funding limits are also among the largest programs in the country: California, Massachusetts, and New Hampshire.

States use a variety of funding sources for their CAPs. Pennsylvania generates the funds for its CAP contributions from bond financing programs, while Illinois' CAP program receives its funding from the state's Small Business Capital Revolving Loan Fund. California charges a 1% Small Business Assistance Fund fee to large companies obtaining environmental revenue bond financing through the state's bond issuing conduit.

3) Fewer eligibility and size restrictions for CAP loans

Some states restrain potential CAP lending by limiting the types of loans allowed under their program. In these states, CAP loans appear to work well for eligible businesses and eligible loans, but the state's authorizing statute does not make the program available for all small business loans.

- Some states place a ceiling on allowable loan size. For example, in one state, the maximum loan size is capped at $150,000. This limits the availability of CAP

lending for small businesses that require larger loans, and it potentially discourages bank participation. As discussed above, it does not appear that loan size and loan default rate are correlated. Some states limit the permissible CAP loan size as a means of targeting the smallest borrowers and conserving state resources; however, this creates the side effect of constraining the program's broadest use.

- Some states only lend to a limited set of industries. Most notably, public CAP funds in California are generated through environmental bond issues, and regulations require that these dollars only be used to support businesses that affect the environment (this requirement excludes most retail and service businesses from CAP eligibility). California's program estimates that 40-50% of possible borrowers are excluded by this limitation, including all retail and service industries. Discussions are currently underway in California to expand the reach of the CAP program to other industries outside of those focused on the environment.

CAP lending data suggest that the program successfully encourages small business lending with a small average loan size to borrowers who might not otherwise meet bank underwriting criteria. At the same time, the program's reach is limited to the states where enacted, and may be further limited by specific funding and program limits in some states.

APPENDICES

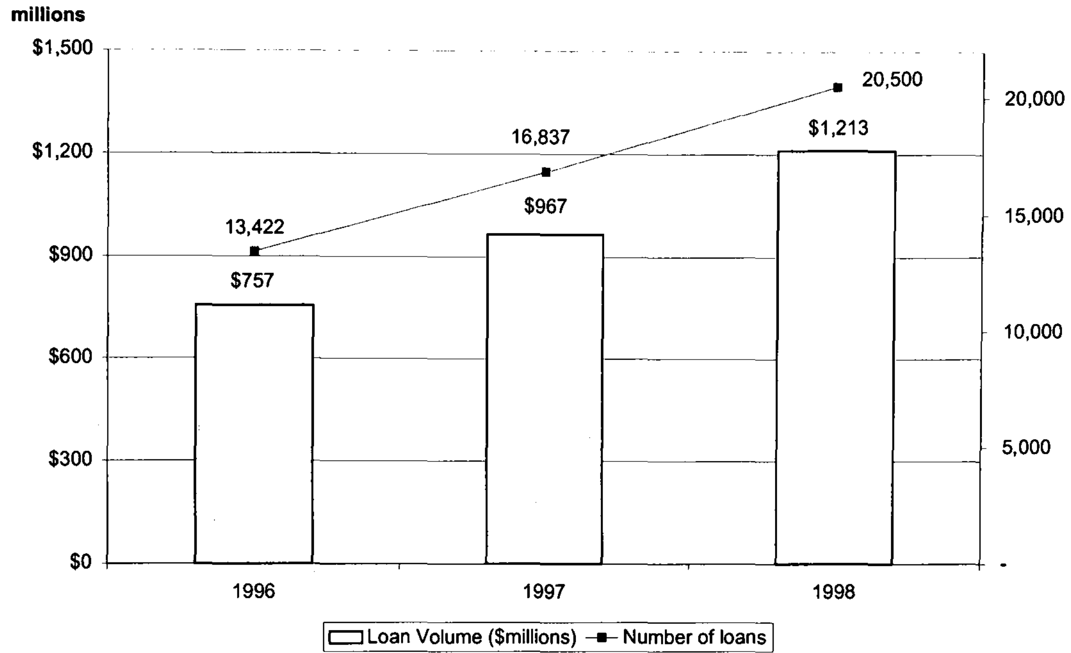


Figure 1: Nationwide Cumulative CAP Loan Volume and Cumulative Number of CAP Loans
millions
$1,500
$1,200
$900
$600
$300
$0
20,000
15,000
10,000
5,000
-
13,422
16,837
20,500
$757
$967
$1,213
1996
1997
1998
Loan Volume ($millions)
Number of loans

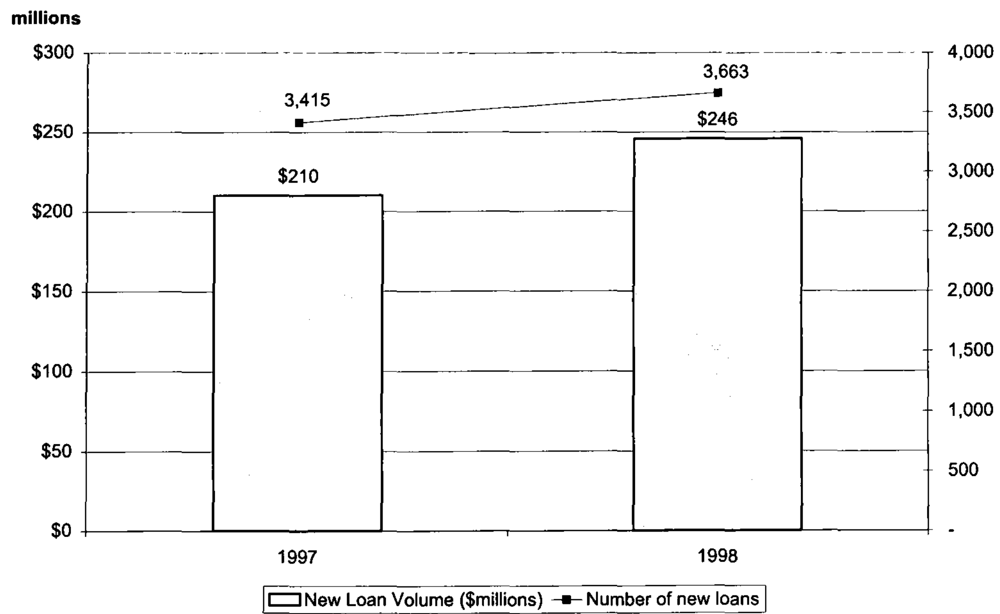


Figure 2: New CAP Loan Volume and Number New CAP Loans 1997-1998
millions
$300
$250
$200
$150
$100
$50
$0
4,000
3,500
3,000
2,500
2,000
1,500
1,000
500
-
3,415
3,663
$210
$246
1997
1998
New Loan Volume ($millions)
Number of new loans

Figure 3: Distribution of State CAP Growth Rates 1998

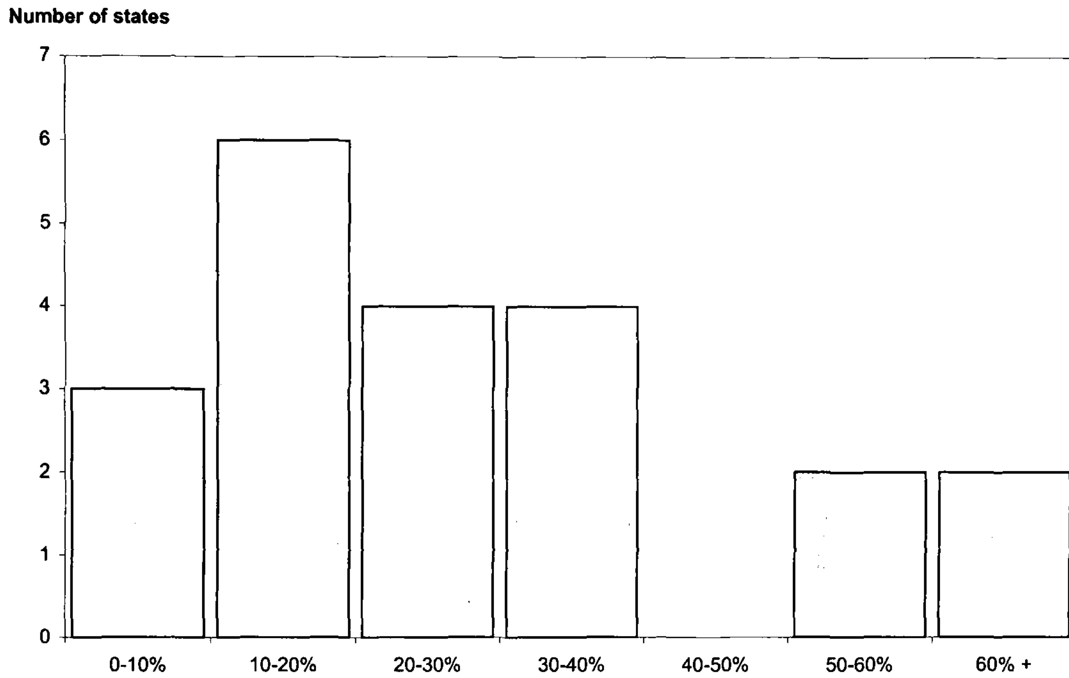
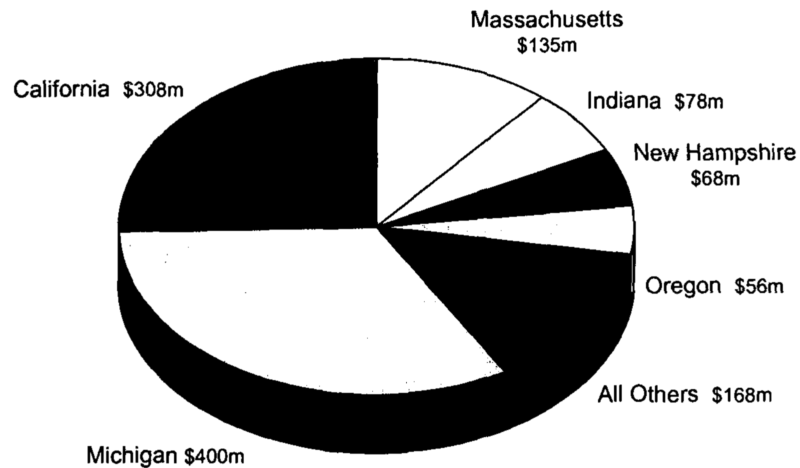


Figure 4a: Cumulative CAP Loan Volume by State through 12/31/98 ($millions)



Total Volume = $1.2 billion

Figure 4b: Cumulative CAP Loan Volume per Capita through 12/31/98

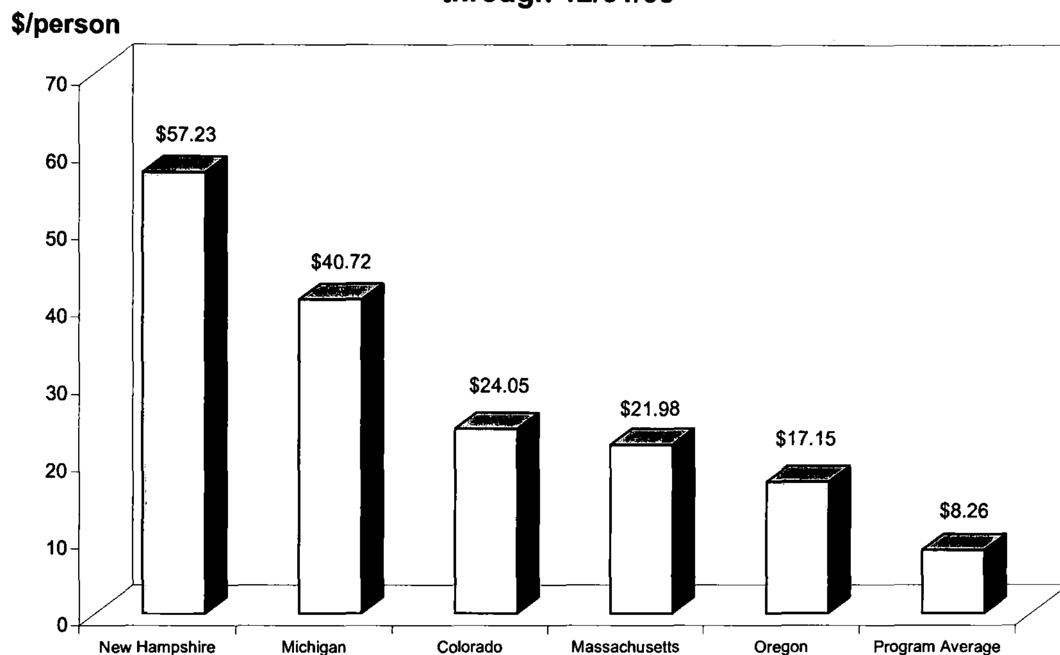
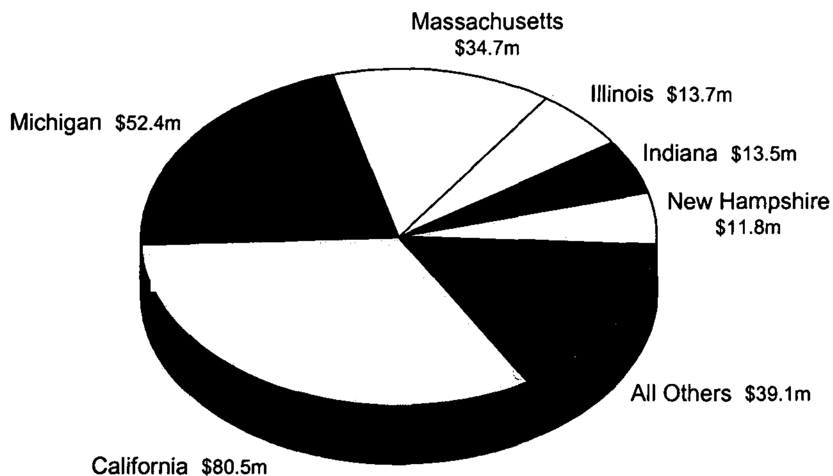


Figure 5a: New CAP Loan Volume by State 1998 ($millions)



Total New Volume = $246 million

Figure 5b: New CAP Loan Volume per Capita 1998

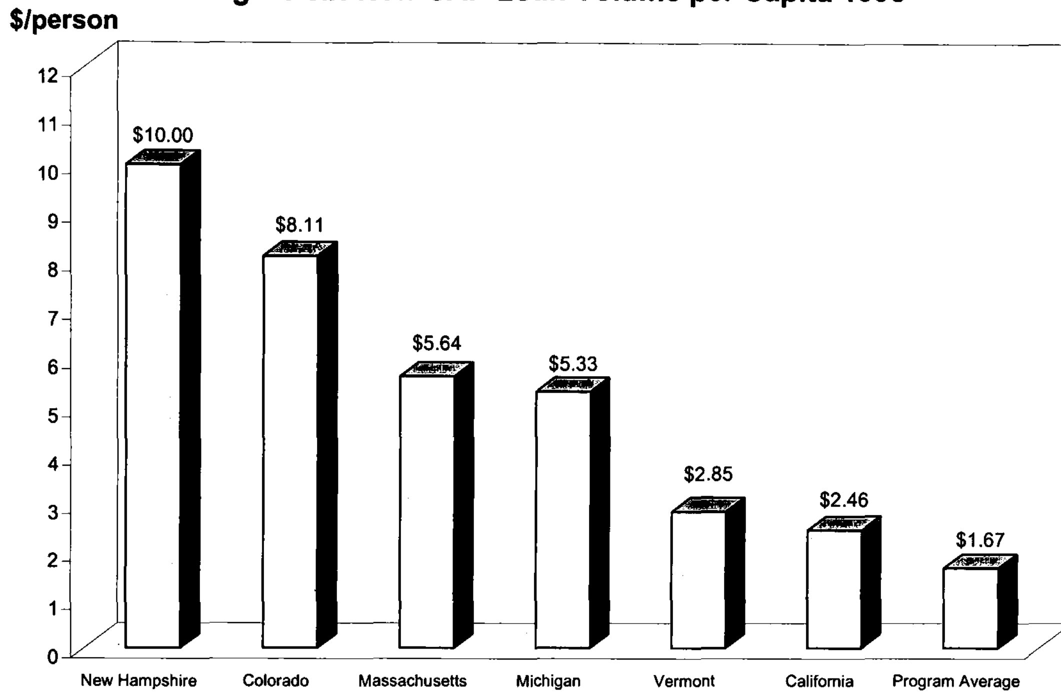
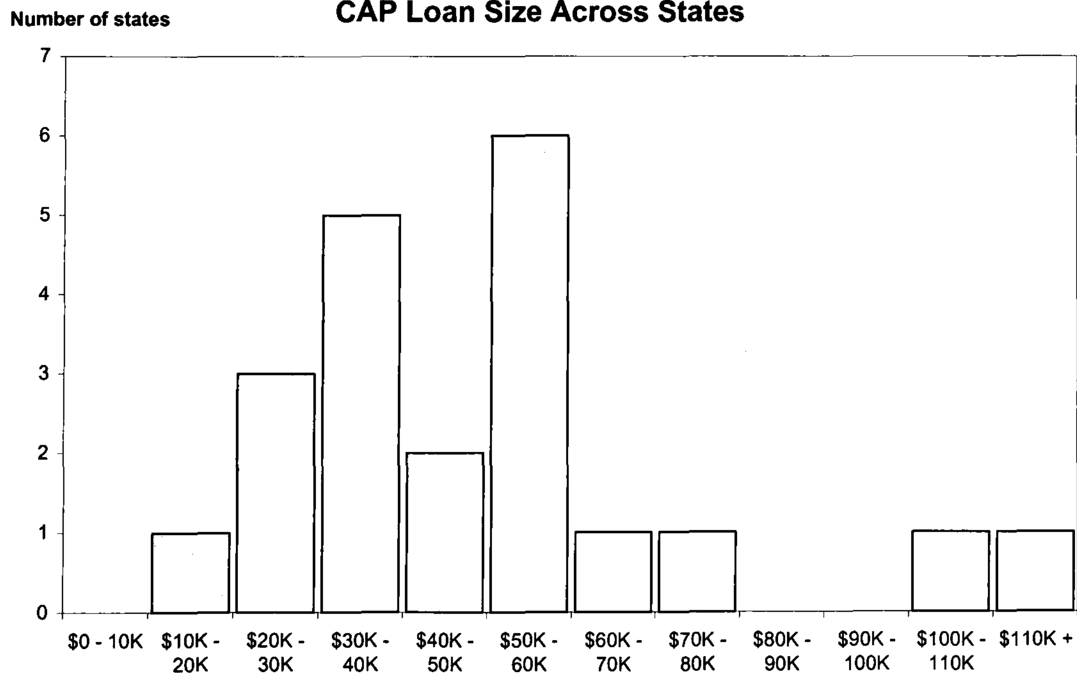


Figure 6: Distribution of Cumulative Average CAP Loan Size Across States



CAP Data Summary

Data collected as of March 1999

Data based on self-reporting by states

State	State pop'n	Total # Firms	Cumulative Volume ($) 12/31/98	Cumulative Volume ($) 12/31/97	Cumulative Volume ($) 12/31/96	New Vol. ($) 1998	Cum. # loans 12/31/98	Cum. # loans 12/31/97	Cum. # loans 12/31/96	New # 1998	Avg. Loan Size ($)	Cum. Vol. ($) Per capita	Cum. Vol. ($) Per firm	1998 Vol. ($) Per firm
Arkansas	2,538,303	159,820	8,128,718	7,572,608	6,255,223	556,109	205	182	149	23	39,652	3.20	50.86	3.48
California	32,666,550	2,259,327	308,276,553	227,795,093	186,953,701	80,481,460	2048	1640	1388	408	150,526	9.44	136.45	35.62
Colorado	397,091	323,147	9,549,412	6,328,344	3,672,094	3,221,068	250	189	138	61	38,198	24.05	29.55	9.97
Connecticut	3,274,069	237,705	25,426,052	21,807,211	15,378,032	3,618,841	332	264	197	68	76,584	7.77	106.96	15.22
Illinois	12,045,326	726,974	21,443,969	7,697,456	0	13,746,513	415	129	n/a	286	51,672	1.78	29.50	18.91
Indiana	5,899,195	364,253	77,544,687	64,093,204	47,555,900	13,451,483	1693	1414	1037	279	45,803	13.14	212.89	36.93
Massachusetts	6,147,142	442,848	135,119,329	100,431,404	67,000,000	34,687,925	2284	1793	1363	491	59,159	21.98	305.11	78.33
Michigan	9,817,242	551,091	399,721,976	347,349,705	284,286,235	52,372,271	7251	6349	5355	902	55,126	40.72	725.33	95.03
Minnesota	4,725,419	358,921	5,437,666	4,858,400	3,968,466	579,266	199	183	150	16	27,325	1.15	15.15	1.61
New Hampshire	1,185,048	97,772	67,818,168	55,972,130	40,190,552	11,846,038	1794	1407	984	387	37,803	57.23	693.64	121.16
New York City	7,322,564	n/a	16,368,913	14,243,913	13,113,860	2,125,000	308	283	266	25	53,146	2.24	n/a	n/a
North Carolina	7,546,493	439,301	11,112,535	7,164,116	4,580,698	3,948,419	220	133	88	87	50,512	1.47	25.30	8.99
Akron, OH	223,019	n/a	13,806,881	13,421,881	13,271,881	385,000	261	257	255	4	52,900	61.91	n/a	n/a
Oklahoma	3,346,713	248,936	22,951,353	18,929,991	16,086,366	4,021,362	760	578	436	182	30,199	6.86	92.20	16.15
Oregon	3,281,974	239,967	56,297,985	48,680,879	39,653,275	7,617,106	1479	1325	1129	154	38,065	17.15	234.61	31.74
Pennsylvania	12,001,451	728,063	6,852,642	5,042,543	2,970,112	1,810,099	168	126	43	42	40,790	0.57	9.41	2.49
Texas	19,759,614	1,256,121	8,081,697	450,000	0	7,631,697	76	4	n/a	72	106,338	0.41	6.43	6.08
Utah	2,099,758	129,202	172,765	172,765	117,065	0	6	3	3	3	28,794	0.08	1.34	0.00
Vermont	590,883	58,924	6,673,095	4,990,228	3,801,140	1,682,867	366	257	177	109	18,233	11.29	113.25	28.56
Virginia	6,791,345	391,451	3,981,982	3,270,761	2,234,586	711,221	59	34	21	25	67,491	0.59	10.17	1.82
Wisconsin	5,223,500	300,348	7,819,172	6,595,867	5,539,777	1,223,305	326	287	243	39	23,985	1.50	26.03	4.07
Totals	146,882,699	9,314,171	1,212,585,550	966,868,499	756,628,963	245,717,051	20,500	16,837	13,422	3,663	59,151			
Average			57,742,169	46,041,357	36,029,951	11,700,812	932	765	610	167		8.26	126.95	26.11
Growth in 98						25.4%				21.8%				

Note: In response to the survey, a number of states made minor corrections to 1996 and 1997 data. The most recently received data are reported here, and therefore are not identical to the data reported in last year's edition.

State	Existing Reserves 12/31/98	Cumulative Losses 12/31/98	Total Reserves Contribution	Total Public Contribution	1998 Public Contribution	Patricipating Banks 12/31/98	Participating Banks 12/31/97	Participating Banks 12/31/96	New Banks 1998	Active Banks 12/31/98
Arkansas	506,350	163,195	669,545	287,529	15,389	10	9	8	1	3
California	6,553,451	19,753,493	26,306,944	13,343,091	3,372,548	45	42	39	3	10
Colorado	562,088	144,083	706,171	n/a	n/a	12	14	12	-2	7
Connecticut	2,665,301	145,582	2,810,883	1,700,806	180,942	30	33	27	-3	12
Illinois	1,612,854	43,731	1,656,585	944,157	590,077	51	43	0	8	23
Indiana	3,767,881	2,749,982	6,517,863	3,445,452	495,963	n/a	125	125	n/a	34
Massachusetts	7,401,563	3,082,507	10,484,070	n/a	n/a	n/a	90	90	n/a	n/a
Michigan	14,600,000	4,515,514	19,115,514	14,893,437	1,883,942	69	77	72	-8	51
Minnesota	718,454	218,117	936,571	570,958	60,824	34	34	34	0	34
New Hampshire	6,605,552	2,104,665	8,710,217	6,134,497	1,048,282	37	36	32	1	25
New York City	1,383,497	599,775	1,983,272	1,048,036	107,625	11	12	11	-1	4
North Carolina	840,125	61,487	901,612	480,580	148,057	26	26	26	0	9
Akron, OH	274,227	500,210	774,437	274,227	29,000	8	8	8	0	8
Oklahoma	725,465	840,964	1,566,429	931,000	124,287	74	74	73	0	29
Oregon	2,050,163	2,644,287	4,694,450	2,416,598	287,294	29	28	28	1	19
Pennsylvania	323,918	128,863	452,781	300,000	n/a	6	6	6	0	5
Texas	687,352	0	687,352	348,353	330,353	11	7	0	4	5
Utah	24,652	0	24,652	10,000	0	2	4	4	-2	2
Vermont	871,925	282,629	1,154,554	204,554	n/a	24	24	21	0	19
Virginia	226,744	45,871	272,614	35,000	n/a	6	1	1	5	4
Wisconsin	66,411	217,968	284,379	272,225	41,228	21	21	21	0	12
Totals	52,467,972	38,242,923	90,710,895	47,640,500	8,715,811	506	714	638	7	315
Average	2,498,475	1,821,092	4,319,566	2,507,395	544,738	27	34	30		16

Capital Access Program State Laws

State	State Law	Date Enacted
Arkansas	Arkansas Statutes Annotated 15-5-1101 et seq.	1993
California	California Health & Safety Code § 44559.1 et seq.	1994
Colorado*	Colorado Revised Statutes 29-4-710.5 et seq.	1993
Connecticut*	Connecticut General Statutes § 8-167 et seq.	1993
Florida*	Florida Statutes 19-288.901 et seq.	1996
Illinois*	30 Illinois Compiled Statutes 750/9 et seq.	1997
Indiana	Indiana Code 4-4-26	1992
Louisiana*	Louisiana Revised Statutes 51.2311 et seq.	1998
Massachusetts	General Laws of Massachusetts chap. 23A, § 57	1993
Michigan*	Michigan Statutes Annotated 3.541 (201) et seq.	1986
Minnesota	Minnesota Statutes chapter 116J.876	1989
New Hampshire	New Hampshire Revised Statutes chap. 162-A:12	1992
New York City*	New York State Consolidated Laws chap. 15	1993
North Carolina	North Carolina 1993 Session Laws, chap. 769, § 28.1 (a7)	1994
Ohio (Akron)*	Ohio Revised Code 1.166	1995
Oklahoma*	74 Oklahoma Statutes 5085.2 et seq.	1992
Oregon	Oregon Revised Statutes 285B.126	1989
Pennsylvania*	73 Pennsylvania Statutes 376.2	1994
Texas	Texas Government Code chap. 481, subchap. BB, § 481.401 et seq.	1997
Utah	Utah Code Annotated 9-2-1303 et seq.	1991
Vermont*	Vermont Statutes Title 10, chap. 12, § 279	1993
Virginia	Virginia Code 9-228.5 et seq.	1996
West Virginia*	West Virginia Code 31-15A-1 et seq.	1991
Wisconsin*	Wisconsin Statutes chap. 560.03	1992

* No specific CAP legislation; generic economic development statute used.

FROM THE OFFICE OF PUBLIC AFFAIRS

December 18, 2002
PO-3700

U.S. International Reserve Position

The Treasury Department today released U.S. reserve assets data for the latest week. As indicated in this table, U.S. reserve assets totaled $76,967 million as of the end of that week, compared to $75,943 million as of the end of the prior week.

I. Official U.S. Reserve Assets *(in US millions)*

	December 6, 2002			December 13, 2002		
TOTAL		75,943			76,967	
1. Foreign Currency Reserves [1]	**Euro**	**Yen**	**TOTAL**	**Euro**	**Yen**	**TOTAL**
a. Securities	6,515	12,717	19,232	6,625	13,031	19,656
Of which, issuer headquartered in the U.S.			0			0
b. Total deposits with:						
b.i. Other central banks and BIS	10,744	2,553	13,297	10,905	2,616	13,521
b.ii. Banks headquartered in the U.S.			0			0
b.ii. Of which, banks located abroad			0			0
b.iii. Banks headquartered outside the U.S.			0			0
b.iii. Of which, banks located in the U.S.			0			0
2. IMF Reserve Position [2]			20,505			20,743
3. Special Drawing Rights (SDRs) [2]			11,867			12,004
4. Gold Stock [3]			11,042			11,042
5. Other Reserve Assets			0			0

II. Predetermined Short-Term Drains on Foreign Currency Assets

	December 6, 2002			December 13, 2002		
	Euro	**Yen**	**TOTAL**	**Euro**	**Yen**	**TOTAL**
1. Foreign currency loans and securities			0			0

2. Aggregate short and long positions in forwards and futures in foreign currencies vis-à-vis the U.S. dollar:

2.a. Short positions	0	0
2.b. Long positions	0	0
3. Other	0	0

III. Contingent Short-Term Net Drains on Foreign Currency Assets

	December 6, 2002			December 13, 2002		
	Euro	Yen	TOTAL	Euro	Yen	TOTAL
1. Contingent liabilities in foreign currency			0			0
1.a. Collateral guarantees on debt due within 1 year						
1.b. Other contingent liabilities						
2. Foreign currency securities with embedded options			0			0
3. Undrawn, unconditional credit lines			0			0
3.a. With other central banks						
3.b. With banks and other financial institutions						
Headquartered in the U.S.						
3.c. With banks and other financial institutions						
Headquartered outside the U.S.						
4. Aggregate short and long positions of options in foreign						
Currencies vis-à-vis the U.S. dollar			0			0
4.a. Short positions						
4.a.1. Bought puts						
4.a.2. Written calls						
4.b. Long positions						
4.b.1. Bought calls						
4.b.2. Written puts						

Notes:

1/ Includes holdings of the Treasury's Exchange Stabilization Fund (ESF) and the Federal Reserve's System Open Market Account (SOMA), valued at current market exchange rates. Foreign currency holdings listed as securities reflect marked-to-market values, and deposits reflect carrying values. Foreign Currency Reserves for the latest week may be subject to revision. Foreign Currency

Reserves for the prior week are final.

2/ The items, "2. IMF Reserve Position" and "3. Special Drawing Rights (SDRs)," are based on data provided by the IMF and are valued in dollar terms at the official SDR/dollar exchange rate for the reporting date. The entries for the latest week reflect any necessary adjustments, including revaluation, by the U.S. Treasury to the prior week's IMF data. IMF data for the latest week may be subject to revision. IMF data for the prior week are final.

3/ Gold stock is valued monthly at $42.2222 per fine troy ounce.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

December 18, 2002
PO-3701

U.S. Assistant Treasury Secretary for Tax Policy Pam Olson
Remarks to the Tax Executives Institute
New York City, New York
December 18, 2002

Good afternoon. I would like to thank the New York Chapter of TEI for this opportunity to discuss several tax policy issues to which we at Treasury have been devoting considerable time – complex issues that truly demand our attention today.

My remarks this afternoon are going to touch on a wide range of tax issues, from our international tax rules, to inversions, tax shelters, simplification, regulations on R&E credits and capitalization, the voluntary disclosure initiative unveiled last week, and the ongoing public dialogue we seek with all of you. That's a lot of ground to cover in one lunch, but I promise not to dwell on any of the topics for an extended time.

I. International Tax Rules

I'll begin with the topic of our international tax rules, a relatively small part of the code that has caused a lot of headache, and created a competitive disadvantage for many U.S. companies doing business abroad. The U.S. international tax rules first developed in the early 1960s, when the U.S. economy was by far the dominant economy in the world, and U.S. companies accounted for over half of all multinational investments worldwide. Needless to say, the world has changed in the past 40 years. When the rules were first developed, they affected relatively few taxpayers and relatively few transactions. Today, there are very few U.S.-based companies that are not faced with applying some aspect of the U.S. international tax rules to their businesses.

To understand the significance of getting the tax rules right, it may be helpful to consider for a moment the importance of international trade to the US economy relative to what it was in the past. In 1960, trade in goods to and from the U.S. represented just over six percent of GDP.
Today, trade in goods to and from the U.S. represents over 20 percent of GDP, more than three times larger than in 1960, while trade in goods and services represents more than 25 percent of GDP today.

Cross border investment, both inflows and outflows, also has grown dramatically in the last 40 years. In 1960, cross border investment represented 1.1% of GDP. In 2000, it was 15.9% of GDP, or annual cross-border flows of more than $1.5 trillion. The aggregate cross border ownership of capital is valued at $15 trillion. Consider the role of U.S. multinational corporations in the economy. They are now responsible for more than one-quarter of U.S. output and about 15% of U.S. employment.

At the same time companies are competing for sales, they are also competing for capital: US-managed firms may have foreign investors, and foreign-managed firms may have U.S. investors. Portfolio investment accounts for approximately 2/3 of US investment abroad and a similar fraction of foreign investment in the U.S.

Viewed from the vantage point of an increasingly global marketplace, our tax rules

appear outmoded, at best, and punitive of U.S. economic interests, at worst. Most other developed countries of the world are concerned with setting a competitiveness policy that permits their workers to benefit from globalization. As Deputy Secretary Dam observed recently, however, our international tax policy seems to have been based on the principle that if we have a competitive advantage, we should tax it!

Let's start with the basics. Our income tax system as a whole dates back to shortly after the turn of the last century, a time when cars were called horseless carriages and buggy whip makers had just gone out of business. A bit has happened since then. Of course, significant changes have been made to the tax code as well. In the international area, we added the subpart F rules back in 1962. I would say that they haven't aged as well as a lot of the 40 somethings in this room. We also made fairly significant changes to the international tax rules in 1986. That would make those rules teenagers now, and they have the characteristics of the average teenager. They're hard to understand, messy, inconsistent, and display little regard for the real world.

The global economy looked very different when the subpart F rules were put in place than it does today. The same is true of the U.S. role in the global economy. Forty years ago the U.S. was dominant, accounting for over half of all multinational investment in the world. We could make decisions about our tax system essentially on the basis of a closed economy, and we could generally count on our trade partners to follow our lead in tax policy. But the world has changed in the last 40 years, and the globalization of the U.S. economy puts ever more pressure on our international tax rules.

What does globalization mean? This audience needs no explanation, but it is useful to think about it for a minute. It means the growing interdependence of countries resulting from increasing integration of trade, finance, investment, people and ideas in one global marketplace. Globalization results in increased cross-border trade, and the establishment of production facilities and distribution networks around the globe. Technology is a key driving force behind globalization. Advances in communications, information technology, and transport have slashed the cost and time taken to move goods, capital, people, and information. Firms in this global marketplace differentiate themselves by being smarter: applying more cost efficient technologies or innovating faster than their competitors. The returns to being smarter are much higher than they once were as the benefits can be marketed worldwide.

The significance of globalization to the U.S. economy since the enactment of subpart F is apparent from the statistics on international trade and investment I mentioned earlier. It is worth noting that numerous studies confirm a strong link between trade and economic growth. Trade appears to raise income by spurring the accumulation of physical and human capital and by increasing output for given levels of capital.

The U.S. tax rules have important effects on international competitiveness both because of the integration of domestic activities of U.S. multinational companies with their foreign activities and because repatriated foreign earnings of foreign investments are subject to U.S. domestic tax. Increasingly, the flow of goods and services is not through purchases between exporters and importers, but through transfers between affiliates of multinational corporations. The rules governing transfer pricing, interest allocation, withholding rates, foreign tax credits, and the taxation of actual or deemed dividends impacts these flows.

The U.S. tax system should not distort trade or investment relative to what would occur in a world without taxes. The difficulty is that every country makes sovereign decisions about its own tax system, so it is impossible for the U.S. to level all playing fields simultaneously for each of the different forms competition might take in every country.

The question we must answer is what should we do to increase the

competitiveness of U.S. businesses and workers. Professor Michael Graetz observed in his book, The Decline (and Fall?) of the Income Tax:

The internationalization of the world economy has made it far more difficult for the United States, or any other country for that matter, to enact a tax system radically different from those in place elsewhere in the world. In today's worldwide economy, we can no longer look solely to our own navels to answer questions of tax policy.

To date, our attempts to address one of the perceived competitive disadvantages created by our laws have been repeatedly ruled inconsistent with the World Trade Organization's rules. Earlier this year, a WTO appellate panel held that the extraterritorial income exclusion regime of our tax law constituted a prohibited export subsidy under the WTO rules.

Just two years before, a WTO appellate panel held that the foreign sales corporation provisions constituted a similar, prohibited subsidy. President Bush has made clear that the U.S. must comply with the WTO rulings. That result should be obvious because - let's face it - no one has a greater stake in the WTO and in free trade than the U.S. Despite the WTO decisions against our foreign sales corporation and extraterritorial income regimes, the WTO rules serve the economic interests of American businesses and workers by opening markets and ensuring fair play.

In addition to making clear that the U.S. must comply, the President made two further decisions. He said that any response to the ruling must increase the competitiveness of U.S. businesses. He also pledged to work with the Congress to create the solution. Treasury is working closely with the tax-writing committees of Congress to develop legislation that makes meaningful changes to our tax law to satisfy the twin goals of honoring our WTO obligations and preserving the competitiveness of U.S. businesses operating in the global marketplace.

We must consider the ways in which our tax system differs from that of our major trading partners to identify aspects that may hinder the competitiveness of U.S. companies and workers. About half of the OECD countries employ a worldwide tax system as does the U.S. However, even limiting comparison of competition among multinational companies established in countries using a worldwide tax system, U.S. multinationals can be disadvantaged when competing abroad. This is because the United States employs a worldwide tax system that, unlike other worldwide systems, may tax active forms of business income earned abroad before it has been repatriated and may more strictly limit the use of the foreign tax credits that prevent double taxation of income earned abroad.

The Accelerator—Subpart F. The focus of the subpart F rules is on passive, investment-type income that is earned abroad through a foreign subsidiary. However, the reach of the subpart F rules extends well beyond passive income to encompass some forms of income from active foreign business operations. No other country has rules for the immediate taxation of foreign-source income that are comparable to the U.S. rules in terms of breadth and complexity.

For example, under subpart F, a U.S. company that uses a centralized foreign distribution company to handle sales of its products in foreign markets is subject to current U.S. tax on the income earned abroad by that foreign distribution subsidiary. In contrast, a local competitor making sales in that market is subject only to the tax imposed by that country. Similarly, a foreign competitor that uses a centralized distribution company to make sales into the same markets generally will be subject only to the tax imposed by the local country. U.S. companies that centralize their foreign distribution facilities therefore face a tax penalty not imposed on their foreign competitors.

The subpart F rules also impose current U.S. taxation on income from certain services transactions, shipping activities and oil related activities performed abroad. In contrast, a foreign competitor engaged in the same activities generally

will not be subject to current home-country tax on its income from these activities. While the purpose of these rules is to differentiate passive or mobile income from active business income, they operate to currently tax some classes of income arising from active business operations structured and located in a particular country for business reasons wholly unrelated to tax considerations.

Another significant problem with our international tax law is the rules regarding Limitations on Foreign Tax Credits. The rules for determining and applying the foreign tax credit are detailed and complex and can have the effect of subjecting U.S.-based companies to double taxation on their income earned abroad. For example, the foreign tax credit may be used only to offset U.S. tax on net foreign-source income and not to offset U.S. tax on U.S.-source income. Net foreign-source income is determined by reducing foreign-source income by U.S. expenses allocated to that income. Under the current rules, the interest expense of a U.S. affiliated group is allocated between U.S. and foreign-source income based on the group's total U.S. and foreign assets. These rules treat the interest expense of a U.S. parent as relating to its foreign subsidiaries even where those subsidiaries are equally or more leveraged than the U.S. parent. This over-allocation of interest expense to foreign income inappropriately reduces the foreign tax credit limitation because it understates foreign income. The effect can be to subject U.S. companies to double taxation. Other countries do not have expense allocation rules that are nearly as extensive as ours.

The U.S. foreign tax credit rules are further complicated by separate foreign tax credit basket limitations and overall foreign loss limitations, both of which give rise to the potential for double taxation.

A third problem with our international tax rules is the Double Tax on Equity-Financed Investments. The U.S. is one of the few OECD countries that does not provide for some form of integration between taxes paid at the corporate level and taxes paid by individuals on distributions from corporations.

The present U.S. system, by taxing income at the corporate level and dividends at the individual level, increases the hurdle rate of return (i.e., the minimum rate of return required on a prospective investment) undertaken by corporations. Whether competing at home against foreign imports or competing abroad through exports from the U.S. or through foreign production, the double tax makes it less likely that the U.S. company can compete successfully against a foreign competitor. Most OECD countries alleviate this problem by reducing personal income tax payments on corporate distributions.

We have a tax code that has not kept pace with the globalization that has transpired over the last 40 years. It is time for us to reconsider the rules based on today's realities and the future unfolding before us.

We must design rules that equip us to compete in the global economy – not fearfully, but hopefully. The fact of the matter is that we – all of us - benefit significantly from vigorous participation in the global economy.
Over the past 20 years, U.S. companies that invest abroad exported more (exporting between one-half and three-quarters of all U.S. exports), paid their workers more, and spent more on R&D and physical capital than companies not engaged globally.

While 80 percent of U.S. investment abroad is located in high-income countries, it is useful to say a word about the investment that goes into developing countries. These countries recognize U.S. investment as important to achieving sustainable poverty-reducing growth and development. I'm asking you to look at this altruistically, but if you can't, then look at it selfishly. Poker games are revenue neutral, but international trade and investment are not poker games. Healthy foreign economies mean more markets for our products. They mean more opportunities for us to profitably invest. But to return to the altruistic point – foreign investment means sharing our ideas, our knowledge, our values, and our capital. That is not a zero sum game.

II. Inversions

Now I would like to discuss a problem that is a corollary to our international tax rules: the problem of "inversions." None of us want to see a company effectively renounce its citizenship for tax purposes, which is what an inversion is, though the departure is only on paper. The fact that inversions have been considered, planned, and executed highlights two serious problems with U.S. tax laws: the opportunities for reducing U.S. income tax on U.S.-based operations and the extent to which our tax laws are out of step with the global economy and the laws of our major trading partners.

The rapid response to inversion transactions by Treasury and both tax-writing committees appears to have halted the transactions. Although Treasury and the Hill have taken different approaches to the issue, we have been united in our determination to address them. This united front makes it highly unlikely the transactions will return before Congress has the opportunity to act.

The delay in enacting legislation has had an ancillary benefit. It has provided us with more time to consider and craft an appropriate response. A too rapid response quite likely would have taken the form of an attempt to ban the transactions – much like treating the symptoms without curing the underlying disease. In this case, the treatment would have masked the symptoms quite effectively. But, the disease would live on and manifest itself in alternatives that achieved the same result with equally – or more – unfortunate consequences for the economy.

As a policy matter, there is no reason for us to enact laws that encourage companies to form offshore, or that favor foreign acquisitions relative to domestic acquisitions. Yet that is the current slope of the playing field, and it is that slope we must correct. Doing so involves reconsidering many of our international tax rules and removing opportunities to inappropriately reduce U.S.-based income, something that must be done without discouraging or harming foreign investment. Striking a satisfactory balance between protecting the U.S. tax base and not harming foreign investment is a difficult task. The many helpful comments we have received will, I am confident, result in the crafting of appropriate rules.

III. Tax Shelters

My next subject is tax shelters. For the last few years, it seems like we've been tuned to radio station NOTAX, broadcasting all shelters, all the time! With all the attention focused on the topic, with legislative changes, regulatory changes, and a torrent of anti-shelter words, how is it that the perception is the problem has grown worse?

In part, it is because the torrent of words was not connected to a torrent of actions. While the risk to the system was identified, the compliance resource allocation remained largely unchanged. For example, shelter registrations filed between 1997 and 2000 included a number of listed transactions. However, until the Office of Tax Shelter Analysis was formed and a strong Treasury commitment to pursuing the transactions was made clear, those registrations gathered dust.

What happens when promoters register transactions and get no response? Same thing that happens when children act up and no one tells them to quit it. They do it again. So promoters told their customers the IRS is "OK" with the transactions. The IRS knows about the transactions and has done nothing to shut them down so obviously things are copasetic, right? Wrong. Companies under continuous audit – like those for whom you in this room work – know better than to believe that. You know the difference between approval and neglect. But, many did not understand that – or they chose to believe otherwise – and so tax practice deteriorated without adult supervision.

Well, folks, the parents have arrived at the party. Unfortunately, we have a lot of cleaning up to do, but the effort is underway. By moving resources from accounting

method nits to transactions promising large permanent tax losses, by supporting taxpayer disclosure, and by acting promptly to resolve issues, we firmly believe we can put this problem behind us and begin to restore a measure of confidence in our tax system. With B. John Williams on board as Chief Counsel and the Justice Department aiding the effort, I believe the efforts of the IRS operating divisions are beginning to get traction.

As we work to put this problem behind us, many of you in this room – including some who have never entered into an abusive tax avoidance device – will have to live through the clean up efforts and our efforts to get our arms around the problem. I apologize for that. We recognize that the new disclosure and list keeping regulations will impose an additional burden on you. We are considering ways to minimize that burden while preserving our goals of increased transparency and certainty. As I see this, taxpayers, practitioners, and the government share a mutual goal here – reducing the burden of complying with and administering the law while ensuring that the IRS's resources are devoted to productive endeavors. You have my commitment that we will work with you to produce the least burdensome rules we possibly can. We hope that you will continue to give us suggestions on how to improve the new disclosure and list keeping rules.

Shelter legislation the Treasury Department helped to craft was introduced in both Houses of Congress this year, but was not enacted. We believe some of the legislative changes at are important to further deterring tax shelter activity. Some of it, we fear, would make tax administration more difficult, thus potentially worsening rather than improving tax compliance. The piece of legislation I would most like to see passed is the change to the registration rules under section 6111. That change would allow us to conform the definition of a potentially abusive tax shelter across the board – for return disclosure, registration, and list maintenance purposes.

One thing I have become convinced of since joining Treasury is the importance of acting even without a legislative mandate. We don't always need laws to tell us the difference between right and wrong or to tell us what we ought to do. Consequently, we are exploring what the IRS and Treasury can do to implement registration on a voluntary basis. Why, you may ask, would anyone voluntarily register anything? Because doing so illustrates best practices, and it is time for us as good citizens to adopt best practices without an act of Congress compelling us to do so. We'll be considering what action we can take to support the voluntary adoption of best practices. The IRS offering such support is not unheard of. Similar support was provided for a best practice – disclosure – in the disclosure initiative and settlement guidelines released a year ago. We welcome your thoughts.

IV. Simplification

Now onto one of our most deadly dull, but important issues, tax simplification. The problems with the U.S. tax system go beyond outdated international tax rules, corporate inversions, and abusive tax shelters. We have complicated compliance by legislating detailed rules on the calculation of taxable income that differ from the rules used to calculate book income, creating inevitable disparities that undermine confidence in our tax and financial accounting systems. We have created a labyrinth of rules so complicated we cannot satisfactorily predict results, then iced the cake with an alternative minimum tax calculation pro-cyclical in effect and loaded with other unintended consequences. We have written rules that have less to do with measuring income than with penalizing certain behaviors or certain classes of taxpayers. We have created a system so complicated that it has eroded the public's confidence.

This is surely not a tax system anyone would set out to create, but it is the system that has evolved over time. Let's face it. We have reached the point where our tax system is held together by chewing gum and chicken wire. Moreover, a lot of the chewing gum and chicken wire was applied in haste, not strategically. It is time for us to clean house.

Last year, the Joint Committee published a 3-volume list of simplification without touching the complexities that reflect congressional policy choices. That is

illustrative of how much must be done.

Let me give you an example. The Code contains five different definitions of child. While there are reasons for the differences, they don't outweigh the complexity they create or the frequent mistakes that result. Last spring, the Treasury Department proposed a uniform definition of child that would apply for all five of the child benefit provisions of the code. That would be significant simplification. It would shorten instructions, make record-keeping simpler, and reduce errors. Of course, there would still be five different provisions in the code covering child benefits. The next step is to find a way to combine some or all of those benefits – perhaps yielding a look-up table of some sort – that would make filing much simpler and give taxpayers a clear picture of what their tax liabilities are likely to be.

The system needs an overhaul because it has become too complex and a barrier to – rather than a facilitator of – economic growth. While we proclaim our desire for a tax system that does not deter individuals from saving and investing, we offer a system that taxes those who save more heavily than those who consume. While we proclaim our desire for a tax system that encourages businesses to invest and grow, we offer a tax system so complex and disadvantageous that we face the specter of companies moving their operations overseas because doing so allows them to lower their taxes. While we proclaim our desire for a system inexpensive to comply with, we offer instead a system that requires burdensome record-keeping, changes year after year, and compels even average Americans to pay someone to prepare their returns to avoid mistakes and find the benefits that would otherwise elude them.

The Treasury Department is developing recommendations for a thorough overhaul of our tax system. The task will be neither easy nor quick. Our economy has grown up around our current system. The result is entanglements that can only be unwound with care. There are no easy or obvious paths to take; each involves trade-offs that must be carefully weighed. But we believe the potential benefits make this a task worth undertaking.

The following are the goals we will strive to achieve:

1. A system that is simple and easy to understand, with reasonable filing and record-keeping requirements, and non-intrusive tax administration.
2. A system that is efficient and minimizes interference in economic decisions.
3. A system that supports the international competitiveness of U.S. businesses and workers.
4. A system that is fiscally sound, raising the revenues necessary for government operations.
5. A system that is stable enough to avoid the constant tinkering of years past.
6. A system that is understood to be fair, treating similarly situated taxpayers alike and equitably distributing tax burdens.

Our citizens deserve a tax system that is transparent, fair, and that assists rather than impedes economic growth. Our current system meets none of those objectives. We must step back and design a system that will drive our economic engine through the 21st Century and beyond.

V. R&E and Capitalization

Legislative simplification is not, of course, the only way to simplify compliance and administration. We are also trying to create simpler and more administrable rules under the current system. I would like to take a moment now to briefly discuss two of the more significant projects that we have been working on: the R&E credit and capitalization. These projects reflect Treasury's view – a view shared by the IRS – that taxpayers should be provided clear rules in advance of undertaking expenses, gathering information, and filing returns, and that issues should be resolved through the rule-making process (either administrative or legislative) and not through litigation. Resolution of issues through litigation is expensive, time-consuming, and

risky to tax administration and the development of sound tax policy. With a properly functioning published guidance process, litigation should be unnecessary except to enforce the laws.

R&E

We have two projects in the research credit area. The first addresses the allocation of the credit among members of a controlled group. The second addresses the qualification of expenses for the credit. Both projects are priorities.

As many of you know, the proposed regulations last December made a number of important changes to the earlier final regulations issued in January of 2001. In particular, the proposed regulations addressed the general standard for qualifying expenses as well as the definition and qualification of internal use software. The proposed regulations also eliminated the credit-specific record-keeping requirements.

Most of the comments we have received support the changes we made in the proposed regulations. However, a number of taxpayers, including many financial institutions have expressed considerable concern about the definition of internal use software.
This definition generally requires that the software be sold for separately stated consideration in order to not be considered internal use software. Other concerns have been expressed about the additional three-part test that applies to this type of software.

As I mentioned earlier, one of our priorities is guidance that resolves controversies between taxpayers and the IRS. By that, we do not mean guidance that simply moves the line of controversy in one direction or another. The definition of internal use software contained in the proposed regulations is intended to provide a clear rule based on a factor that distinguishes internal use software from commercial software. As with any bright-line rule, there are many cases that will be near that line, on both sides.

We recognize the concerns expressed by many taxpayers, in a number of different industries, that the proposed definition of internal use software is too broad—that it sweeps in software that is outside Congress' original contemplation of what should qualify for the credit. We recognize the concern that the proposed definition may disadvantage taxpayers who undertake software development in house rather than purchasing software from a vendor and taxpayers providing services other than computer services relative to taxpayers in the computer service business.

We are considering all of these comments with an eye towards issuing final guidance as soon as possible. As many of you know, the research credit has been one of the most contentious issues between large taxpayers and the IRS, and our goal for this guidance is the resolution of those controversies.

Capitalization

This morning, Treasury and the IRS issued proposed regulations addressing when costs to acquire, create or enhance intangible assets must be capitalized under section 263(a). The objectives of the proposed regulations are to reduce controversy, provide certainty regarding the expenses that must be capitalized, facilitate record keeping for those expenses, reduce examination resources currently devoted to capitalization issues, and balance administrative and record keeping costs with clear reflection of income principles.

The proposed regulations follow the structure of the advance notice of proposed rulemaking issued in January. Similar to the advanced notice, the proposed regulations describe specific categories of expenditures that taxpayers will be required to capitalize under section 263(a). These categories include costs certain to result in future benefits of a substantial nature that historically have been understood to be capital expenditures. Other expenditures for intangible assets

would not be subject to capitalization under section 263(a). The standard we have used to guide our formulation of the rules is the significant future benefit test articulated by the Supreme Court, flavored by practicality and common sense. It is important to note that "significant future benefit" is not, standing alone, a rule. That is because it would not provide useful guidance to taxpayers or IRS agents. It is, rather, the measuring rod we have used to determine the correctness of the rules we have proposed.
By creating an exclusive list of capitalized costs, the proposed regulation seeks to provide clear and administrable rules that will reduce controversy between taxpayers and the IRS.

To reduce administrative and record keeping costs, the proposed regulations also propose safe harbors and simplifying assumptions—that practically and common sense that I mentioned. For example, they include a "12 month rule" that permits deduction of the costs of certain intangible assets whose lives are of a relatively short duration, de minimis rules that permit deduction of certain costs that do not exceed $5,000, and a rule that permits deduction of employee compensation (including bonuses and commissions) and overhead costs. The proposed regulations also contain a 15 year safe harbor amortization period for costs to create certain intangible assets that do not have a readily ascertainable useful life.

We believe these proposed regulations, when finalized, will significantly reduce the amount of controversy that we've seen in the capitalization area in recent years.

VI. Voluntary Disclosure Initiative

Before I conclude, I would like to briefly mention the IRS announcement last week that it has revised and updated a key practice that assists agency investigators in determining whether a case is recommended for criminal prosecution. A taxpayer's timely, voluntary disclosure of a substantial unreported tax liability has long been an important factor in deciding whether the taxpayer's case should ultimately be referred for criminal prosecution. The IRS has modernized this practice to allow more taxpayers to voluntarily comply with their obligations and to reduce the uncertainty over what constitutes a "timely" disclosure. This is an important step in helping taxpayers and their advisers understand the steps they can take and the circumstances in which they can get back into compliance with the tax laws without fear of prosecution. With these practices in place, we hope that more taxpayers will do the right thing and voluntarily disclose their outstanding tax liabilities.

VII. Public dialogue

Let me close by noting that we are committed to a better and more open dialogue with the public. One illustration of that is our quarterly updates of the business plan, which reflect our continued conversation with you about the issues we need to address. Another illustration of that is the issuance in proposed form of section 302/318, consolidated return, and tax shelter regulations. A notice of proposed rulemaking is the opening in a dialogue with the public about what the rules should be. We will work diligently to propose sound rules and to do so rapidly enough to meet your needs.

Unfortunately, no immortals have yet gone to work at IRS or Treasury. We're all human. We will make mistakes. We will also have differences of opinion from time to time. But have no doubt about it. We appreciate it when you praise us, but we especially value your criticism. It helps us stay on track.

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
December 17, 2002

Contact: Office of Financing
(202) 691-3550

TREASURY'S INFLATION-INDEXED SECURITIES JANUARY REFERENCE CPI NUMBERS AND DAILY INDEX RATIOS

Public Debt announced today the reference Consumer Price Index (CPI) numbers and daily index ratios for the month of January for the following Treasury inflation-indexed securities:

(1) 3-3/8% 10-year notes due January 15, 2007
(2) 3-5/8% 10-year notes due January 15, 2008
(3) 3-5/8% 30-year bonds due April 15, 2028
(4) 3-7/8% 10-year notes due January 15, 2009
(5) 3-7/8% 30-year bonds due April 15, 2029
(6) 4-1/4% 10-year notes due January 15, 2010
(7) 3-1/2% 10-year notes due January 15, 2011
(8) 3-3/8% 30-1/2-year bonds due April 15, 2032
(9) 3-3/8% 10-year notes due January 15, 2012
(10) 3% 10-year notes due July 15, 2012

This information is based on the non-seasonally adjusted U.S. City Average All Items Consumer Price Index for All Urban Consumers (CPI-U) published by the Bureau of Labor Statistics of the U.S. Department of Labor.

In addition to the publication of the reference CPI's (Ref CPI) and index ratios, this release provides the non-seasonally adjusted CPI-U for the prior three-month period.

The information for February is expected to be released on January 16, 2003.

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January Reference CPI Numbers and Daily Index Ratios Table PDF format (file size-16KB, uploaded-12/17/02)

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U.S. Department of the Treasury, Bureau of the Public Debt

Last Updated January 12, 2005

PO - 3702

3-3/8% TREASURY 10-YEAR INFLATION-INDEXED NOTES

Due January 15, 2007

Ref CPI and Index Ratios for January 2003

Contact: Office of Financing 202-691-3550

DESCRIPTION:	Series A-2007
CUSIP NUMBER:	9128272M3
DATED DATE:	January 15, 1997
ORIGINAL ISSUE DATE:	February 6, 1997
ADDITIONAL ISSUE DATE:	April 15, 1997
MATURITY DATE:	January 15, 2007
Ref CPI on DATED DATE:	158.43548
TABLE FOR MONTH OF:	January 2003
NUMBER OF DAYS IN MONTH:	31
CPI-U (NSA) September 2002	181.0
CPI-U (NSA) October 2002	181.3
CPI-U (NSA) November 2002	181.3

Month	Calendar Day	Year	Ref CPI	Index Ratio
January	1	2003	181.30000	1.14431
January	2	2003	181.30000	1.14431
January	3	2003	181.30000	1.14431
January	4	2003	181.30000	1.14431
January	5	2003	181.30000	1.14431
January	6	2003	181.30000	1.14431
January	7	2003	181.30000	1.14431
January	8	2003	181.30000	1.14431
January	9	2003	181.30000	1.14431
January	10	2003	181.30000	1.14431
January	11	2003	181.30000	1.14431
January	12	2003	181.30000	1.14431
January	13	2003	181.30000	1.14431
January	14	2003	181.30000	1.14431
January	15	2003	181.30000	1.14431
January	16	2003	181.30000	1.14431
January	17	2003	181.30000	1.14431
January	18	2003	181.30000	1.14431
January	19	2003	181.30000	1.14431
January	20	2003	181.30000	1.14431
January	21	2003	181.30000	1.14431
January	22	2003	181.30000	1.14431
January	23	2003	181.30000	1.14431
January	24	2003	181.30000	1.14431
January	25	2003	181.30000	1.14431
January	26	2003	181.30000	1.14431
January	27	2003	181.30000	1.14431
January	28	2003	181.30000	1.14431
January	29	2003	181.30000	1.14431
January	30	2003	181.30000	1.14431
January	31	2003	181.30000	1.14431

3-5/8% TREASURY 10-YEAR INFLATION-INDEXED NOTES

Due January 15, 2008

Ref CPI and Index Ratios for January 2003

Contact: Office of Financing 202-691-3550

DESCRIPTION:	Series A-2008
CUSIP NUMBER:	9128273T7
DATED DATE:	January 15, 1998
ORIGINAL ISSUE DATE:	January 15, 1998
ADDITIONAL ISSUE DATE:	October 15, 1998
MATURITY DATE:	January 15, 2008
Ref CPI on DATED DATE:	161.55484
TABLE FOR MONTH OF:	January 2003
NUMBER OF DAYS IN MONTH:	31
CPI-U (NSA) September 2002	181.0
CPI-U (NSA) October 2002	181.3
CPI-U (NSA) November 2002	181.3

Month	Calendar Day	Year	Ref CPI	Index Ratio
January	1	2003	181.30000	1.12222
January	2	2003	181.30000	1.12222
January	3	2003	181.30000	1.12222
January	4	2003	181.30000	1.12222
January	5	2003	181.30000	1.12222
January	6	2003	181.30000	1.12222
January	7	2003	181.30000	1.12222
January	8	2003	181.30000	1.12222
January	9	2003	181.30000	1.12222
January	10	2003	181.30000	1.12222
January	11	2003	181.30000	1.12222
January	12	2003	181.30000	1.12222
January	13	2003	181.30000	1.12222
January	14	2003	181.30000	1.12222
January	15	2003	181.30000	1.12222
January	16	2003	181.30000	1.12222
January	17	2003	181.30000	1.12222
January	18	2003	181.30000	1.12222
January	19	2003	181.30000	1.12222
January	20	2003	181.30000	1.12222
January	21	2003	181.30000	1.12222
January	22	2003	181.30000	1.12222
January	23	2003	181.30000	1.12222
January	24	2003	181.30000	1.12222
January	25	2003	181.30000	1.12222
January	26	2003	181.30000	1.12222
January	27	2003	181.30000	1.12222
January	28	2003	181.30000	1.12222
January	29	2003	181.30000	1.12222
January	30	2003	181.30000	1.12222
January	31	2003	181.30000	1.12222

3-5/8% TREASURY 30-YEAR INFLATION-INDEXED BONDS

Due April 15, 2028

Ref CPI and Index Ratios for January 2003

Contact: Office of Financing 202-691-3550

DESCRIPTION:	Bonds of April 2028
CUSIP NUMBER:	912810FD5
DATED DATE:	April 15, 1998
ORIGINAL ISSUE DATE:	April 15, 1998
ADDITIONAL ISSUE DATE:	July 15, 1998
MATURITY DATE:	April 15, 2028
Ref CPI on DATED DATE:	161.74000
TABLE FOR MONTH OF:	January 2003
NUMBER OF DAYS IN MONTH:	31
CPI-U (NSA) September 2002	181.0
CPI-U (NSA) October 2002	181.3
CPI-U (NSA) November 2002	181.3

Month	Calendar Day	Year	Ref CPI	Index Ratio
January	1	2003	181.30000	1.12093
January	2	2003	181.30000	1.12093
January	3	2003	181.30000	1.12093
January	4	2003	181.30000	1.12093
January	5	2003	181.30000	1.12093
January	6	2003	181.30000	1.12093
January	7	2003	181.30000	1.12093
January	8	2003	181.30000	1.12093
January	9	2003	181.30000	1.12093
January	10	2003	181.30000	1.12093
January	11	2003	181.30000	1.12093
January	12	2003	181.30000	1.12093
January	13	2003	181.30000	1.12093
January	14	2003	181.30000	1.12093
January	15	2003	181.30000	1.12093
January	16	2003	181.30000	1.12093
January	17	2003	181.30000	1.12093
January	18	2003	181.30000	1.12093
January	19	2003	181.30000	1.12093
January	20	2003	181.30000	1.12093
January	21	2003	181.30000	1.12093
January	22	2003	181.30000	1.12093
January	23	2003	181.30000	1.12093
January	24	2003	181.30000	1.12093
January	25	2003	181.30000	1.12093
January	26	2003	181.30000	1.12093
January	27	2003	181.30000	1.12093
January	28	2003	181.30000	1.12093
January	29	2003	181.30000	1.12093
January	30	2003	181.30000	1.12093
January	31	2003	181.30000	1.12093

3-7/8% TREASURY 10-YEAR INFLATION-INDEXED NOTES

Due January 15, 2009

Ref CPI and Index Ratios for January 2003

Contact: Office of Financing 202-691-3550

DESCRIPTION:	Series A-2009
CUSIP NUMBER:	9128274Y5
DATED DATE:	January 15, 1999
ORIGINAL ISSUE DATE:	January 15, 1999
ADDITIONAL ISSUE DATE:	July 15, 1999
MATURITY DATE:	January 15, 2009
Ref CPI on DATED DATE:	164.00000
TABLE FOR MONTH OF:	January 2003
NUMBER OF DAYS IN MONTH:	31
CPI-U (NSA) September 2002	181.0
CPI-U (NSA) October 2002	181.3
CPI-U (NSA) November 2002	181.3

Month	Calendar Day	Year	Ref CPI	Index Ratio
January	1	2003	181.30000	1.10549
January	2	2003	181.30000	1.10549
January	3	2003	181.30000	1.10549
January	4	2003	181.30000	1.10549
January	5	2003	181.30000	1.10549
January	6	2003	181.30000	1.10549
January	7	2003	181.30000	1.10549
January	8	2003	181.30000	1.10549
January	9	2003	181.30000	1.10549
January	10	2003	181.30000	1.10549
January	11	2003	181.30000	1.10549
January	12	2003	181.30000	1.10549
January	13	2003	181.30000	1.10549
January	14	2003	181.30000	1.10549
January	15	2003	181.30000	1.10549
January	16	2003	181.30000	1.10549
January	17	2003	181.30000	1.10549
January	18	2003	181.30000	1.10549
January	19	2003	181.30000	1.10549
January	20	2003	181.30000	1.10549
January	21	2003	181.30000	1.10549
January	22	2003	181.30000	1.10549
January	23	2003	181.30000	1.10549
January	24	2003	181.30000	1.10549
January	25	2003	181.30000	1.10549
January	26	2003	181.30000	1.10549
January	27	2003	181.30000	1.10549
January	28	2003	181.30000	1.10549
January	29	2003	181.30000	1.10549
January	30	2003	181.30000	1.10549
January	31	2003	181.30000	1.10549

3-7/8% TREASURY 30-YEAR INFLATION-INDEXED BONDS

Due April 15, 2029

Ref CPI and Index Ratios for January 2003

Contact: Office of Financing 202-691-3550

DESCRIPTION:	Bonds of April 2029
CUSIP NUMBER:	912810FH6
DATED DATE:	April 15, 1999
ORIGINAL ISSUE DATE:	April 15, 1999
ADDITIONAL ISSUE DATES:	October 15, 1999
	October 15, 2000
MATURITY DATE:	April 15, 2029
Ref CPI on DATED DATE:	164.39333
TABLE FOR MONTH OF:	January 2003
NUMBER OF DAYS IN MONTH:	31
CPI-U (NSA) September 2002	181.0
CPI-U (NSA) October 2002	181.3
CPI-U (NSA) November 2002	181.3

Month	Calendar Day	Year	Ref CPI	Index Ratio
January	1	2003	181.30000	1.10284
January	2	2003	181.30000	1.10284
January	3	2003	181.30000	1.10284
January	4	2003	181.30000	1.10284
January	5	2003	181.30000	1.10284
January	6	2003	181.30000	1.10284
January	7	2003	181.30000	1.10284
January	8	2003	181.30000	1.10284
January	9	2003	181.30000	1.10284
January	10	2003	181.30000	1.10284
January	11	2003	181.30000	1.10284
January	12	2003	181.30000	1.10284
January	13	2003	181.30000	1.10284
January	14	2003	181.30000	1.10284
January	15	2003	181.30000	1.10284
January	16	2003	181.30000	1.10284
January	17	2003	181.30000	1.10284
January	18	2003	181.30000	1.10284
January	19	2003	181.30000	1.10284
January	20	2003	181.30000	1.10284
January	21	2003	181.30000	1.10284
January	22	2003	181.30000	1.10284
January	23	2003	181.30000	1.10284
January	24	2003	181.30000	1.10284
January	25	2003	181.30000	1.10284
January	26	2003	181.30000	1.10284
January	27	2003	181.30000	1.10284
January	28	2003	181.30000	1.10284
January	29	2003	181.30000	1.10284
January	30	2003	181.30000	1.10284
January	31	2003	181.30000	1.10284

4-1/4% TREASURY 10-YEAR INFLATION-INDEXED NOTES

Due January 15, 2010

Ref CPI and Index Ratios for January 2003

Contact: Office of Financing 202-691-3550

DESCRIPTION:	Series A-2010
CUSIP NUMBER:	9128275W8
DATED DATE:	January 15, 2000
ORIGINAL ISSUE DATE:	January 18, 2000
ADDITIONAL ISSUE DATE:	July 17, 2000
MATURITY DATE:	January 15, 2010
Ref CPI on DATED DATE:	168.24516
TABLE FOR MONTH OF:	January 2003
NUMBER OF DAYS IN MONTH:	31
CPI-U (NSA) September 2002	181.0
CPI-U (NSA) October 2002	181.3
CPI-U (NSA) November 2002	181.3

Month	Calendar Day	Year	Ref CPI	Index Ratio
January	1	2003	181.30000	1.07759
January	2	2003	181.30000	1.07759
January	3	2003	181.30000	1.07759
January	4	2003	181.30000	1.07759
January	5	2003	181.30000	1.07759
January	6	2003	181.30000	1.07759
January	7	2003	181.30000	1.07759
January	8	2003	181.30000	1.07759
January	9	2003	181.30000	1.07759
January	10	2003	181.30000	1.07759
January	11	2003	181.30000	1.07759
January	12	2003	181.30000	1.07759
January	13	2003	181.30000	1.07759
January	14	2003	181.30000	1.07759
January	15	2003	181.30000	1.07759
January	16	2003	181.30000	1.07759
January	17	2003	181.30000	1.07759
January	18	2003	181.30000	1.07759
January	19	2003	181.30000	1.07759
January	20	2003	181.30000	1.07759
January	21	2003	181.30000	1.07759
January	22	2003	181.30000	1.07759
January	23	2003	181.30000	1.07759
January	24	2003	181.30000	1.07759
January	25	2003	181.30000	1.07759
January	26	2003	181.30000	1.07759
January	27	2003	181.30000	1.07759
January	28	2003	181.30000	1.07759
January	29	2003	181.30000	1.07759
January	30	2003	181.30000	1.07759
January	31	2003	181.30000	1.07759

3-1/2% TREASURY 10-YEAR INFLATION-INDEXED NOTES

Due January 15, 2011

Ref CPI and Index Ratios for January 2003

Contact: Office of Financing 202-691-3550

Ref CPI and Index Ratios for January 2003:
3-1/2% TREASURY 10-YEAR INFLATION-INDEXED NOTES

DESCRIPTION:	Series A-2011
CUSIP NUMBER:	9128276R8
DATED DATE:	January 15, 2001
ORIGINAL ISSUE DATE:	January 16, 2001
ADDITIONAL ISSUE DATE:	July 16, 2001
MATURITY DATE:	January 15, 2011
Ref CPI on DATED DATE:	174.04516
TABLE FOR MONTH OF:	January 2003
NUMBER OF DAYS IN MONTH:	31
CPI-U (NSA) September 2002	181.0
CPI-U (NSA) October 2002	181.3
CPI-U (NSA) November 2002	181.3

Month	Calendar Day	Year	Ref CPI	Index Ratio
January	1	2003	181.30000	1.04168
January	2	2003	181.30000	1.04168
January	3	2003	181.30000	1.04168
January	4	2003	181.30000	1.04168
January	5	2003	181.30000	1.04168
January	6	2003	181.30000	1.04168
January	7	2003	181.30000	1.04168
January	8	2003	181.30000	1.04168
January	9	2003	181.30000	1.04168
January	10	2003	181.30000	1.04168
January	11	2003	181.30000	1.04168
January	12	2003	181.30000	1.04168
January	13	2003	181.30000	1.04168
January	14	2003	181.30000	1.04168
January	15	2003	181.30000	1.04168
January	16	2003	181.30000	1.04168
January	17	2003	181.30000	1.04168
January	18	2003	181.30000	1.04168
January	19	2003	181.30000	1.04168
January	20	2003	181.30000	1.04168
January	21	2003	181.30000	1.04168
January	22	2003	181.30000	1.04168
January	23	2003	181.30000	1.04168
January	24	2003	181.30000	1.04168
January	25	2003	181.30000	1.04168
January	26	2003	181.30000	1.04168
January	27	2003	181.30000	1.04168
January	28	2003	181.30000	1.04168
January	29	2003	181.30000	1.04168
January	30	2003	181.30000	1.04168

3-3/8% TREASURY 30-1/2-YEAR INFLATION-INDEXED BONDS
Due April 15, 2032

Ref CPI and Index Ratios for January 2003

Contact: Office of Financing 202-691-3550

DESCRIPTION:	Bonds of April 2032
CUSIP NUMBER:	912810FQ6
DATED DATE:	October 15, 2001
ORIGINAL ISSUE DATE:	October 15, 2001
ADDITIONAL ISSUE DATE:	
MATURITY DATE:	April 15, 2032
Ref CPI on DATED DATE:	177.50000
TABLE FOR MONTH OF:	January 2003
NUMBER OF DAYS IN MONTH:	31
CPI-U (NSA) September 2002	181.0
CPI-U (NSA) October 2002	181.3
CPI-U (NSA) November 2002	181.3

Month	Calendar Day	Year	Ref CPI	Index Ratio
January	1	2003	181.30000	1.02141
January	2	2003	181.30000	1.02141
January	3	2003	181.30000	1.02141
January	4	2003	181.30000	1.02141
January	5	2003	181.30000	1.02141
January	6	2003	181.30000	1.02141
January	7	2003	181.30000	1.02141
January	8	2003	181.30000	1.02141
January	9	2003	181.30000	1.02141
January	10	2003	181.30000	1.02141
January	11	2003	181.30000	1.02141
January	12	2003	181.30000	1.02141
January	13	2003	181.30000	1.02141
January	14	2003	181.30000	1.02141
January	15	2003	181.30000	1.02141
January	16	2003	181.30000	1.02141
January	17	2003	181.30000	1.02141
January	18	2003	181.30000	1.02141
January	19	2003	181.30000	1.02141
January	20	2003	181.30000	1.02141
January	21	2003	181.30000	1.02141
January	22	2003	181.30000	1.02141
January	23	2003	181.30000	1.02141
January	24	2003	181.30000	1.02141
January	25	2003	181.30000	1.02141
January	26	2003	181.30000	1.02141
January	27	2003	181.30000	1.02141
January	28	2003	181.30000	1.02141
January	29	2003	181.30000	1.02141
January	30	2003	181.30000	1.02141
January	31	2003	181.30000	1.02141

3-3/8% TREASURY 10-YEAR INFLATION-INDEXED NOTES

Due January 15, 2012

Ref CPI and Index Ratios for January 2003

Contact: Office of Financing 202-691-3550

DESCRIPTION:	Series A-2012
CUSIP NUMBER:	9128277J5
DATED DATE:	January 15, 2002
ORIGINAL ISSUE DATE:	January 15, 2002
ADDITIONAL ISSUE DATE:	
MATURITY DATE:	January 15, 2012
Ref CPI on DATED DATE:	177.56452
TABLE FOR MONTH OF:	January 2003
NUMBER OF DAYS IN MONTH:	31
CPI-U (NSA) September 2002	181.0
CPI-U (NSA) October 2002	181.3
CPI-U (NSA) November 2002	181.3

Month	Calendar Day	Year	Ref CPI	Index Ratio
January	1	2003	181.30000	1.02104
January	2	2003	181.30000	1.02104
January	3	2003	181.30000	1.02104
January	4	2003	181.30000	1.02104
January	5	2003	181.30000	1.02104
January	6	2003	181.30000	1.02104
January	7	2003	181.30000	1.02104
January	8	2003	181.30000	1.02104
January	9	2003	181.30000	1.02104
January	10	2003	181.30000	1.02104
January	11	2003	181.30000	1.02104
January	12	2003	181.30000	1.02104
January	13	2003	181.30000	1.02104
January	14	2003	181.30000	1.02104
January	15	2003	181.30000	1.02104
January	16	2003	181.30000	1.02104
January	17	2003	181.30000	1.02104
January	18	2003	181.30000	1.02104
January	19	2003	181.30000	1.02104
January	20	2003	181.30000	1.02104
January	21	2003	181.30000	1.02104
January	22	2003	181.30000	1.02104
January	23	2003	181.30000	1.02104
January	24	2003	181.30000	1.02104
January	25	2003	181.30000	1.02104
January	26	2003	181.30000	1.02104
January	27	2003	181.30000	1.02104
January	28	2003	181.30000	1.02104
January	29	2003	181.30000	1.02104
January	30	2003	181.30000	1.02104
January	31	2003	181.30000	1.02104

3% TREASURY 10-YEAR INFLATION-INDEXED NOTES
Due July 15, 2012

Ref CPI and Index Ratios for January 2003

Contact: Office of Financing 202-691-3550

DESCRIPTION:	Series C-2012
CUSIP NUMBER:	912828AF7
DATED DATE:	July 15, 2002
ORIGINAL ISSUE DATE:	July 15, 2002
ADDITIONAL ISSUE DATE:	October 15, 2002
MATURITY DATE:	July 15, 2012
Ref CPI on DATED DATE:	179.80000
TABLE FOR MONTH OF:	January 2003
NUMBER OF DAYS IN MONTH:	31
CPI-U (NSA) September 2002	181.0
CPI-U (NSA) October 2002	181.3
CPI-U (NSA) November 2002	181.3

Month	Calendar Day	Year	Ref CPI	Index Ratio
January	1	2003	181.30000	1.00834
January	2	2003	181.30000	1.00834
January	3	2003	181.30000	1.00834
January	4	2003	181.30000	1.00834
January	5	2003	181.30000	1.00834
January	6	2003	181.30000	1.00834
January	7	2003	181.30000	1.00834
January	8	2003	181.30000	1.00834
January	9	2003	181.30000	1.00834
January	10	2003	181.30000	1.00834
January	11	2003	181.30000	1.00834
January	12	2003	181.30000	1.00834
January	13	2003	181.30000	1.00834
January	14	2003	181.30000	1.00834
January	15	2003	181.30000	1.00834
January	16	2003	181.30000	1.00834
January	17	2003	181.30000	1.00834
January	18	2003	181.30000	1.00834
January	19	2003	181.30000	1.00834
January	20	2003	181.30000	1.00834
January	21	2003	181.30000	1.00834
January	22	2003	181.30000	1.00834
January	23	2003	181.30000	1.00834
January	24	2003	181.30000	1.00834
January	25	2003	181.30000	1.00834
January	26	2003	181.30000	1.00834
January	27	2003	181.30000	1.00834
January	28	2003	181.30000	1.00834
January	29	2003	181.30000	1.00834
January	30	2003	181.30000	1.00834
January	31	2003	181.30000	1.00834

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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December 19, 2002
PO-3703

Telecommunications Service Priority (TSP) Program.

The Financial and Banking Information Infrastructure Committee (FBIIC), chaired by Treasury Assistant Secretary for Financial Institutions Wayne A. Abernathy, today announced its policy and process for sponsoring qualified private sector financial organizations for the Telecommunications Service Priority (TSP) Program.

The TSP Program, administered by the National Communications System (NCS), was developed to ensure priority treatment for the nation's most important telecommunication services -- those supporting National Security and Emergency Preparedness (NS/EP) missions. The TSP Program authorizes and requires service vendors to provide and restore TSP-assigned services before non-TSP services. It also provides vendors with legal protection for giving preferential treatment to NS/EP users over non-NS/EP users.

The FBIIC is a standing committee of the President's Critical Infrastructure Protection Board and also serves as the Office of Homeland Security Financial Markets Work Group. The FBIIC is charged with coordinating federal and state financial regulatory efforts to improve the reliability and security of the U.S. financial system.

Members of the FBIIC include representatives of the Commodity Futures Trading Commission, the Conference of State Bank Supervisors, the Federal Deposit Insurance Corporation, the Federal Housing Finance Board, the Federal Reserve Bank of New York, the Federal Reserve Board, the National Association of Insurance Commissioners, the National Credit Union Administration, the Office of the Comptroller of the Currency, the Office of Federal Housing Enterprise Oversight, the Offices of Homeland and Cyberspace Security, the Office of Thrift Supervision, and the Securities and Exchange Commission.

The FBIIC Telecommunications Service Priority policy is attached. It is also available on the FBIIC website www.fbiic.gov.

Related Documents:

- TSP Policy

Issued: December 11, 2002

Financial and Banking Information Infrastructure Committee
Sponsorship of Priority Telecommunications Access for Private Sector Entities
through the National Communications System
Telecommunications Service Priority (TSP) Program

Background

The National Communications System (NCS) was established in 1963 to provide priority communications support to critical government functions during emergencies. In 1984 the National Security and Emergency Preparedness (NS/EP) capabilities of NCS were broadened and an interagency group (currently twenty-two federal departments and agencies) was formed to help coordinate and plan NS/EP services. The NCS has developed a number of priority telecommunications services that are also available to private sector entities through sponsorship by an NCS member department or agency. The events of September 11, 2001 put a new focus on the importance of these programs to the nation and to the financial sector.

In order to provide guidance to financial organizations seeking sponsorship for NCS services, the Financial and Banking Information Infrastructure Committee[1] (FBIIC) is developing a series of policies on the sponsorship of priority telecommunications access for private sector entities through the NCS. The goal of the policies is twofold: first, to make financial organizations and service providers aware of NCS programs and, second, to provide a consistent set of guidelines regarding qualification criteria and the appropriate process for organizations that want to gain access to the programs.

As a first step, on July 22, 2002 the FBIIC established a policy and process to sponsor qualifying financial organizations for Government Emergency Telecommunications Service (GETS)[2]. The enclosed policy addresses the FBIIC's policy and process to sponsor qualifying financial sector organizations for the NCS Telecommunications Service Priority (TSP) Program.

TSP Program

The TSP Program was developed to ensure priority treatment for the Nation's most important telecommunication services, services supporting NS/EP missions. Following natural or technical disasters, telecommunications service vendors may become overwhelmed with requests for new services and requirements to restore existing services. The TSP Program authorizes and requires service vendors to provision and restore TSP assigned services before non-TSP services and provides vendors with legal protection for giving preferential treatment to NS/EP users over non-NS/EP users.

[1] The Financial and Banking Information Infrastructure Committee (FBIIC) is a standing committee of the President's Critical Infrastructure Protection Board, serves as the Office of Homeland Security Financial Markets Work Group, and is charged with coordinating federal and state financial regulatory efforts to improve the reliability and security of the U.S. financial system. Treasury's Assistant Secretary for Financial Institutions chairs the committee. Members of the FBIIC include representatives of the Commodity Futures Trading Commission, the Conference of State Bank Supervisors, the Federal Deposit Insurance Corporation, the Federal Housing Finance Board, the Federal Reserve Bank of New York, the Federal Reserve Board, the National Association of Insurance Commissioners, the National Credit Union Administration, the Office of the Comptroller of the Currency, the Office of Federal Housing Enterprise Oversight, the Offices of Homeland and Cyberspace Security, the Office of Thrift Supervision, and the Securities and Exchange Commission.

[2] The GETS Policy is posted at www.fbiic.gov.

The TSP Program has two components: restoration and provisioning. A restoration priority is applied to new or existing telecommunication services to ensure their restoration before any non-TSP services. Priority restoration is necessary for a TSP service because interruptions may have a serious adverse effect on the supported NS/EP function. TSP restoration priorities must be requested and assigned before a service outage occurs. As a matter of general practice, telecommunications service vendors restore existing TSP services before provisioning new TSP services. A provisioning priority is obtained to facilitate priority installation of new telecommunication services. Provisioning on a priority basis becomes necessary when a service user has an urgent need for a new NS/EP service that must be installed immediately (e.g., in an emergency) or in a shorter than normal interval.

Telecommunication carrier tariffs for providing TSP are filed with the FCC and state regulatory agencies. The tariffs permit carriers to assess a one-time charge and a monthly charge for each circuit assigned a TSP restoration authorization code. In the event new service is provisioned under TSP, carriers can apply a surcharge to the normal installation charges for each telecommunication service ordered. Finally, telecommunication carriers can assess a penalty to TSP customers for reporting an erroneous outage on a TSP circuit that is traced to the customer's premise equipment. Private-sector organizations that lease circuits that are granted TSP status must bear the cost of all tariffs for TSP. More information about the TSP program is available on the NCS website (http://www.ncs.gov) under *Programs.*

All NS/EP missions fall into one of five TSP Program categories. All NS/EP telecommunication services qualify for some level of TSP protection. The level is determined in part by the category that represents the organization's mission. The five categories are: (A) National Security Leadership, (B) National Security Posture and US Population Attack Warning, (C) Public Health, Safety, and Maintenance of Law and Order, (D) Public Welfare and Maintenance of the National Economic Posture, and (E) Emergency (Provisioning Requests Only). Categories A through D are referred to as "essential services".

Telecommunications services are designated as essential where a disruption of "a few minutes to one day" could seriously affect the continued operations that support an NS/EP function. Essential services are assigned a priority on a scale of 1 to 5 (with 1 as the highest priority) based on the appropriate subcategory. Services in subcategory A qualify for priority levels 1-5; those in subcategory B qualify for priority levels 2-5; those in subcategory C qualify for priority levels 3-5; and services in subcategory D qualify for priority levels 4-5.

Any organization, Federal government, State government, local government, private industry, or foreign government that has telecommunication services supporting an NS/EP mission is eligible to participate in the TSP Program. All non-Federal TSP requests must be sponsored by a Federal agency. A sponsor can be any federal agency with which a non-Federal user may be affiliated. The sponsoring Federal agency ensures the telecommunications service supports an NS/EP function and merits TSP.

FBIIC Telecommunications Service Priority (TSP) Sponsorship Policy

Sponsorship Criteria

The FBIIC policy builds upon and extends the TSP sponsorship policies established by the Federal Reserve Board. The FBIIC policy contains additional sponsorship criteria to explicitly encompass a broader group of eligible telecommunication circuits.

The FBIIC agencies have determined that to qualify for TSP sponsorship, financial organizations and their service providers must support the performance of NS/EP functions necessary to maintain the national economic posture (category D above). The FBIIC agencies will sponsor circuits which meet the criteria described below.

1) Circuits Supporting Critical Payment System Participants (Depository Institutions, Financial Utilities)

The Federal Reserve Board originally established policies and procedures for its sponsorship of organizations for priority provisioning and restoration of telecommunications services under the TSP program in 1993 (58 FR 38569, July 19, 1993). The Board recently updated its sponsorship policy and expanded its sponsorship criteria. Further information is available through the Board's website www.federalreserve.gov.

2) Circuits Supporting Key Securities & Derivatives Markets Participants

In addition, the Securities and Exchange Commission and the Commodity Futures Trading Commission will sponsor circuits owned or leased by organizations that play key roles in the conduct or operation of the securities and derivatives markets and related clearance and settlement systems.

3) Circuits Supporting Other NS/EP Services

The FBIIC agencies will also sponsor circuits owned or leased by an organization that do not meet the above sponsorship criteria if a disruption of those circuits could seriously affect operations that support the maintenance of the national economic posture.

Sponsorship Process

The individual FBIIC agencies will contact appropriate financial organizations and service providers for which they are the primary regulator and inform them of the process to be followed to apply for TSP sponsorship.

If a financial organization or service provider believes that one or more of its circuits qualify for TSP sponsorship, it should submit a sponsorship request in accordance with the process established by its primary regulator.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

December 18, 2002
PO-3704

Treasury Department Announces Additional Interim Guidance on Terrorism Insurance for Insurance Industry

The Treasury Department today announced additional interim guidance for the insurance industry in meeting certain requirements under the Terrorism Risk Insurance Act of 2002, which was signed into law by President Bush on November 26, 2002.

Today's interim guidance is designed to assist insurers in determining whether they are covered by, and how they may comply with, certain immediately applicable provisions of the Terrorism Risk Insurance Act prior to the issuance of final regulations by the Treasury.

"We emphasize again that the terrorism risk insurance program is in force today, even as we refine the operational details," said Treasury Assistant Secretary Wayne Abernathy, who oversees the Terrorism Risk Insurance Program. "We hope that today's round of guidance will serve as an immediate, if temporary, roadmap for insurers as they continue to incorporate the new law's provisions into their business models. We will continue our close and productive working relationship with the National Association of Insurance Commissioners (NAIC) to develop and issue the most effective guidance possible."

Today's interim guidance, along with interim guidance issued by the Treasury on December 3, 2002, can be used by insurers in complying with the statutory requirements prior to the issuance of regulations, and remains in effect until superceded by regulations or subsequent notice. Both interim guidance notices and other information related to the Terrorism Risk Insurance Program can be found at www.treasury.gov/trip. Prior to issuance of final regulations, insurers and other interested parties will have an opportunity to submit comments on proposed regulations.

Today's notice provides interim guidance concerning the definition of insurer in general and also concerning specific categories of insurers under the Act. All entities that meet the definition of insurer under the Act are required to participate in the Program. This includes state-licensed or admitted insurers, eligible alien surplus line carriers, and insurers that are approved by federal agencies in connection with maritime, aviation, or energy activity.

This guidance builds upon the Treasury's previous interim guidance (that described the lines of commercial property and casualty insurance covered by the Program and how an insurer's "direct earned premium" would be measured).

In addition to providing further guidance concerning which entities are considered insurers under the Program, the notice provides guidance concerning the scope of insurance coverage, including geographic scope, under the Program, and how an insurer under the Program may calculate its deductible for purposes of the Program. For alien surplus line carriers and foreign insurers that are approved by a federal agency in connection with maritime, aviation or energy activity, this guidance describes procedures that should be followed so that this category of insurers is treated in a manner similar to domestic insurers and so that they may estimate the portion of their insurance coverage that covered by the Program.

To assist all categories of insurers under the Program, the guidance provides clarification regarding participation by affiliates and parent companies and how the Treasury intends to treat such entities for purposes of the Program. As described in this guidance, all affiliates that meet the definition of insurer and are under common control with an insurer should be considered as one insurer for purposes of the Program. The guidance also describes how newly-formed insurers (e.g. newly formed insurance companies that meet the definition of insurer but do not have the necessary data to calculate their deductibles) can calculate their deductibles.

This guidance also provides a list of state residual market entities and state workers' compensation funds that are required to participate in the Program. Although these entities are required to participate as insurers in the Program, some may be unable to determine their risk exposure at this time. The Treasury is waiving the disclosure and "make available" requirements for this limited group of entities and funds until regulations are issued for this group.

Finally, although the Treasury stated in its previous interim guidance that the NAIC's model disclosures were not the exclusive means by which insurers could comply with the Act, the Treasury has received numerous questions on that issue. Today's interim guidance provides additional disclosure guidance.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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December 18, 2002
PO-3704b

Treasury Department Announces Additional Interim Guidance on Terrorism Insurance Industry

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This guidance builds upon the Treasury's previous interim guidance (that described the lines of commercial property and casualty insurance covered by the Program and how an insurer's "direct earned premium" would be measured).

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estimate the portion of their insurance coverage that covered by the Program.

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Finally, although the Treasury stated in its previous interim guidance that the NAIC's model disclosures were not the exclusive means by which insurers could comply with the Act, the Treasury has received numerous questions on that issue. Today's interim guidance provides additional disclosure guidance.

Related Documents:

- Interim Guidance on Terrorism Insurance

BILLING CODE 4810-02

DEPARTMENT OF THE TREASURY

31 CFR Part 103

RIN 1505-AA87

Financial Crimes Enforcement Network; Anti-Money Laundering Requirements —Correspondent Accounts for Foreign Shell Banks; Recordkeeping and Termination of Correspondent Accounts for Foreign Banks.

AGENCY: Financial Crimes Enforcement Network (FinCEN), Treasury.

ACTION: Final Rule.

SUMMARY: The Financial Crimes Enforcement Network (FinCEN) is issuing this final rule to extend the time by which certain financial institutions must obtain information from each foreign bank for which they maintain a correspondent account concerning (1) the foreign bank's status as "shell" bank, (2) whether the foreign bank provides banking services to foreign shell banks, (3) certain owners of the foreign bank, and (4) the identity of a person in the United States to accept service of legal process.

DATES: This final rule is effective [INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER].

FOR FURTHER INFORMATION CONTACT: Office of the Chief Counsel (FinCEN), (703) 905-3590; Office of the Assistant General Counsel for Banking & Finance (Treasury), (202) 622-0480, or Office of the Assistant General Counsel for Enforcement (Treasury), (202) 622-1927 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

I. Background

On September 26, 2002, FinCEN published a final rule (67 FR 60562) implementing sections 313(a) and 319(b) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT) Act of 2001 (the Act). Section 313(a) of the Act added subsection (j) to 31 U.S.C. 5318, which prohibits a Acovered financial institution@ from providing Acorrespondent accounts@ in the United States to foreign banks that do not have a physical presence in any country (foreign shell banks). Section 313(a) also requires those financial institutions to take reasonable steps to ensure that correspondent accounts provided to foreign banks are not being used to provide banking services indirectly to foreign shell banks. Section 319(b) of the Act added subsection (k) to 31 U.S.C. 5318, which requires any covered financial institution that provides a correspondent account to a foreign bank to maintain records of the foreign bank=s owners and to maintain the name and address of an agent in the United States designated to accept service of legal process for the foreign bank for records regarding the correspondent account.

The September 26, 2002 final rule provided that a covered financial institution could satisfy the requirements of section 313(a) and 319(b) by obtaining from a foreign bank a certification that contained the necessary information, or by otherwise obtaining documentation of the required information. With respect to correspondent accounts that existed on October 28, 2002, the final rule required a covered financial institution to close a correspondent account, within a commercially reasonable time, if the covered financial institution did not receive the certification from the foreign bank, or otherwise obtain documentation of the required information, on or before December 26, 2002.

A significant number of covered financial institutions, principally in the securities industry, have noted that the December 26, 2002 deadline to obtain the required information is proving to be inadequate. Many securities firms indicated that providing an effective explanation of their duties under the Act to a wide variety of foreign banks, which may speak different languages and operate in different ways than their U.S. counterparts, has in some cases, lengthened the process. Moreover, the broad definition of a correspondent account found in the Final Rule has increased the number of accounts subject to these requirements and, consequently, has increased the burden on U.S. banks and broker-dealers to secure the required information. Finally, because the Act has generally increased the overall level of regulatory requirements for securities firms and depository institutions, they have been managing an increased overall workload as a result of additional regulations, within a finite set of resources. For these reasons, the process of gathering the necessary information to comply with section 313(a) and 319(b) of the Act is taking longer than the time provided in the September 28 final rule.

II. The Current Rulemaking

This rule extends the time by which a covered financial institution must obtain the information required to satisfy the requirements of sections 313(a) and 319(b) from December 26, 2002 to March 31, 2003. Treasury and FinCEN do not anticipate granting a further extension beyond March 31 and expect that covered financial institutions will comply with the September 26, 2002 final rule with respect to correspondent accounts established for foreign banks that have not provided the required information by that date.

III. Procedural Requirements

Because this rule extends the time by which a covered financial institution must obtain the information necessary to satisfy the requirements of section 313(a) and 319(b) of the Act before taking actions to terminate a correspondent account, it has been determined that notice and public procedure are unnecessary pursuant to 5 U.S.C. 553 (b)(B) and that a delayed effective date is not required pursuant to 5 U.S.C. 553(d)(1).

It has been determined that this rule is not a significant regulatory action for purposes of Executive Order 12866. Because no notice of proposed rulemaking is required, the provisions of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*) do not apply.

List of Subjects in 31 CFR Part 103

Banks, banking; Brokers; Counter money laundering; Counter-terrorism; Currency; Foreign banking; Reporting and recordkeeping requirements.

Authority and Issuance

For the reasons set forth in the preamble, 31 CFR part 103 is amended as follows:

PART 103? FINANCIAL RECORDKEEPING AND REPORTING OF CURRENCY AND FOREIGN TRANSACTIONS

1. The authority citation for part 103 is revised to read as follows:

Authority: 12 U.S.C. 1829b and 1951-1959; 31 U.S.C. 5311-5314 and 5316-5332; title III, secs. 312, 313, 314, 319, 352, Pub. L. 107-56, 115 Stat. 307.

2. Section 103.177 is revised by amending paragraph (d)(1) to read as follows:

103.177 Prohibition on correspondent accounts for foreign shell banks; Records concerning owners of foreign banks and agents for service of legal process.

* * * * *

(d) *Closure of correspondent accounts*. (1) *Accounts existing on October 28, 2002*. In the case of any correspondent account that was in existence on October 28, 2002, if the covered financial institution has not obtained a certification (or recertification) from the foreign bank, or has not otherwise obtained documentation of the information required by such certification (or recertification), on or before March 31, 2003, and at least once every three years thereafter, the covered financial institution shall close all correspondent accounts with such foreign bank within a commercially reasonable time, and shall not permit the foreign bank to establish any new positions or execute any transaction through any such account, other than transactions necessary to close the account.

* * * * *

DATED: _________, 2002

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James Sloan
Director, Financial Crimes Enforcement Network

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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December 18, 2002
PO-3705

Treasury Issues Rule Extending the Deadline for Obtaining Shell Bank Certifications Under the USA PATRIOT Act

The Treasury Department today sent to the Federal Register a final rule extending by 90 days the deadline for U.S. depository institutions and securities broker-dealers to confirm that correspondent accounts maintained for foreign banks are not being used to provide services, directly or indirectly, to foreign shell banks. This final rule similarly extends the deadline for the requirement that these two types of financial institutions obtain certain information from foreign banks for which they maintain correspondent accounts. The new deadline is March 31, 2003.

Section 313 of the USA PATRIOT Act prohibits U.S. depository institutions and securities broker-dealers ("covered financial institutions") from maintaining correspondent accounts for foreign shell banks, and requires that they take reasonable steps to ensure that they are not providing banking services to foreign shell banks indirectly through correspondent accounts maintained for other foreign banks. A shell bank is a foreign bank with no physical presence in any jurisdiction.

Section 319(b) of the Act requires any covered financial institution that provides a correspondent account to a foreign bank to maintain records of the owners of the foreign bank and to maintain the name and address of an agent in the United States designated to accept service of legal process for the foreign bank for records regarding the correspondent account. Final Treasury regulations issued in September provided that a covered financial institution could satisfy the requirements of section 313(a) and 319(b) by obtaining from a foreign bank a certification that contained the necessary information, or by otherwise obtaining documentation of the required information.

With respect to correspondent accounts that existed on October 28, 2002, the final rule required a covered financial institution to close a correspondent account within a commercially reasonable time, if the covered financial institution did not receive the certification from the foreign bank, or otherwise obtain documentation of the required information, on or before December 26, 2002. Despite diligent efforts by U.S. financial institutions, the Treasury has learned that many covered financial institutions have not been able to obtain all required certifications from their foreign bank customers by this deadline. Accordingly, the Treasury has determined that it is necessary and appropriate to extend this deadline for a brief period of 90 days to afford covered financial institutions an opportunity to secure the necessary certifications before terminating correspondent accounts.

The Treasury expects that this extension will be published in the Federal Register prior to December 26, 2002. However, should publication be delayed, covered financial institutions will not be expected to begin the process of terminating accounts on that date.

Related Documents:

- Final Extention Rule

BILLING CODE 4810-02

DEPARTMENT OF THE TREASURY

31 CFR Part 103

RIN 1505-AA87

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* * * * *

DATED: ________, 2002

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James Sloan
Director, Financial Crimes Enforcement Network

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

December 18, 2002
PO-3706

Treasury Department Will Begin Releasing Auction Results Electronically in 2003

The Treasury Department today announced that beginning January 13, 2003, it will begin releasing the official results of Treasury bill and note auctions electronically to accredited news services and the public.

"Automating this process is an important step forward in our effort to achieve a consistent two-minute release of Treasury auction results to the market," said Peter Fisher, Treasury Under Secretary for Domestic Finance.

The results will be posted to a special Internet site for automated retrieval by the news services. Auction results will also be posted on the Bureau of the Public Debt's public website as quickly as possible thereafter. The official release time of Treasury bill and note auctions will be the time the auction results data is made available to the news services on the special Internet site.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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December 19, 2002
PO-3707

FBIIC Outlines Policy for Telecommunications Service Priority Program

7The Financial and Banking Information Infrastructure Committee (FBIIC), chaired by Treasury Assistant Secretary for Financial Institutions Wayne A. Abernathy, today announced its policy and process for sponsoring qualified private sector financial organizations for the Telecommunications Service Priority (TSP) Program.

The TSP Program, administered by the National Communications System (NCS), was developed to ensure priority treatment for the nation's most important telecommunication services -- those supporting National Security and Emergency Preparedness (NS/EP) missions. The TSP Program authorizes and requires service vendors to provide and restore TSP-assigned services before non-TSP services. It also provides vendors with legal protection for giving preferential treatment to NS/EP users over non-NS/EP users.

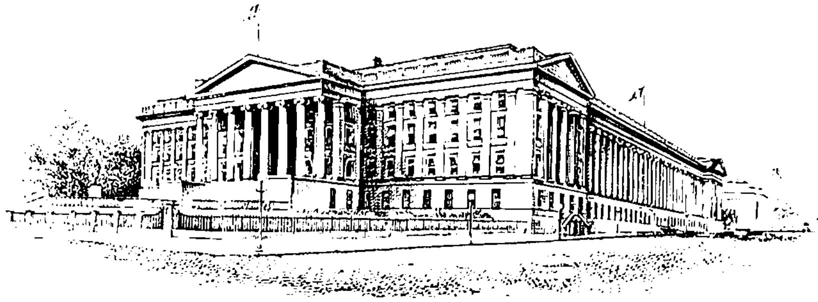
The FBIIC is a standing committee of the President's Critical Infrastructure Protection Board and also serves as the Office of Homeland Security Financial Markets Work Group. The FBIIC is charged with coordinating federal and state financial regulatory efforts to improve the reliability and security of the U.S. financial system.

Members of the FBIIC include representatives of the Commodity Futures Trading Commission, the Conference of State Bank Supervisors, the Federal Deposit Insurance Corporation, the Federal Housing Finance Board, the Federal Reserve Bank of New York, the Federal Reserve Board, the National Association of Insurance Commissioners, the National Credit Union Administration, the Office of the Comptroller of the Currency, the Office of Federal Housing Enterprise Oversight, the Offices of Homeland and Cyberspace Security, the Office of Thrift Supervision, and the Securities and Exchange Commission.

The FBIIC Telecommunications Service Priority policy is attached. It is also available on the FBIIC website www.fbiic.gov.

Related Documents:

- TSP Policy



DEPARTMENT OF THE TREASURY
OFFICE OF PUBLIC AFFAIRS

Issued December 11, 2002

Financial and Banking Information Infrastructure Committee Sponsorship of Priority Telecommunications Access for Private Sector Entities through the National Communications System Telecommunications Service Priority (TSP) Program

Background

The National Communications System (NCS) was established in 1963 to provide priority communications support to critical government functions during emergencies. In 1984 the National Security and Emergency Preparedness (NS/EP) capabilities of NCS were broadened and an interagency group (currently twenty-two federal departments and agencies) was formed to help coordinate and plan NS/EP services. The NCS has developed a number of priority telecommunications services that are also available to private sector entities through sponsorship by an NCS member department or agency. The events of September 11, 2001 put a new focus on the importance of these programs to the nation and to the financial sector.

In order to provide guidance to financial organizations seeking sponsorship for NCS services, the Financial and Banking Information Infrastructure Committee[1] (FBIIC) is developing a series of policies on the sponsorship of priority telecommunications access for private sector entities through the NCS. The goal of the policies is twofold: first, to make financial organizations and service providers aware of NCS programs and, second, to provide a consistent set of guidelines regarding qualification criteria and the appropriate process for organizations that want to gain access to the programs.

[1] The Financial and Banking Information Infrastructure Committee (FBIIC) is a standing committee of the President's Critical Infrastructure Protection Board, serves as the Office of Homeland Security Financial Markets Work Group, and is charged with coordinating federal and state financial regulatory efforts to improve the reliability and security of the U.S. financial system. Treasury's Assistant Secretary for Financial Institutions chairs the committee. Members of the FBIIC include representatives of the Commodity Futures Trading Commission, the Conference of State Bank Supervisors, the Federal Deposit Insurance Corporation, the Federal Housing Finance Board, the Federal Reserve Bank of New York, the Federal Reserve Board, the National Association of Insurance Commissioners, the National Credit Union Administration, the Office of the Comptroller of the Currency, the Office of Federal Housing Enterprise Oversight, the Offices of Homeland and Cyberspace Security, the Office of Thrift Supervision, and the Securities and Exchange Commission.

As a first step, on July 22, 2002 the FBIIC established a policy and process to sponsor qualifying financial organizations for Government Emergency Telecommunications Service (GETS)[2]. The enclosed policy addresses the FBIIC's policy and process to sponsor qualifying financial sector organizations for the NCS Telecommunications Service Priority (TSP) Program.

TSP Program

The TSP Program was developed to ensure priority treatment for the Nation's most important telecommunication services, services supporting NS/EP missions. Following natural or technical disasters, telecommunications service vendors may become overwhelmed with requests for new services and requirements to restore existing services. The TSP Program authorizes and requires service vendors to provision and restore TSP assigned services before non-TSP services and provides vendors with legal protection for giving preferential treatment to NS/EP users over non-NS/EP users.

The TSP Program has two components: restoration and provisioning. A restoration priority is applied to new or existing telecommunication services to ensure their restoration before any non-TSP services. Priority restoration is necessary for a TSP service because interruptions may have a serious adverse effect on the supported NS/EP function. TSP restoration priorities must be requested and assigned before a service outage occurs. As a matter of general practice, telecommunications service vendors restore existing TSP services before provisioning new TSP services. A provisioning priority is obtained to facilitate priority installation of new telecommunication services. Provisioning on a priority basis becomes necessary when a service user has an urgent need for a new NS/EP service that must be installed immediately (e.g., in an emergency) or in a shorter than normal interval.

Telecommunication carrier tariffs for providing TSP are filed with the FCC and state regulatory agencies. The tariffs permit carriers to assess a one-time charge and a monthly charge for each circuit assigned a TSP restoration authorization code. In the event new service is provisioned under TSP, carriers can apply a surcharge to the normal installation charges for each telecommunication service ordered. Finally, telecommunication carriers can assess a penalty to TSP customers for reporting an erroneous outage on a TSP circuit that is traced to the customer's premise equipment. Private-sector organizations that lease circuits that are granted TSP status must bear the cost of all tariffs for TSP. More information about the TSP program is available on the NCS website (http://www.ncs.gov) under *Programs.*

All NS/EP missions fall into one of five TSP Program categories. All NS/EP telecommunication services qualify for some level of TSP protection. The level is determined in part by the category that represents the organization's mission. The five categories are: (A) National Security Leadership, (B) National Security Posture and US Population Attack Warning, (C) Public Health, Safety, and Maintenance of Law and Order, (D) Public Welfare and Maintenance of the National Economic Posture, and (E) Emergency (Provisioning Requests Only). Categories A through D are referred to as "essential services".

[2] The GETS Policy is posted at www.fbiic.gov.

Telecommunications services are designated as essential where a disruption of "a few minutes to one day" could seriously affect the continued operations that support an NS/EP function. Essential services are assigned a priority on a scale of 1 to 5 (with 1 as the highest priority) based on the appropriate subcategory. Services in subcategory A qualify for priority levels 1-5; those in subcategory B qualify for priority levels 2-5; those in subcategory C qualify for priority levels 3-5; and services in subcategory D qualify for priority levels 4-5.

Any organization, Federal government, State government, local government, private industry, or foreign government that has telecommunication services supporting an NS/EP mission is eligible to participate in the TSP Program. All non-Federal TSP requests must be sponsored by a Federal agency. A sponsor can be any federal agency with which a non-Federal user may be affiliated. The sponsoring Federal agency ensures the telecommunications service supports an NS/EP function and merits TSP.

Sponsorship Criteria

The FBIIC policy builds upon and extends the TSP sponsorship policies established by the Federal Reserve Board. The FBIIC policy contains additional sponsorship criteria to explicitly encompass a broader group of eligible telecommunication circuits.

The FBIIC agencies have determined that to qualify for TSP sponsorship, financial organizations and their service providers must support the performance of NS/EP functions necessary to maintain the national economic posture (category D above). The FBIIC agencies will sponsor circuits which meet the criteria described below.

1) Circuits Supporting Critical Payment System Participants (Depository Institutions, Financial Utilities)

The Federal Reserve Board originally established policies and procedures for its sponsorship of organizations for priority provisioning and restoration of telecommunications services under the TSP program in 1993 (58 FR 38569, July 19, 1993). The Board recently updated its sponsorship policy and expanded its sponsorship criteria. Further information is available through the Board's website www.federalreserve.gov.

2) Circuits Supporting Key Securities & Derivatives Markets Participants

In addition, the Securities and Exchange Commission and the Commodity Futures Trading Commission will sponsor circuits owned or leased by organizations that play key roles in the conduct or operation of the securities and derivatives markets and related clearance and settlement systems.

3) Circuits Supporting Other NS/EP Services

The FBIIC agencies will also sponsor circuits owned or leased by an organization that do not meet the above sponsorship criteria if a disruption of those circuits could seriously affect operations that support the maintenance of the national economic posture.

Sponsorship Process

The individual FBIIC agencies will contact appropriate financial organizations and service providers for which they are the primary regulator and inform them of the process to be followed to apply for TSP sponsorship.

If a financial organization or service provider believes that one or more of its circuits qualify for TSP sponsorship, it should submit a sponsorship request in accordance with the process established by its primary regulator.

DEPARTMENT OF THE TREASURY

TREASURY NEWS

OFFICE OF PUBLIC AFFAIRS • 1500 PENNSYLVANIA AVENUE, N.W. • WASHINGTON, D.C. • 20220 • (202) 622-2960

EMBARGOED UNTIL 11:00 A.M.
December 19, 2002

CONTACT: Office of Financing
202/691-3550

TREASURY OFFERS 13-WEEK AND 26-WEEK BILLS

The Treasury will auction 13-week and 26-week Treasury bills totaling $30,000 million to refund an estimated $30,507 million of publicly held 13-week and 26-week Treasury bills maturing December 26, 2002, and to pay down approximately $507 million. Also maturing is an estimated $22,000 million of publicly held 4-week Treasury bills, the disposition of which will be announced December 23, 2002.

The Federal Reserve System holds $13,604 million of the Treasury bills maturing on December 26, 2002, in the System Open Market Account (SOMA). This amount may be refunded at the highest discount rate of accepted competitive tenders either in these auctions or the 4-week Treasury bill auction to be held December 24, 2002. Amounts awarded to SOMA will be in addition to the offering amount.

Up to $1,000 million in noncompetitive bids from Foreign and International Monetary Authority (FIMA) accounts bidding through the Federal Reserve Bank of New York will be included within the offering amount of each auction. These noncompetitive bids will have a limit of $100 million per account and will be accepted in the order of smallest to largest, up to the aggregate award limit of $1,000 million.

TreasuryDirect customers have requested that we reinvest their maturing holdings of approximately $992 million into the 13-week bill and $582 million into the 26-week bill.

The allocation percentage applied to bids awarded at the highest discount rate will be rounded up to the next hundredth of a whole percentage point, e.g., 17.13%.

This offering of Treasury securities is governed by the terms and conditions set forth in the Uniform Offering Circular for the Sale and Issue of Marketable Book-Entry Treasury Bills, Notes, and Bonds (31 CFR Part 356, as amended).

Details about each of the new securities are given in the attached offering highlights.

oOo

Attachment

PO-3708

HIGHLIGHTS OF TREASURY OFFERINGS OF BILLS
TO BE ISSUED DECEMBER 26, 2002

December 19, 2002

Offering Amount	$14,000 million	$16,000 million
Maximum Award (35% of Offering Amount)	$ 4,900 million	$ 5,600 million
Maximum Recognized Bid at a Single Rate	$ 4,900 million	$ 5,600 million
NLP Reporting Threshold	$ 4,900 million	$ 5,600 million
NLP Exclusion Amount	$ 4,600 million	None

Description of Offering:

Term and type of security	91-day bill	182-day bill
CUSIP number	912795 ME 8	912795 MT 5
Auction date	December 23, 2002	December 23, 2002
Issue date	December 26, 2002	December 26, 2002
Maturity date	March 27, 2003	June 26, 2003
Original issue date	September 26, 2002	December 26, 2002
Currently outstanding	$18,025 million	---
Minimum bid amount and multiples	$1,000	$1,000

The following rules apply to all securities mentioned above:

Submission of Bids:

Noncompetitive bids: Accepted in full up to $1 million at the highest discount rate of accepted competitive bids.

Foreign and International Monetary Authority (FIMA) bids: Noncompetitive bids submitted through the Federal Reserve Banks as agents for FIMA accounts. Accepted in order of size from smallest to largest with no more than $100 million awarded per account. The total noncompetitive amount awarded to Federal Reserve Banks as agents for FIMA accounts will not exceed $1,000 million. A single bid that would cause the limit to be exceeded will be partially accepted in the amount that brings the aggregate award total to the $1,000 million limit. However, if there are two or more bids of equal amounts that would cause the limit to be exceeded, each will be prorated to avoid exceeding the limit.

Competitive bids:

(1) Must be expressed as a discount rate with three decimals in increments of .005%, e.g., 7.100%, 7.105%.

(2) Net long position (NLP) for each bidder must be reported when the sum of the total bid amount, at all discount rates, and the net long position equals or exceeds the NLP reporting threshold stated above.

(3) Net long position must be determined as of one half-hour prior to the closing time for receipt of competitive tenders.

Receipt of Tenders:

Noncompetitive tenders..... Prior to 12:00 noon eastern standard time on auction day

Competitive tenders........ Prior to 1:00 p.m. eastern standard time on auction day

Payment Terms: By charge to a funds account at a Federal Reserve Bank on issue date, or payment of full par amount with tender. *TreasuryDirect* customers can use the Pay Direct feature, which authorizes a charge to their account of record at their financial institution on issue date.

DEPARTMENT OF THE TREASURY

TREASURY NEWS

OFFICE OF PUBLIC AFFAIRS • 1500 PENNSYLVANIA AVENUE, N.W. • WASHINGTON, D.C. • 20220 • (202) 622-2960

EMBARGOED UNTIL 11:00 A.M.
December 19, 2002

CONTACT: Office of Financing
202/691-3550

TREASURY OFFERS 2-YEAR NOTES

The Treasury will auction $27,000 million of 2-year notes to refund $20,679 million of publicly held notes maturing December 31, 2002, and to raise new cash of approximately $6,321 million.

In addition to the public holdings, Federal Reserve Banks hold $6,195 million of the maturing notes for their own accounts, which may be refunded by issuing an additional amount of the new security.

Up to $1,000 million in noncompetitive bids from Foreign and International Monetary Authority (FIMA) accounts bidding through the Federal Reserve Bank of New York will be included within the offering amount of the auction. These noncompetitive bids will have a limit of $100 million per account and will be accepted in the order of smallest to largest, up to the aggregate award limit of $1,000 million.

Note: The closing times for receipt of noncompetitive and competitive tenders will be at 11:00 a.m. and 11:30 a.m. eastern standard time, respectively.

TreasuryDirect customers requested that we reinvest their maturing holdings of approximately $521 million into the 2-year note.

The auction will be conducted in the single-price auction format. All competitive and noncompetitive awards will be at the highest yield of accepted competitive tenders. The allocation percentage applied to bids awarded at the highest yield will be rounded up to the next hundredth of a whole percentage point, e.g., 17.13%.

The notes being offered today are eligible for the STRIPS program.

The 2-year notes being announced today will mature on Friday, December 31, 2004. Federal Reserve Banks intend to be open and make payments on that date.

This offering of Treasury securities is governed by the terms and conditions set forth in the Uniform Offering Circular for the Sale and Issue of Marketable Book-Entry Treasury Bills, Notes, and Bonds (31 CFR Part 356, as amended).

Details about the new security are given in the attached offering highlights.

oOo

Attachment

PO-3709

HIGHLIGHTS OF TREASURY OFFERING TO THE PUBLIC OF
2-YEAR NOTES TO BE ISSUED DECEMBER 31, 2002

December 19, 2002

Offering Amount ....$27,000 million
Maximum Award (35% of Offering Amount) ....$ 9,450 million
Maximum Recognized Bid at a Single Rate ....$ 9,450 million
NLP Reporting Threshold ....$ 9,450 million

Description of Offering:
Term and type of security ....2-year notes
Series V-2004
CUSIP number ....912828 AR 1
Auction date ....December 23, 2002
Issue date ....December 31, 2002
Dated date ....December 31, 2002
Maturity date ....December 31, 2004
Interest rate ....Determined based on the highest accepted competitive bid
Yield ....Determined at auction
Interest payment dates ....June 30 and December 31
Minimum bid amount and multiples $1,000
Accrued interest payable by investor ....None
Premium or discount ....Determined at auction

STRIPS Information:
Minimum amount required $1,000
Corpus CUSIP number ....912820 HN 0
Due date(s) and CUSIP number(s)
for additional TINT(s) ....December 31, 2004 - - 912833 ZC 7

Submission of Bids:
Noncompetitive bids:
Accepted in full up to $5 million at the highest accepted yield.
Foreign and International Monetary Authority (FIMA) bids: Noncompetitive bids submitted through the Federal Reserve Banks as agents for FIMA accounts. Accepted in order of size from smallest to largest with no more than $100 million awarded per account. The total noncompetitive amount awarded to Federal Reserve Banks as agents for FIMA accounts will not exceed $1,000 million. A single bid that would cause the limit to be exceeded will be partially accepted in the amount that brings the aggregate award total to the $1,000 million limit. However, if there are two or more bids of equal amounts that would cause the limit to be exceeded, each will be prorated to avoid exceeding the limit.
Competitive bids:
(1) Must be expressed as a yield with three decimals, e.g., 7.123%.
(2) Net long position for each bidder must be reported when the sum of the total bid amount, at all yields, and the net long position equals or exceeds the NLP reporting threshold stated above.
(3) Net long position must be determined as of one half-hour prior to the closing time for receipt of competitive tenders.

Receipt of Tenders:
Noncompetitive tenders:
Prior to 11:00 a.m. eastern standard time on auction day.
Competitive tenders:
Prior to 11:30 a.m. eastern standard time on auction day.

Payment Terms: By charge to a funds account at a Federal Reserve Bank on issue date, or payment of full par amount with tender. *TreasuryDirect* customers can use the Pay Direct feature which authorizes a charge to their account of record at their financial institution on issue date.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

December 17, 2002
PO-3710

"The U.S. Treasury in Foreign Affairs"
Remarks by Kenneth W. Dam
Deputy Secretary of the Treasury
Delivered to the Washington Institute for Foreign Relations
December 17, 2002

This afternoon I would like to discuss the U.S. Treasury's role, not as a domestic agency, but as a foreign policy institution. There can be no denying the Treasury's influence and effect on U.S. foreign policy.

Consider Treasury's role. Treasury controls some of the key financial levers of U.S. foreign policy. It guides U.S. participation in the major international financial institutions, such as the World Bank, International Monetary Fund, and several regional development banks. Treasury is at the vanguard of President Bush's development agenda and his efforts to reform the effectiveness of foreign assistance. Treasury also possesses a high degree of technical competence on international issues, from terrorist finance to international tax policy to money laundering to the financial aspects of trade policy.

Despite the clear nexus between these core Treasury activities and U.S. foreign policy, I am always struck that many people are puzzled by Treasury's perspective in the interagency process. Some attribute to us a purely marginal role in traditional foreign policy matters. Others believe Treasury is essentially a domestic agency. Both views hold kernels of truth. After all, Treasury is the key steward of a more than $10 trillion U.S. economy.

But we also appreciate that U.S. economic performance disproportionately impacts the global economy. Consider that in 2001, U.S. gross domestic product accounted for more than 20 percent of total world output. When you factor in Japan's underperformance and Europe's recently sluggish growth, the U.S. economy's impact on the global economy is even more profound. When the United States grows, the rest of the world grows, and vice-versa.

That is why the number of Treasury policymakers who focus on international economic affairs is roughly comparable to that of those who deal with domestic issues. Each day, Treasury policymakers work on major international issues. Let's explore a few.

I. Financial Levers of U.S. Foreign Policy

Treasury leads our nation's fight to disrupt the flow of money to terrorists and their supporters. We chair an interagency committee that sets the strategic priorities for the financial front of the war on terrorism and works on the implementation of these priorities, through actions such as public designation and asset freezing, law enforcement, diplomacy, and cooperation with and through multilateral institutions.

Our most public weapon in the financial war on terrorism has been the public designation of terrorist-related entities and the blocking of their assets. To date, we have blocked more than the $123 million. Our actions have also significantly disrupted and deterred further terrorist finance. By working with our allies to implement an international mechanism for designation and freezing, we have made

it much harder for terrorists to hide their money in the world's banks or send it abroad through formal financial channels.

But our strategy goes well beyond designation and blocking. We and our allies have vigorously engaged multilateral institutions such as the IMF, the World Bank, the UN, and the Financial Action Task Force (FATF) in an effort to set improved standards for transferring funds abroad through less traditional means. For example, new standards have been set to protect charitable institutions from being abused as vehicles for terrorist financing, and new principles are being established to regulate informal systems of transferring money, often known as hawala.

Of course, we cannot fight the financial war on terrorism alone – and we haven't had to. Over 200 countries and jurisdictions have joined us in issuing blocking orders. We will continue to work with members of the international community to set new standards, to assess country performance, and to assist one another in this fight. While I am generally pleased with our overall successes to date, I believe we can always do better – and we will.

Another important area where Treasury impacts U.S. foreign policy is through U.S. participation in the major international financial institutions, a number of which I have already mentioned, such as the International Monetary Fund, the World Bank and the multilateral development banks. The U.S. is the biggest contributor to most of these institutions. Since the executive boards use weighted voting, we have a considerable voice in whether, when, how much, and under what conditions they lend to countries like Argentina, Brazil or Turkey. This is a tremendous responsibility.

Consider the notion of financial contagion, for example. The Bush Administration has worked hard – as have many in the private sector – to dispel the fiction that contagion necessarily and automatically spreads when one emerging market economy faces difficulties. Already, we believe that investors are beginning to make better judgments about specific emerging markets. They are no longer allowing conditions in one country to lead inexorably to crises in others. Current examples of so-called contagion, such as the impact of Argentina on Uruguay, can be explained in other ways, for example, by examining the close economic linkages between specific countries.

Treasury is also working to improve the transparency and predictability of the way in which sovereign debt is restructured – if such restructuring proves necessary – such as by including collective action clauses in sovereign debt agreements. We also have encouraged the IMF to study whether a Sovereign Debt Restructuring Mechanism might serve well as a possible complement over time to such collective action clauses.

In addition to leading U.S. participation in the major international financial institutions, Treasury, in cooperation with the State Department and USAID, also implements the President's international development agenda. Development is a complex international issue. Bridging the gap between the needs of the poorest countries and their capacity to use external and domestic resources effectively is a challenge.

We are convinced that the international community can do a better job in combating poverty by focusing on measures to increase productivity and hence living standards. One way is to focus on the factors that enable people and countries to become more productive, such as policies that encourage a strong private sector, that improve the quality of education and health care, and that increase access to safe water. A second complementary way is to insist on the better use of public funds by demanding measurable results.

These principles are reflected in the President's development agenda and his newly proposed Millennium Challenge Account, or MCA. The concept that underlies the MCA is a simple one. Countries that are committed to ruling justly, to promoting economic freedom, and to investing in their people will receive more U.S.

assistance. Country performance will be measured on the basis of clear, concrete and objective criteria that closely correlate to economic growth and poverty reduction.

Already we are putting money behind our ideas, with the MCA representing a 50% increase in our core bilateral assistance program. This means a $5 billion annual increase over current levels, phased in over three years, and more U.S. money for programs that raise productivity growth, such as programs for primary education, communicable disease prevention and clean water. The approach is geared to producing real results for real people.

Our development responsibilities also give us an important role in post-conflict assistance. Take our recent efforts to aid in the reconstruction of Afghanistan. On December 4, President Bush signed the Afghanistan Freedom Support Act, which confirms our long-term financial commitment to rehabilitation and rebuilding of Afghanistan. The next few years will be critical ones for the country's future. Afghanistan's government needs to develop administrative, financial and legal structures, and it needs to produce results that will change the lives of the Afghan people. This means better roads, improved public services, and enhanced security for the Afghan people so that they may earn their livelihoods in peace.

II. Treasury's Technical Expertise on International Issues: Trade, FSC & International Taxation

The U.S. Treasury is also an institution with an impressive technical capacity that its senior policymakers bring to bear on a number of complex international issues. Take the issue of international trade, for example.

While the United States Trade Representative (USTR) leads most aspects of U.S. trade negotiations, Treasury negotiates most financial services provisions of U.S. trade agreements, in part because of its close ties to the financial community and its regulators, but also because of its core competency on financial services issues. Recently, we worked closely with USTR to finalize the U.S.-Chile Free Trade Agreement. We are working just as hard to reach an agreement with Singapore. Treasury is also leading U.S. efforts to liberalize financial services markets worldwide as part of the new Doha round of WTO negotiations.

Though complementary to USTR's approach on broader trade issues, Treasury's tactics can be different, particularly in the realm of financial services. In our discussions with foreign financial and economic officials, we are able to make the case for freer trade in financial services in the context of economic reform. Since most developing countries have no interest in seeking access to U.S. financial services markets, haggling over concessions holds little promise. We try to present trade liberalization as a sound policy option rather than as a negotiated concession.

Take, for example, the "Asian Tigers," a group of countries that now are beginning to experience the limits of export-led growth.

Export-led growth may have served much of Asia well in the 1980's and 1990's, but with cheaper exports emerging from China, not to mention a recent worldwide economic slowdown, export-led growth no longer seems to be a winning strategy. Instead, countries that are successfully weathering the global economy today are those that took steps to diversify and focused on stimulating domestic demand. For many in this latter group, like Korea, liberalized financial services markets have been key engines of growth. Through official dialogue, Treasury has supported Korea in these efforts. In other countries, we are providing direct technical assistance.

Treasury also plays a leading role in resolving an international dispute that features elements of both tax and trade. Earlier this year, a WTO appellate panel held that the extraterritorial income exclusion regime of U.S. tax law constituted a subsidy violating WTO rules. Just two years before, a WTO appellate panel held that the

foreign sales corporation provisions constituted a similar, prohibited subsidy. The WTO arbitration panel has issued its findings on damages, authorizing retaliation of up to $4 billion a year of U.S. exports, a figure unprecedented in WTO history. Such retaliation would have an impact on the global economy far beyond the specific U.S. products targeted.

President Bush has made clear that the United States will comply with the WTO's ruling. We believe the United States has too great a stake in the WTO, and in freer trade, to turn our backs on WTO rules. The President has also made clear that our response to the WTO's decision must increase the competitiveness of U.S. business, and he has pledged to work closely with the Congress to create the solution. Therefore, Treasury is working closely with Congress' tax-writing committees to develop legislation that will meaningfully amend our tax law to honor our WTO obligations and preserve the competitiveness of U.S. businesses operating in the global marketplace.

Together with Congress, Treasury has the responsibility of setting the rules that govern the taxation of foreign income earned by U.S. corporations. Our challenge is to set these rules in a way that is fair to taxpayers both with foreign operations and without them. A necessary goal is to ensure that companies headquartered in the United States are not disadvantaged when competing in the global marketplace.

This is particularly important because most goods and services no longer flow through purchases between exporters and importers, but through transfers between the affiliates of multinational corporations. Therefore, the rules governing transfer pricing, interest allocation, withholding rates, foreign tax credits, and the taxation of actual or deemed dividends impact these flows significantly.

In a related sphere, Treasury also negotiates international tax treaties. These treaties help increase the amount of investment between the United States and other countries. In addition, we negotiate international tax information exchange agreements, which provide for the exchange of information upon request for use in civil or criminal tax cases. In the past year, we have signed eight of these agreements with significant financial centers around the world, and more are on the way. The agreements – such as the ones we have entered into with Antigua and Barbuda, the Bahamas, the British Virgin Islands, the Cayman Islands, the Netherlands Antilles, Guernsey, Jersey, and the Isle of Man – help clean up the international financial system. Tax evasion, money laundering and terrorist finance flourish together.

III. Conclusion

While Treasury's core international activities center on boosting growth in the U.S. economy, reforming the international financial institutions, promoting economic development and freer trade, enhancing international tax policy and fighting financial crime and terrorist finance, there are still other areas where Treasury engages abroad. Treasury, for instance, chairs an important dialogue with the European Union on financial and regulatory issues, data privacy, and accounting reform, among other issues. Treasury, as I mentioned before, also provides technical assistance to a number of countries around the globe. I could delve much more deeply into any of these areas, but considering the list I have just reviewed, I'd like to cite a couple of observations.

My first observation is the great importance of the first item: promoting growth in the U.S. economy. With the U.S. economy growing faster than other major developed economies, albeit not as fast as we would like, no single thing matters more for international economic policy – and especially the developing world's future – than the health of the U.S. economy.
Ironically, the U.S. economy is the very part of the world economy on which practitioners of foreign relations spend the least amount of time. U.S. fiscal, tax, and monetary policy are driven by government institutions where a domestic perspective predominates.

My second observation concerns the importance of the private sector. For example, in advancing the economies of poor countries, we cannot rely on loans and grants from international financial institutions to do the job. Rather, we try to focus the U.S. development agenda on helping to establish minimal conditions in which local enterprises can grow, prosper, and attract foreign investment. Our efforts in the area of development, as well as on trade and tax policy, center on the recognition that the private sector is the most important implementer of international economic policy. This is true, to a degree, even in the hunt for terrorist finance. We cannot be successful in stemming terrorist finance without the cooperation of private sector financial institutions. Incidentally, I am pleased to say that we have been getting their cooperation in abundance.

Economic policy is well recognized today as an essential component of foreign relations. At the same time, the things that matter most in the international economic policy arena are one or two steps removed from the focal point of most foreign policy executives, both here and abroad. Therefore, the U.S. Treasury must and will continue its leadership on the hard, incremental work of establishing the right conditions for worldwide economic growth.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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December 20, 2002
PO-3711

Fact Sheet Regarding the Treasury Department's Use of Sanctions Authorized Under Section 311 of the USA PATRIOT ACT

"With our designations today under Section 311, we are signaling to the world that we are serious about ensuring that the international financial system is safeguarded against the threat of money laundering. Our words have meaning and our actions have real teeth: these jurisdictions are bad for business, and U.S. institutions now must recognize this fact."

"We are telling the world clearly that these jurisdictions are bad for business and that their financial controls cannot be trusted. We are serious about ensuring that the international financial system not be abused by money launderers, terrorist financiers, and other criminals."

"Our use of Section 311 today to designate two jurisdictions as "primary money laundering concerns" is yet another tool that we are using to ensure the international financial system is not abused by criminals. The world stands on notice: these jurisdictions do not take the fight against money laundering and financial crime seriously."

-Deputy Treasury Secretary Ken Dam

USA PATRIOT Act Section 311

Section 311 (31 U.S.C. 5318A) authorizes Treasury to designate a foreign jurisdiction, financial institution, class of transactions, or type of account as being of "primary money laundering concern," and to impose one or more of five "special measures."

Four of the special measures impose information-gathering and record-keeping requirements upon those U.S. financial institutions dealing either directly with the jurisdiction designated as one of primary money laundering concern, or dealing with those having direct dealings with the designated jurisdiction. Under the fifth special measure, a U.S. financial institution may be prohibited from opening or maintaining in the U.S. a correspondent account or a payable-through account for a foreign financial institution if the account involves the designee.

This is the first time this authority has been invoked.

Countries Designated: Ukraine and Nauru

Ukraine

Treasury, in consultation with other U.S. agencies, designated Ukraine as being of "primary money laundering concern" on December 20, 2002.

Treasury intends to impose requirements on U.S. financial institutions based on Special Measures 1 – 4.

Treasury is soliciting comments from U.S. financial institutions regarding the parameters of the proposed special measure.

Nauru

Treasury, in consultation with other U.S. agencies, designated Nauru as being of "primary money laundering concern" on December 20, 2002.

The Treasury intends to impose Special Measure 5, which will prohibit U.S. financial institutions from opening or maintaining correspondent accounts with Nauru-licensed financial institutions.

Financial Action Task Force (FATF)

FATF is the premier multilateral body in the international fight against money laundering and terrorist financing. For more information on FATF consult its website at www.fatf-gafi.org.

Through its Non-Cooperative Countries and Territories (NCCT) process, FATF seeks to identify and take action with respect to jurisdictions that fail to meet international anti-money laundering standards.

As a result of their failure to put into place sufficient anti-money laundering frameworks, FATF – through the NCCT process – has called upon its members to impose countermeasures with respect to Ukraine and Nauru.

Related Documents:

- Designation of Nauru and Ukraine as Primary Money Laundering Concerns

BILLING CODE 4810-25

DEPARTMENT OF THE TREASURY

Departmental Offices

Designation of Nauru and Ukraine as Primary Money Laundering Concerns

AGENCY: Departmental Offices, Treasury.

ACTION: Notice of Designation.

SUMMARY: This notice advises the public that the Department of the Treasury, on December 20, 2002, designated the countries of Nauru and Ukraine as primary money laundering concerns pursuant to section 5318A of title 31, United States Code, as added by section 311 of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT ACT) Act of 2001.

DATES: The designations made by this notice are effective December 20, 2002. Comments on certain aspects of this notice should be submitted by [INSERT DATE THAT IS 30 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]. In making comments, please refer to the "Public Comments Requested" in the supplementary information portion of this preamble.

ADDRESSES: Commenters are encouraged to submit comments by electronic mail because paper mail in the Washington, D.C. area may be delayed. Comments submitted by electronic mail may be sent to regcomments@do.treas.gov with the caption in the body of the text, "ATTN: Section 311 – Designation of Jurisdictions." Comments also may be submitted by paper mail (preferably and original and three copies) to Department of the Treasury, 1500 Pennsylvania Avenue, NW. Washington, DC 20220 "ATTN: 311 – Designation of Jurisdictions." Comments should be sent by one method only. Comments may be inspected at the Department of the Treasury between 10 a.m. and 4

p.m., in Washington, D.C. Persons wishing to inspect the comments submitted must request an appointment by telephoning (202) 622-0990 (not a toll-free number).

FOR FURTHER INFORMATION CONTACT: Office of Enforcement, Department of the Treasury, (202) 622-0400 ; Office of the Assistant General Counsel (Enforcement), (202) 622-1927; or the Office of the Assistant General Counsel (Banking and Finance), (202) 622-0480 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

I. Designation of Nauru and Ukraine as Primary Money-Laundering Concerns

This document formally designates the countries of Nauru and Ukraine as primary money-laundering concerns under 31 U.S.C. 5318A, as added by section 311(a) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT ACT) Act of 2001 (Public Law 107-56) (the Act).

II. Imposition of Special Measures

The Department of the Treasury places these jurisdictions, and those with whom they have dealings, upon notice of its intent, after appropriate consultation, to follow this designation with the imposition of special measures authorized by section 5318A(a). With respect to Nauru, Treasury intends to impose the special measure described in section 5318A(b)(5), which will prohibit financial dealings by U.S. financial institutions with any Nauru licensed institution, unless otherwise excepted. Under the terms of section 5318A(a)(2)(C), this special measure can be imposed only by promulgation of a rule. Treasury intends to initiate a rulemaking shortly.

With respect to Ukraine, Treasury intends to impose one or more of the information-gathering and record-keeping requirements of the special measures described in section 5318A(b)(1) through (4). Those special measures can be imposed by an order, which is limited in duration to 120 days, and which may be extended indefinitely through

a rulemaking (see section 5318A(a)(2) and (3)). Treasury intends to issue an order while simultaneously initiating a rulemaking to impose special measures on Ukraine.

III. Public Comments Requested

The Department of the Treasury solicits comments from all interested persons concerning the appropriate special measures to impose on Ukraine. Specifically, Treasury solicits comments from the financial sector, including domestic financial institutions and domestic financial agencies, concerning its ability to comply with orders or regulations that impose actions under special measures one through four authorized by section 5318A(a). Treasury has also determined to propose imposition of special measure five upon Nauru, but solicits comments from any institution licensed by Nauru as to reasons the institution should be excepted from the prohibitions imposed under this measure. The prohibitions of special measure five would not apply to the Bank of Nauru.

IV. Background

On October 26, 2001, the President signed into law the USA PATRIOT Act. Title III of the Act makes a number of amendments to the anti-money laundering provisions of the Bank Secrecy Act (BSA), which are codified in subchapter II of chapter 53 of title 31, United States Code. These amendments are intended to make it easier to prevent, detect, and prosecute international money laundering and the financing of terrorism.

BSA section 5318A, as added by section 311 of the Act, authorizes the Secretary of the Treasury (Secretary) to designate a foreign jurisdiction, institution, class of transactions or type of account as being of "primary money laundering concern," and to impose one or more of five "special measures" with respect to such a jurisdiction, institution, class of transactions, or type of account. The Secretary has delegated his authority under section 5318A to the Under Secretary of the Treasury (Enforcement).

Section 5318A specifies those factors that the Secretary must consider before designating a jurisdiction, institution, transaction, or account as of "primary money

laundering concern." The evaluation of these factors against the summary of the administrative record, as subsequently set forth in this designation, has resulted in the conclusion that both jurisdictions are of primary money laundering concern.[1]

Once the Secretary has considered the factors, consulted with the Secretary of State and the Attorney General (or their designees), and made a finding that a jurisdiction is a primary money laundering concern, the Secretary is authorized to impose one or more of the five "special measures" described in 5318A(b). These special measures can be imposed individually, jointly, or in combination with respect to a designated "primary money laundering concern." Four of the special measures impose information-gathering and record-keeping requirements upon those domestic financial institutions and agencies dealing either directly with the jurisdiction designated as one of primary money laundering concern, or dealing with those having direct dealings with the designated jurisdiction.[2] Those four measures require: (1) keeping records and filing reports on particular transactions, including the identities of the participants in the transactions and

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[1] The following factors, in accordance with the requirements of section 5318A(c)(2)(A), are considered to be potentially relevant factors in evaluating the necessity of designating Nauru and Ukraine. Nauru and Ukraine meet the majority of these factors. First, whether organized criminal groups, international terrorists, or both, have transacted business within the designated jurisdiction. Second, with respect to its banking practices, Treasury must also evaluate (1) the extent to which the jurisdiction or financial institutions operating in the jurisdiction offer bank secrecy or special regulatory advantages to non-residents or nondomiciliaries of the jurisdiction; (2) the substance and quality of administration of the bank supervisory and counter-money laundering laws of the jurisdiction; (3) the relationship between the volume of financial transactions occurring in the jurisdiction and the size of the economy of the jurisdiction; and (4) the extent to which the jurisdiction is characterized as an offshore banking or secrecy haven by credible international organizations or multilateral expert groups. Third, with respect to its enforcement mechanisms, Treasury must evaluate whether the United States has a mutual legal assistance treaty with the jurisdiction, and determine the experience of United States law enforcement officials and regulatory officials in obtaining information about transactions originating in, or routed through to, such jurisdiction. Finally, Treasury must evaluate the extent to which the jurisdiction is characterized by high levels of official or institutional corruption.

[2] Treasury is currently examining the extent of the applicability of these requirements on those financial institutions enumerated under the USA PATRIOT Act.

the beneficial owners of the funds involved; (2) obtaining information on the beneficial ownership of any account opened or maintained in the United States by a foreign person or a foreign person's representative; (3) identifying and obtaining information about customers permitted to use, or whose transactions are routed through, a foreign bank's "payable-through" account; or (4) identifying and obtaining information about customers permitted to use, or whose transactions are routed through, a foreign bank's "correspondent" account.

Under the fifth special measure, a domestic financial institution or agency may be prohibited from opening or maintaining in the United States a correspondent account or a payable-through account for or on behalf of a foreign financial institution if the account involves the designee.

In selecting which special measures to impose, the Secretary must consider a number of factors.[3] In addition, imposition of special measures (1) through (4) requires consultation with the Chairman of the Board of Governors of the Federal Reserve System, any other appropriate Federal banking agency (as defined in section 3 of the Federal Deposit Insurance Act), the Secretary of State, the Securities and Exchange Commission, the Commodity Futures Trading Commission, the National Credit Union Administration Board, and any other agencies and interested parties as the Secretary may find appropriate. Imposition of special measure (5) requires consultation with the

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[3] In determining generally what special measures to select and to impose, the Secretary, in consultation with the agencies and "interested parties" set forth immediately above, must consider the following factors: (1) whether similar action has been or is being taken by other nations or multilateral groups; (2) whether the imposition of any particular special measure would create a significant competitive disadvantage, including any undue cost or burden associated with compliance, for financial institutions organized or licensed in the United States; (3) the extent to which the action or the timing of the action would have a significant adverse systemic impact on the international payment, clearance, and settlement system, or on legitimate business activities involving the particular jurisdiction, institution or class of transactions; and (4) the effect of the action on United States national security and foreign policy.

Secretary of State, the Attorney General and the Chairman of the Board of the Federal Reserve System.

The Treasury intends, after consultation as provided above, to impose the fifth special measure with respect to Nauru, and actions under special measures one through four with respect to Ukraine. Section 5318A lists several factors that the Secretary must consider, in consultation with the Secretary of State and the Attorney General, before imposing these special measures. Pursuant to section 5318A, any of these first four special measures can be imposed by order, regulation or as otherwise permitted by law. Special measures imposed by an order can be effective for not more than 120 days, unless subsequently continued by a regulation promulgated before the end of the 120-day period.

The fifth special measure can only be imposed through the issuance of a regulation. The issuance of the fifth measure also requires consultation with the Chairman of the Federal Reserve.

A. Nauru:

At one point in time, the island of Nauru had one of the highest per capita incomes in the developing world due to the mining and export of phosphates, a funding source expected to be completely depleted within five to ten years. Most of the funds emanating from the phosphate mining, originally contained in the country's trust funds, have been depleted through waste, poor investments and fraud. In addition to these problems, the Nauru government itself has been characterized by extensive instability.

In an effort to raise funds, the island has resorted to several alternate endeavors, including the selling of offshore banking licenses. Nauru is notorious for permitting the establishment of offshore banks with no physical presence in Nauru or in any other country. These banks maintain no banking records that Nauru or any other jurisdiction

can review. The evidence indicates that the entities that obtain these offshore banking licenses are subject to cursory and wholly inadequate review by the country's officials and lack any credible on-going supervision. In addition, one of the common requirements imposed by Nauru on these offshore banks is they not engage in economic transactions involving either the currency of Nauru (currently the Australian dollar) or its citizens or residents. Consequently, these offshore banks have no apparent legitimate connection with the economy or business activity of Nauru. Indeed, only one bank appears to be physically located in Nauru, the "Bank of Nauru." It is a local community bank that also serves as the Central Bank.

Nauru's Banking Act also prohibits employees or officers of a financial institution from revealing to anyone, including government officials, any information relating to banking transactions in and out of Nauru. In addition, foreign authorities may only receive, with the prior approval of the Nauruan Minister of Finance, macro-level information, such as the total sums of moneys and types of currency transferred from a country into Nauru. Foreign authorities cannot receive information regarding individual transactions. Consequently, there is an extensive secrecy regime surrounding the Nauru banking system.

The Financial Crimes Enforcement Network has recently reported that 400 offshore banks have been granted licenses by Nauru.[4] It has been verified by on-site reports that a 1,000 square foot wooden structure is "home" to some 400 of these banks who have no physical or legal residence anywhere else in the world. The United States Government has been able to verify the names of 161 of the institutions licensed by Nauru, and they are presented as Appendix A to this designation. These are institutions for which the limited information available indicated that there is a strong likelihood as to their status as offshore shell banks that are not subject to effective banking supervision.

[4] FinCEN Advisory Issue 21 (July 2000).

Although the jurisdiction, and not the institutions themselves, are being designated, the list of institutions demonstrates the extensive opportunities for money-laundering activity on the island.

As a consequence of the current practices of Nauru, the Financial Action Task Force (FATF) placed Nauru on the "Non-Cooperative Country and Territory" (NCCT) list in June 2000 for maintaining an inadequate anti-money laundering (AML) regime according to international standards. According to the FATF, Nauru's anti-money laundering weaknesses included, but were not limited to, the following: money laundering was not a criminal offense; offshore banks licensed by Nauru were not required to maintain customer identification or transaction records; Nauruan financial institutions were under no obligation to report suspicious transactions; and Nauru maintained strong bank secrecy laws. On August 28, 2001, Nauru passed the Anti-Money Laundering Act of 2001 ("the AML Act"). On September 25, 2001, however, FATF indicated that the AML Act was not consistent with international standards because it did not apply to the numerous offshore banks licensed by Nauru. In response to FATF pressure, on December 6, 2001, Nauru passed amendments to its AML Act. Nonetheless, according to the FATF, the revised anti-money laundering law that now exists provides for a wholly inadequate anti-money laundering legislative and regulatory regime. In addition, Nauru has not yet addressed the remaining and most important deficiency of its AML legislation, that is, adequate procedures for licensing, regulating and supervising its offshore banks. Thus, despite repeated warnings by FATF of its concern with Nauru's practices, and the clear consequences of not amending its practices, Nauru has not shouldered its responsibility to establish a sufficient AML regime.

On the basis of FATF's determination, an evaluation of the factors set forth in section 5318A, and after consulting with the Secretary of State and the Attorney General, the Secretary has determined that reasonable grounds exist for concluding that Nauru is a "primary money laundering concern." Accordingly, Treasury is prepared to subsequently

impose by regulation special measure five against Nauru, which would prohibit any U.S. financial institution from opening or maintaining in the United States any correspondent account or a payable-through account for a foreign financial institution if the account involves Nauru or any institution licensed by Nauru. This prohibition would not, however, apply to the Bank of Nauru. Treasury has determined to except the Bank of Nauru, which as noted, serves as the Central Bank, from these prohibitions in order to ensure the people of Nauru can continue to meet their legitimate banking needs. Those U.S. financial institutions currently dealing with the Nauru licensed institutions (Appendix A) should begin considering their compliance obligations in anticipation of the imposition of this measure.

Treasury solicits submissions from any bank located in or licensed by Nauru that would establish its legitimacy for purposes of being granted an exception under any proposed regulation imposing special measure five with respect to Nauru.

B. Ukraine:

Ukraine suffers from widespread corruption.. On Transparency International's 2002 Corruption Perception Index, Ukraine ranked eighty-fifth out of the 102 listed countries.[5] Prosecutions of corruption are based upon the law "On Combating Corruption," that was passed in October 1995. This law is, however, rarely enforced, and on the rare occasions when it is enforced, it is normally aimed at lower or middle-level state employees. With respect to the economy, the Ukrainian system is primarily a cash-based system, with limited use of non-cash financial instruments. The banking system of Ukraine has only been in existence for approximately ten years and contains several deficiencies, including the lack of any record-keeping requirements for banks. While the

[5] Transparency International (TI) is an international non-governmental organization devoted to combating corruption. One of its services is to conduct surveys of businesses and analysts (both within and outside the country) in order to determine this annual ranking. Each year, a composite index is compiled and Ukraine has consistently been near the bottom of this ranking. TI's annual Corruption Perceptions Index ("CPI") is cited by the world's media as the leading index in the field. The CPI ranks countries by perceived levels of corruption among public officials.

current banking legislation prohibits the opening of anonymous accounts, there nonetheless remain within the system thousands of anonymous, coded, or numbered accounts containing a total of more than US $20,000,000. In addition, there is a thriving gray or black market system within Ukraine. With regard to recordkeeping requirements, the secrecy laws in the banking sector of Ukraine provide administrative authorities with limited access to customer account information. Furthermore, although banks in Ukraine are required to report both large-scale and dubious transactions, they are not subject to penalty or sanction for failing to make such reports, thus making the requirement wholly voluntary. In addition, non-bank financial institutions are under no obligation to identify beneficial owners when their clients appear to be acting on behalf of another party.

The FATF identified Ukraine in September 2001 as being non-cooperative in the fight against money laundering and placed Ukraine on the NCCT list. Ukraine was placed on the NCCT list because it lacked an effective anti-money laundering regime, including an efficient and mandatory system for reporting suspicious transactions to a financial intelligence unit, adequate customer identification provisions, and sufficient resources devoted to combating money laundering. Currently, Ukraine does not have a comprehensive anti-money laundering law that meets international standards. On the basis of Ukraine's lack of an adequate anti-money laundering regime, the FATF decided that counter-measures should take effect on December 15, 2002, unless Ukraine enacted comprehensive legislation that meets international standards.. On November 28, 2002, Ukraine's Supreme Council (Parliament) passed a Law on Prevention and Counteraction of the Legalization (Laundering) of the Proceeds from Crime, and the President of Ukraine signed the Law on December 7. Notwithstanding this new legislation, the system for reporting suspicious transactions remains so constrained as to be virtually ineffective. Additionally, the statute contains contradictory language regarding the ability of Ukraine's financial intelligence unit to share information with law enforcement. Thus, the unit's authority to fulfill this fundamental responsibility remains very much in

doubt. Having analyzed the legislation, FATF has determined it to be inadequate and has called on its members to apply counter-measures.

On the basis of FATF's determination, an evaluation of the factors set forth in Section 311 and the appropriate consultations, the Secretary has determined reasonable grounds exist for concluding that Ukraine is a "primary money laundering concern." Furthermore, unless Ukraine demonstrates that it has taken proactive steps to address the concerns giving rise to its designation, Treasury anticipates issuing a notice of proposed rule making, subsequent to this designation, concurrent with an order imposing actions under special measures one through four for a period of 120 days. While this order is in effect, the imposition of a final rule imposing these measures would be evaluated. There are two measures under consideration by Treasury. U.S. financial institutions would be required to identify and record the nominal or beneficial owners of accounts with any one of the following characteristics: (1) the accountholder has an address in Ukraine; (2) $50,000 or more is transferred from a U.S. account into an account in the Ukraine; or (3) $50,000 or more is transferred from an account in the Ukraine into a U.S. account. A broader requirement would require U.S. financial institutions to identify and record the beneficial owners involved in a financial transaction that is captured electronically and that is over $50,000.

V. **Designation of Nauru and Ukraine as Primary Money Laundering Concerns**

By virtue of the authority vested in me as Under Secretary of the Treasury, including section 5318A of title 31, United States Code, for the foregoing reasons I hereby designate the countries of Nauru and Ukraine as "primary money laundering concerns" for purposes of section 5318A of title 31, United States Code.

DATED: DECEMBER 20, 2002

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Jimmy Gurulé

Under Secretary of the Treasury

Appendix A

The following is a list of financial institutions believed to be licensed by Nauru. It is not intended to be an exhaustive list, and the requirement to terminate correspondent relationships will apply to all Nauru institutions, not just those on this list.

Certain Nauru institutions on this list are known to bear a name resembling that ofan unrelated US regulated institution or of an international organization. In addition, there may be other entities unrelated to the Nauru institutions with similar or identical names. As such, financial institutions should not assume that any institution that they may encounter with a name similar or identical to any entity on this list, is in fact, related to any Nauru entity without additional inquiry.

NAURU-REGISTERED BANKS

Access Bank International Ltd
Adriatica Bank
Agro Trust Bank, Inc.
Ako Bank (A.K.A. Akobank/Ako-Bank/Akkobank) Corp.
Alliance Bank (possibly A.K.A. European Credit Alliance Bank, Inc.)
Amoko Bank Corporation
Apollo Bank, Inc.
Ardex International Bank
Atlantic Capital Trust PLC
Augusta Bank Corp.
Babylon Bank Corp.
Baltic Pacific Bank
Bank for International Settlements Corp. (A.K.A. Bis Corp.)
Bank of the Nations
Bank Thalia
Bartang Bank and Trust, Inc.
Benmore Union Bank
Business Mediterranean Bank
Capital Bank Inc.
Capital International Bank Ltd. Corp.
Caribbean Unified Bank
Carlton Bank Trust Inc.
Cassaf Bank Corp. (A.K.A. Casaf, Kasaf)
Central Pacific Bank
Central Pacific National Bank
Chierici Bank
City Trading Bank, Inc.
Cometa Bank (A.K.A. Kometa)
Commercial Intercontinental Bank, Inc.
Commex Bank

Communication Pacific Bank Corp.
Continental Assets, Ltd.
Cortex Bank of London
CP Bank
Creditbankinc (A.K.A. Credit Bank Inc.)
Crystal Merchant Bank
Diffusion (A.K.A. Diffusion Finance) Bank, Inc.
Dom Mitra Bank (A.K.A. Dom Mitra National)
Doris Bank
East and Central Asian Bankers Trust, Inc..
East Investment Bank Corp.
Eastock Bank (A.K.A. Eastok)
East-West International Bank S.A.
Ecumene Bank, Inc. (A.K.A. Ecumene Bank Ltd.)
Elmstone Bank, Inc..
Energy Capital Bank S.A.
Euro-American Bank
Euro-Atlantic Bank Corp. (A.K.A. Euro-Atlantik)
Euro Capital Bank Inc.
Euro-Central Investment Bank, Inc.
Euro-Nord Bank Corp.
European Credit Alliance Bank, Inc. (A.K.A. ECAB)(possibly A.K.A. Alliance Bank)
European Overseas Bank Incorporated
Exchange Bank and Trust
Export and Import Bank Corp. (A.K.A. EXIM)
Federal Commercial Bank
Fidelity International Bank, Inc.
Financial Continent Bank, Inc.
First American International Bank
First Capital Bank
First Credit and Trade Bank
First European Charter Bank, Inc.
First Fidelity Bank, Inc.
First Financial Security Bank, Inc.
First International Bank
First Investment Bank
First Republic Bank of Nauru
First Sky Bank Corp.
First Southern Banking Corp.
First Southern Bank of Nauru
First Trading Bank Corp. (A.K.A. First Trading Bank Inc.)
Founders Bank Ltd.
General Europe Bank Inc.
Global Heritage Bank
Global Market Development Bank
Global Specialty Bank

Greater International Bank of Nauru (A.K.A. Greater International Bank Corp.)
Guardian Bank Corp.
Guardian Banking Corp.
Hampshire Bank and Trust Inc. (A.K.A. H-Bank)
Harmony Investment Bank, Inc.
IMRI Credit Bank, Inc.
Info Assets Management Bank Corp.
Innovation Development Bank
Intercredit Bank (A.K.A. Interkredit Bank)
Inter Development Bank
International Bank for Economic Affairs Corp.
International Cassaf Bank
International Commercial Bank Corp. (A.K.A. International Commercial Banking Corp.)
(possibly A.K.A. International Commerce Bank Corp.)
International Exchange Bank
International Industrial and Investment Bank, Inc.
International Metal Trading Bank (A.K.A. IMTB)
International Overseas Bank, Inc. (A.K.A. Interoverseas Bank)
International Prime Bank Corp.
International Trade and Finance Bank Corp.
International Treasury Banking Corporation, Inc.
Intertrust Credit (A.K.A. Intertrust and Credit) Bank
Investment Bank of London Inc.
Jefferson Bank and Trust Inc.
Liberty International Bank and Trust.
Maritime Pacific Bank, Inc.
Mars Bank
MC Bank
Mediterranean International Bank Corp.
Merchant Deposit Bank Corp.
Meridian Merchants Bank, Inc.
MFC Bank Ltd.
Millenium Bank Corp.
National Commerce Bank Inc.
Nations Bank
Nations Trust Bank
Nistru Bank, Inc.
Nord-West Investment Bank, Inc.
Northern Security Bank
North-West Bank, Inc.
NR Bank
NTBank
Pam Bank
Panacea Bank and Trust
Panin Bank International
Pioneer (A.K.A. Pioner) Invest Bank

Prime International Bank
Private Finance Bank and Trust, Inc.
Ram Bank
Reconversion and Development Bank (A.K.A. RDB-Bank)
Republic and Commercial Bank, Inc.
Rockland Bank
Royal Meridian International Bank Inc.
Russian Clearing and Commercial Bank, Inc.
SCB Bank
Sinex Bank
South Pacific Commercial Bank
Sovereign Allied Bank
Sprint Bank, Inc.
Standard Capital Bank Corp.
Standard Hellier Bank Inc.
Standard Investments Bank, Inc.
Sterling International Bank, Inc.
Supreme Banking Corporation
Swiss American Bank
Swiss Trading Bank, Inc.
Swiss Union Bank Corp.
T-Bank, Inc.
TOCA Bank.
Tower Bank.
Tridal Investment Bank, Inc.
Trust Investment Bank, Inc.
Trust Merchant Bank, Inc.
Unibank International, Inc.
Union Credit Bank, Inc.
Union Lombard Bank and Trust Corp.
United Bank and Trust Company
United Bank of Industry and Trade (A.K.A. UBIT Bank)
United Industrial Bank, Inc. (A.K.A. Uninbank, A.K.A. Unin Bank)
United West Bank (A.K.A. Unwest Bank), Inc.
Universal Bank
Universal Baltic Bank Inc.
Universal European Bank, Inc. (A.K.A. Unieurobank)
Veksmarkbank
Westerhall Private Bank
Westock (A.K.A. Westok) Bank
White Knight Merchant Bank

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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December 20, 2002
PO-3712

TREASURY CLARIFIES FOREIGN TAX CREDIT CHANGES FOR 2003

Today, the Treasury Department and the IRS issued Notice 2003-5 to provide guidance to taxpayers regarding the application of statutory changes to the foreign tax credit rules that were enacted as part of the Taxpayer Relief Act of 1997 but that apply only as of January 2003.

"This timely and much needed guidance gives taxpayers the rules for the foreign tax credit reforms now taking effect," stated Assistant Secretary for Tax Policy Pam Olson. "While the transition into the new look-through rules for dividends from 10/50 corporations is complicated, our aim is to provide clear rules and minimize complexity. Legislative proposals have been introduced that would further simplify these rules. We look forward to working with Congress on those proposals. We expect to issue regulations incorporating this guidance early next year and look forward to taxpayer's comments."

The 1997 Act included a provision significantly reforming the treatment for foreign tax credit purposes of dividends paid by certain foreign corporations with U.S. ownership (so-called "10/50 corporations"). The 1997 Act provision, which is effective for taxable years beginning after December 31, 2002, eliminates the separate foreign tax credit baskets for dividends from each 10/50 corporation and instead provides "look-through" treatment for dividends paid by a 10/50 corporation out of earnings and profits accumulated in post-2002 taxable years.

The notice provides guidance on the application of the new look-through rules and the transition from the previous treatment. The notice indicates that Treasury and the IRS intend to issue regulations incorporating this guidance and that taxpayers may rely on the notice. The transition issues addressed include the carryover and carryback of excess foreign tax credits and the treatment of separate limitation losses and overall foreign losses. Other issues addressed include ordering rules for distributions and the treatment of distributions of pre-acquisition earnings.

The text of the notice is attached.

Related Documents:

- Notice 2003-5

Notice 2003-5

I. PURPOSE

This notice provides guidance relating to the application of section 904 to dividends paid by a foreign corporation that is a noncontrolled section 902 corporation as defined in section 904(d)(2)(E) (10/50 corporation).[1] This guidance is necessary to reflect the provisions of the Taxpayer Relief Act of 1997 that modified the treatment of dividends from 10/50 corporations in taxable years beginning after December 31, 2002 (post-2002 taxable years). Treasury and the Service intend to issue regulations concerning the treatment of dividends paid by a 10/50 corporation that incorporate the guidance set forth in this notice.

II. BACKGROUND

Prior to the Taxpayer Relief Act of 1997 (Public Law 105-34, 111 Stat. 788 (the 1997 Act)), section 904(d)(1)(E) required a domestic corporation meeting the stock ownership requirements of section 902(a) (qualifying shareholder) to compute a separate foreign tax credit limitation for dividends received from each 10/50 corporation. The 1997 Act eliminated the requirement that the foreign tax credit limitation be computed on the basis of a separate category (basket) for dividends from each 10/50 corporation, and instead provided that dividends paid by a 10/50 corporation out of earnings and profits accumulated in post-2002 taxable years (post-2002 earnings) generally will be treated as income in a separate basket based on the separate basket of the underlying earnings and profits being distributed (look-through treatment). Section 904(d)(4). Dividends paid by 10/50 corporations that are not passive foreign investment companies (PFICs) out of earnings and profits accumulated in taxable years beginning before January 1, 2003 (pre-2003 taxable years, and pre-2003 earnings) will be assigned to a single 10/50 dividend basket. Dividends paid by each 10/50 corporation that is a PFIC out of pre-2003 earnings will be assigned to a separate 10/50 dividend basket. Sections 904(d)(1)(E) and 904(d)(2)(E)(iv).

The 1997 Act amendments provide look-through treatment to qualifying shareholders for dividends paid by a 10/50 corporation in a manner similar to the treatment of dividends paid by a controlled foreign corporation (CFC). Dividends paid by a CFC to a U.S. shareholder (as defined in section 951(b)) are entitled to look-through treatment if the distribution is out of earnings and profits accumulated during periods in which the CFC

[1] Unless otherwise noted, references to section 904 in this notice are to the Internal Revenue Code of 1986 (Code), as in effect for taxable years beginning after December 31, 2002.

was a CFC. Sections 904(d)(2)(E)(i) and 904(d)(3). A dividend paid by a CFC out of earnings accumulated when the CFC was not a CFC but was a 10/50 corporation is treated as a dividend from a 10/50 corporation. Accordingly, such a dividend receives look-through treatment if paid out of post-2002 earnings, but is treated as income in the single 10/50 dividend basket if paid out of pre-2003 earnings. Section 904(d)(3) extends look-through treatment to interest, rents, and royalties paid to a U.S. shareholder by a CFC as well as to inclusions of income under section 951(a)(1)(A) (subpart F inclusions). In the case of a 10/50 corporation, however, only dividends paid out of post-2002 earnings are eligible for look-through treatment.

III. APPLICATION OF LOOK-THROUGH RULES TO DIVIDENDS PAID BY 10/50 CORPORATIONS IN POST-2002 TAXABLE YEARS

A. In general

Under section 904(d)(4), dividends paid by a 10/50 corporation out of post-2002 earnings generally will be eligible for look-through treatment. Dividends paid by a 10/50 corporation out of pre-2003 earnings will be treated as income in the single 10/50 dividend basket (or, in the case of dividends from a PFIC, in a separate 10/50 dividend basket). Sections 904(d)(1)(E) and 904(d)(2)(E)(iv). Look-through treatment also applies to dividends paid by a CFC out of earnings accumulated during periods when it was a CFC. Section 904(d)(2)(E)(i). In light of this rule, Treasury and the Service believe that it is appropriate to provide comparable treatment for dividends paid by a 10/50 corporation out of such earnings. Accordingly, the regulations will apply look-through treatment to dividends paid by a 10/50 corporation out of pre-2003 earnings that were accumulated in periods during which the 10/50 corporation was a CFC, except as discussed below.

Proposed §1.904-4(g)(3)(i)(C)(1) would not provide look-through treatment in the case of earnings accumulated while the distributing corporation was a CFC but distributed after a pre-2003 intervening period during which the distributing corporation was a 10/50 corporation. See also Proposed §1.904-4(g)(3)(i)(C)(2) (providing the same result more generally where a look-through corporation has an intervening period during which such corporation was not a look-through corporation). Treasury and the Service are considering modifying the proposed regulations when they are finalized to provide for look-through treatment in such cases.

B. Distributions by 10/50 corporations out of pre-acquisition earnings and profits

The Secretary is authorized to prescribe regulations regarding the treatment of distributions by a 10/50 corporation out of earnings and profits accumulated in periods prior to the taxpayer's acquisition of the stock. See section 904(d)(4)(C)(ii)(II). Pursuant to this authority, the regulations will apply look-through treatment to dividends paid to a new qualifying shareholder by a 10/50 corporation out of post-2002 earnings accumulated during periods when the foreign corporation was either a 10/50 corporation with respect to any qualifying shareholder or a CFC but before the recipient became a shareholder of the

corporation. The regulations also will provide that dividends paid by a 10/50 corporation out of post-2002 earnings accumulated in periods when the 10/50 corporation was neither a 10/50 corporation with respect to any qualifying shareholder nor a CFC are assigned to the single 10/50 dividend basket in the case of a distribution from a 10/50 corporation that is not a PFIC, and to a separate 10/50 dividend basket in the case of a 10/50 corporation that is a PFIC. Consistent with §1.904-4(g)(3)(iii) (concerning earnings accumulated in the taxable year in which a corporation becomes a CFC), the regulations also will provide that earnings and profits accumulated in the taxable year in which the corporation became a 10/50 corporation will be considered earnings and profits accumulated after the corporation became a 10/50 corporation.

C. Ordering rule for post-2002 distributions from 10/50 corporations

Under section 902(c)(3), the multi-year pools of post-1986 undistributed earnings (as defined in section 902(c)(1)) and post-1986 foreign income taxes (as defined in section 902(c)(2)) of a foreign corporation are determined by taking into account only periods beginning on and after the first day of the foreign corporation's first taxable year in which a domestic corporation owns 10 percent or more of its voting stock, or in the case of a lower-tier foreign corporation, such corporation is a member of a "qualified group" (as defined in section 902(b)(2)).

Under section 902(c)(6)(B)(i), dividends are treated as paid first out of the post-1986 undistributed earnings. Pre-1987 accumulated profits (defined in section 902(c)(6)(A) and §1.902-1(a)(10) to include both earnings accumulated in pre-1987 taxable years and earnings accumulated in post-1986 taxable years preceding the first year in which the foreign corporation has a qualifying shareholder) are treated as distributed only after the pools of post-1986 undistributed earnings are exhausted, and then out of annual layers of earnings and taxes on a last-in, first-out (LIFO) basis. Distributions out of pre-1987 accumulated profits are governed by the section 902 rules in effect under pre-1987 law. Section 902(c)(6)(A).

Section 1.904-4(g)(3)(i)(B) sets forth a LIFO ordering rule for determining the earnings to which a dividend paid by a CFC is attributable. The dividend is deemed made first from the pools of post-1986 undistributed earnings attributable to the period after the corporation was a CFC (look-through pools), next from the non-look-through pool of post-1986 undistributed earnings (as defined in §1.904-4(g)(3)(iv)(B)), if any, and finally on a LIFO basis from the annual layers of pre-1987 accumulated profits. Since 10/50 corporations will be considered look-through entities beginning in post-2002 taxable years, the regulations will provide a similar LIFO ordering rule for dividends from a 10/50 corporation. Specifically, a dividend from a 10/50 corporation will be deemed made first from post-1986 undistributed earnings attributable to the post-2002 period when the corporation was eligible for look-through; second, from the non-look-through pool of post-1986 undistributed earnings; and finally, on a LIFO basis from pre-1987 accumulated profits. Treasury and the IRS request comments on the allocation of deficits in the look-through pools or the non-look-through pool in determining the earnings to which a dividend

from a 10/50 corporation is attributable, consistent with the rules of §1.902-2.

IV. ALLOCATING AND APPORTIONING EXPENSES OF 10/50 CORPORATIONS; DIVIDENDS PAID BY LOWER-TIER CORPORATIONS

A. Expense allocation

Because 10/50 corporations will be treated as look-through entities with respect to certain dividends paid in post-2002 taxable years, deductible expenses of a 10/50 corporation will reduce the corporation's pools of post-1986 undistributed earnings. The regulations will generally provide that expenses of a 10/50 look-through corporation will be allocated and apportioned in the same manner as expenses of a CFC. See, e.g., section 954(b)(5); §1.904-5(c)(2)(ii).

However, the regulations will not extend the special allocation rule for related person interest expense under section 954(b)(5) and §1.904-5(c)(2)(ii) (providing that interest paid by a CFC to a U.S. shareholder or any related look-through entity is first allocated to reduce foreign personal holding company income which is passive income) to interest paid by 10/50 corporations, since such corporations are not look-through entities with respect to interest payments and are not subject to subpart F. Accordingly, all interest paid by a 10/50 corporation will be apportioned to reduce the payor's pools of post-1986 undistributed earnings under the rules applicable to unrelated person interest expense.

B. Look-through treatment of dividends paid by certain lower-tier corporations

In order for a taxpayer to qualify for look-through treatment with respect to a dividend from a 10/50 corporation, the taxpayer must be a qualifying shareholder with respect to the 10/50 corporation. Sections 904(d)(2)(E) and 904(d)(4). Because a shareholder's eligibility for look-through treatment under section 904(d)(4) is based on the eligibility requirements under section 902, the regulations will apply look-through treatment to a dividend paid by a 10/50 corporation to another foreign corporation where the recipient is eligible to compute foreign taxes deemed paid under section 902(b)(1), (i.e., where both the payor and payee corporations are members of the same qualified group as defined in section 902(b)(2)).

A taxpayer's eligibility for look-through treatment of a dividend paid by a 10/50 corporation is based on eligibility requirements under section 902. In contrast, a taxpayer's eligibility for look-through treatment of a dividend from a CFC is based on whether the taxpayer is a U.S. shareholder with respect to the CFC. See sections 904(d)(3)(A) and 904(d)(3)(D). Treasury and the Service believe that the eligibility requirements for look-through treatment for 10/50 corporations and CFCs should be conformed to the extent possible, taking into account the differing eligibility requirements under the Code for look-through treatment of dividends from CFCs and 10/50 corporations. Accordingly, the regulations will apply look-through treatment to any dividend paid by a CFC to another member of the same qualified group (as defined in section 902(b)). Finally, the regulations will retain the current rule of §1.904-5(i)(3), to the extent it applies look-through treatment to dividends between CFCs

that have a common 10 percent U.S. shareholder but do not meet the qualified group test.

C. Tax accounting elections

Section 1.964-1(c)(3) permits "controlling U.S. shareholders" of a CFC to make or change tax accounting elections on behalf of the CFC. The controlling U.S. shareholders must meet several requirements before an election is deemed made on behalf of the CFC. See §1.964-1(c)(3). Section 1.861-9T(f)(3)(ii) provides similar rules to allow the controlling U.S. shareholders to elect the asset method or modified gross income method for purposes of apportioning interest expense.

The regulations will apply similar rules in order to provide a mechanism for shareholders of a 10/50 corporation to make or change tax elections on behalf of the corporation for purposes of computing the 10/50 corporation's earnings and profits for U.S. tax purposes. Specifically, the regulations will permit the majority domestic corporate shareholders of a 10/50 corporation to make or change tax elections on behalf of the corporation (subject to generally applicable restrictions, such as elections requiring the consent of the Commissioner). The term "majority domestic corporate shareholders" means those domestic corporations that meet the ownership requirements of section 902(a) with respect to the 10/50 corporation (or to a first-tier foreign corporation that is a member of the same qualified group as the 10/50 corporation), that, in the aggregate, own directly or indirectly more than 50 percent of the combined voting power of all of the voting stock of the 10/50 corporation that is owned directly or indirectly by all domestic corporations that meet the ownership requirements of section 902(a) with respect to the 10/50 corporation (or a relevant first-tier foreign corporation). See §1.985-2(c)(3)(i).

V. CARRYOVERS AND CARRYBACKS OF EXCESS FOREIGN TAXES UNDER SECTION 904(c)

Section 904(c) provides that to the extent a taxpayer's foreign income taxes paid or accrued in any taxable year exceed the limitation under section 904 for that year, the excess is carried back first to the second taxable year preceding the taxable year, and then to the first taxable year preceding the taxable year, and finally is carried forward to the five taxable years following the taxable year. As discussed below, regulations will provide transition rules for the carryover and carryback of excess foreign income taxes (excess credits) between pre-2003 taxable years (when pre-2003 distributions from 10/50 corporations are treated as income in separate 10/50 dividend baskets) and post-2002 taxable years (when distributions out of post-2002 earnings are subject to look-through treatment, and distributions out of pre-2003 earnings are treated as income in the single 10/50 dividend basket or, in the case of a PFIC, a separate 10/50 dividend basket).

Except as discussed below in Part VI.A, to the extent a taxpayer has pre-2003 excess credits in any non-PFIC separate 10/50 dividend basket and these credits are carried forward to post-2002 taxable years, the regulations will provide that such credits may be used to the extent that the single 10/50 dividend basket has excess foreign tax credit

limitation. This treatment is consistent with consolidating in the single 10/50 dividend basket dividends paid by all non-PFIC 10/50 corporations out of pre-2003 accumulated earnings. Treasury and the Service do not believe that it is consistent with the statute to carry forward excess credits in the separate 10/50 dividend baskets, on a look-through basis, to the baskets to which dividends paid by a 10/50 corporation out of post-2003 earnings are assigned. Excess credits in separate 10/50 dividend baskets should be carried forward to the single 10/50 dividend basket and not the look-through baskets because such excess credits are most appropriately associated with pre-2003 earnings, dividends out of which are allocated to the single 10/50 dividend basket.

With respect to carrybacks of excess credits from post-2002 taxable years to pre-2003 taxable years, the regulations will apply a rule similar to the carryforward rule discussed above: to the extent a taxpayer has post-2002 excess credits in the single 10/50 dividend basket and these credits are carried back to pre-2003 taxable years, the credits will reduce excess limitation in separate 10/50 dividend baskets (other than 10/50 dividend baskets with respect to PFICs). If the amount of credits carried back to the 2001 or 2002 taxable year is smaller than the aggregate excess limitation in all of the taxpayer's separate 10/50 dividend baskets for the year, the regulations will provide that the amount will be allocated pro rata among the non-PFIC separate 10/50 dividend baskets based on the relative amount of excess limitation in each such basket. The regulations will provide that to the extent a taxpayer has post-2002 excess credits in a look-through basket and these credits are carried back to pre-2003 taxable years, the credits will be carried back within the same look-through basket and not to the separate 10/50 dividend baskets. Excess credits in one separate 10/50 dividend basket carried forward from taxable years beginning in 1998-2002 cannot then be carried back to reduce excess limitation in a different separate 10/50 dividend basket with excess limitation in taxable years beginning in 2001 or 2002. Under section 904(c), only foreign taxes that are paid or accrued in a taxable year (and not taxes that are carried forward from a prior taxable year) are eligible to be carried back to prior taxable years.

VI. SEPARATE LIMITATION LOSSES AND OVERALL FOREIGN LOSSES

Section 904(f) contains rules for allocating and recapturing foreign losses. To the extent a loss in a separate basket (separate limitation loss or SLL) exceeds income in the same basket, the SLL is allocated to and reduces income in other baskets on a proportionate basis. Section 904(f)(5)(B). The SLL is subject to recapture in subsequent years to the extent income is earned in the loss basket. Section 904(f)(5)(C). An overall foreign loss (OFL) arises where there is a loss in all of a taxpayer's baskets combined. To the extent an OFL reduces U.S. source taxable income, it is subject to recapture in subsequent years at a rate of 50 percent (or such larger percent as the taxpayer may choose) of any foreign source income earned. Section 904(f)(1); §1.904(f)-1(d)(1). Since all the non-PFIC separate 10/50 dividend baskets will be replaced by a single 10/50 dividend basket in post-2002 taxable years, the regulations will provide transition rules, as described below, for recapture in a post-2002 taxable year of (1) an OFL or SLL in a separate 10/50 dividend basket that offset U.S. source income or foreign source income in other baskets

in a pre-2003 taxable year, and (2) an SLL in another basket (e.g., the general or passive basket) that offset income in a separate 10/50 dividend basket in a pre-2003 taxable year.

A. Recapture of an OFL or SLL arising in a separate 10/50 dividend basket

The regulations will provide that a taxpayer consolidates OFL and SLL accounts of non-PFIC separate 10/50 dividend baskets (i.e., OFLs and SLLs arising in non-PFIC separate 10/50 dividend baskets that offset U.S. source income or foreign source income in other baskets, respectively) into one set of OFL and SLL accounts of the single 10/50 dividend basket beginning in the taxpayer's first post-2002 taxable year. Thus, for example, where a taxpayer had OFLs and SLLs in non-PFIC separate 10/50 dividend baskets that offset U.S. source income and foreign source income in the general and passive baskets, the OFL and SLL recapture accounts will be consolidated in the single 10/50 dividend basket, and income subsequently earned in the single 10/50 dividend basket will be recaptured as U.S. source income and foreign source income in the general and passive baskets to the extent of the respective OFL and SLL combined accounts. Any SLL recapture account in a non-PFIC separate 10/50 dividend basket with respect to another non-PFIC separate 10/50 dividend basket will be eliminated since "recapture" to and from the single 10/50 dividend basket would be meaningless.

Treasury and the Service recognize that requiring taxpayers to consolidate the separate 10/50 OFL and SLL recapture accounts into one set of OFL and SLL accounts of the single 10/50 dividend basket may be unfavorable to taxpayers that have an OFL or SLL account in a separate 10/50 dividend basket and that no longer are qualifying shareholders with respect to the foreign corporation. In pre-2003 taxable years, recapture of the OFL or SLL account would not occur because the taxpayer would not receive any additional dividends from the corporation that would be treated as 10/50 dividend income in the separate 10/50 loss basket (unless the former shareholder reacquired a sufficient interest in the corporation to become a qualifying shareholder). Accordingly, the regulations will provide that where a taxpayer no longer is a qualifying shareholder with respect to a foreign corporation on December 20, 2002 (or no longer is a qualifying shareholder on the first day of the taxpayer's first post-2002 taxable year, pursuant to a transaction that is the subject of a binding contract which is in effect on December 20, 2002), any OFL or SLL recapture accounts with respect to the taxpayer's separate 10/50 dividend basket for that corporation will not be consolidated into the single 10/50 dividend basket's OFL and SLL accounts.

Consistent with the exception for OFL and SLL accounts with respect to stock of a foreign corporation in which the taxpayer is no longer a qualifying shareholder, the regulations will not permit a taxpayer to carry over excess credits arising in separate 10/50 dividend baskets to the single 10/50 dividend basket where OFL and SLL accounts in the separate 10/50 dividend baskets are not consolidated into the OFL and SLL accounts of the single 10/50 dividend basket. However, the regulations will allow a taxpayer to elect to carry over all excess credits in non-PFIC separate 10/50 dividend baskets to the single 10/50 dividend basket if the taxpayer consolidates the OFL and SLL recapture accounts of all such separate 10/50 dividend baskets into the OFL and SLL accounts of the single 10/50

dividend basket.

B. Recapture of an SLL arising in other baskets

The regulations will provide that to the extent an SLL in another basket (e.g., the general or passive basket) offset income in a non-PFIC separate 10/50 dividend basket in a pre-2003 taxable year, income in the loss basket subsequently earned in post-2002 taxable years will be recaptured as income in the single 10/50 dividend basket. Recapturing SLL accounts that originally offset income in separate 10/50 dividend baskets as income in the single 10/50 dividend basket is consistent with the rule (discussed in Part V, above) permitting taxpayers to carry over excess credits from separate 10/50 dividend baskets into the single 10/50 dividend basket. For example, assume a general basket SLL offset income in a separate 10/50 dividend basket. In such a case, any excess credits in that separate 10/50 basket will carry over to the single 10/50 dividend basket, and general basket income in a post-2002 taxable year will be recharacterized as income in the single 10/50 dividend basket.

VII. TREATMENT OF SEPARATE 10/50 DIVIDEND BASKETS MAINTAINED AT THE CFC LEVEL

Where a CFC has non-PFIC separate 10/50 dividend baskets containing earnings and deficits accumulated in pre-2003 taxable years, the regulations will require, as a general rule, that the earnings and deficits be consolidated in and form the opening balance of the earnings pool of the single 10/50 dividend basket beginning in the CFC's first U.S. post-2002 taxable year. The pools of post-1986 foreign income taxes in the non-PFIC separate 10/50 dividend baskets similarly will be consolidated in the post-1986 foreign income taxes pool of the single 10/50 dividend basket. However, a separate 10/50 dividend basket containing non-look-through earnings of the CFC accumulated in periods prior to becoming a CFC will not be consolidated. These earnings will be treated as earnings in the non-look-through pool of post-1986 undistributed earnings, which are deemed distributed only after distributions exhaust the post-1986 look-through pools, which include the earnings in the pool of the post-2002 single 10/50 dividend basket. See §1.904-4(g)(3)(i)(B).

The regulations also will provide an exception from the general rule combining earnings and deficits and foreign income taxes where a CFC has an accumulated deficit in a separate 10/50 dividend basket with respect to stock in a foreign corporation that is no longer a member of a qualified group that includes the CFC. Treasury and the Service were concerned that requiring consolidation in this case could result in a large deficit in the single 10/50 dividend basket for some CFCs. Treasury and the Service also believe it is appropriate in this situation to simplify the general rule requiring the ratable allocation of deficits in determining deemed-paid taxes in connection with distributions or inclusions. See §1.960-1(i)(4). Accordingly, the regulations will provide that where a CFC has a deficit in a separate 10/50 dividend basket with respect to stock in a foreign corporation that is not a member of a qualified group that includes the CFC on December 20, 2002 (or

is not a qualified group member on the first day of the CFC's first post-2002 taxable year pursuant to a binding contract in effect on December 20, 2002), the deficit in the separate 10/50 dividend basket will not be consolidated in the opening balance of the CFC's single 10/50 dividend basket. Instead, the deficit will be allocated to reduce post-1986 undistributed earnings in the CFC's other baskets (ratably on the basis of accumulated earnings in the other baskets as of the first day of the CFC's first post-2002 taxable year), and the deficit will be permanently reduced to zero. In pre-2003 taxable years, only dividend income from the same 10/50 corporation could eliminate the deficit in the separate 10/50 dividend basket, so that if the 10/50 corporation was no longer a member of the same qualified group as the CFC, the CFC would not have any additional earnings in that basket out of which to pay a dividend, and its U.S. shareholder therefore would be ineligible to claim an indirect credit with respect to any foreign taxes in the deficit basket. See §1.902-1(b)(4). Accordingly, any foreign taxes in the separate 10/50 dividend basket will remain in that basket, and a qualifying shareholder of the CFC generally will not be eligible to claim an indirect credit for these taxes.

VIII. EFFECTIVE DATE

Regulations to be issued relating to the guidance set forth in this notice will be effective for taxable years beginning after December 31, 2002. Until such regulations are issued, taxpayers may rely on this notice.

IX. REQUEST FOR COMMENTS AND CONTACT INFORMATION

Treasury and the Service request comments on the rules described in this notice and any additional issues that should be addressed by regulations. Written comments may be submitted to the Office of Associate Chief Counsel (International), Attention: Ginny Chung (Notice 2003-5), room 4555, CC:INTL:Br3, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, 20224. Alternatively, taxpayers may submit comments electronically to Notice.Comments@m1.irscounsel.treas.gov. Comments will be available for public inspection and copying. Treasury and the IRS request comments by February 18, 2003. For further information regarding this notice, contact Ginny Chung of the Office of Associate Chief Counsel (International) at (202) 622-3850 (not a toll-free call).

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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December 20, 2002
PO-3713

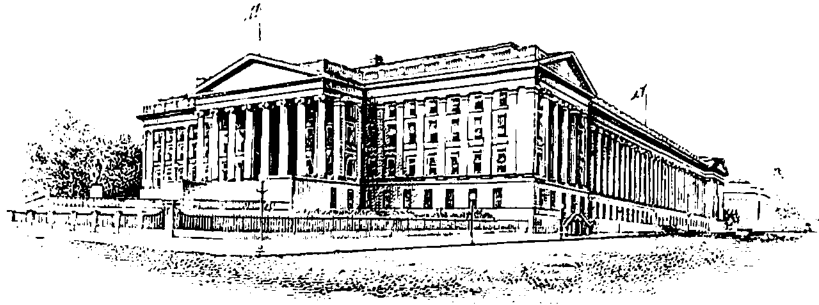
ATSB Decision On Evergreen International Airlines, Inc.

WASHINGTON, DC – The Air Transportation Stabilization Board (Board) announced today its conditional approval of the application by Evergreen International Airlines, Inc. for a Federal guarantee pursuant to the Air Transportation Safety and System Stabilization Act (Act) and implementing regulations promulgated by the Office of Management and Budget (Regulations). The Board's decision was unanimous.

The Board's approval is subject to several conditions, including a reduced guarantee amount, certain structural and financial enhancements and other conditions identified in the letter to Evergreen International Airlines, Inc., which is attached below.
Additional information about the ATSB is available on its web site, www.ustreas.gov/offices/domestic-finance/atsb/.

Related Documents:

- Evergreen International Airlines, Inc. Decision Letter



DEPARTMENT OF THE TREASURY
OFFICE OF PUBLIC AFFAIRS

AIR TRANSPORTATION STABILIZATION BOARD

December 20, 2002

Mr. Delford M. Smith
Chairman
Evergreen International Airlines, Inc.
3850 Three Mile Lane
McMinnville, Oregon 97128

Re: Application for a Loan Guarantee Under the Air Transportation Safety and System Stabilization Act

Dear Mr. Smith:

We refer to the application of Evergreen International Airlines, Inc. (the "Applicant"), dated June 27, 2002 as supplemented (the "Application"), for a Federal loan guarantee under the Air Transportation Safety and System Stabilization Act, Pub. L. No. 107-42, 115 Stat. 230 (the "Act") and the regulations promulgated thereunder, 14 CFR Part 1300 (the "Regulations"). The Applicant has requested a Federal guarantee in connection with a $150 million financing. The Air Transportation Stabilization Board (the "Board") is asked to participate by providing a Federal government guarantee of $148.5 million, representing 99 percent of the total financing.

The Board has carefully considered the Application under the standards set out in the Act and Regulations. The Board's consideration has included a review and analysis of the Application by the Board's staff and the Board's financial and industry consultants. Based on its review, the Board has determined that the Application meets the requirements for a Federal loan guarantee under the Act and the Regulations. In particular, the Board has determined that the Applicant has demonstrated a reasonable assurance of repayment.

While the Applicant has demonstrated that its business plan is financially sound, certain terms of the proposed loan transaction are unacceptable to the Board. Accordingly, the Board has determined to extend an offer of a guarantee, subject to satisfaction, as

determined by the Board in its sole discretion, of all the conditions in the Act and the Regulations and the following:

- The Board is willing to guarantee an amount not to exceed $90,000,000.

- Terms must include certain structural and financial enhancements acceptable to the Board.

- Certain issues as to collateral, asset sales and existing and future senior and subordinate indebtedness must be resolved in a manner acceptable to the Board.

- The Board must receive additional fees and warrants in amounts and on terms acceptable to the Board.

- Final loan documents, guarantees, certifications, the warrant and registration rights agreement, and appropriate opinions of counsel, all in form and substance satisfactory to the Board, remain to be negotiated by the Board. We note that the Board may require control rights, representations, warranties, covenants (including, without limitation, covenants relating to the Applicant's financial ratios), anti-dilution protections and registration rights in connection with the warrants, and other customary lending provisions which are different from or in addition to those described in the Summary of Indicative Terms and Conditions included in the Application. All the conditions referred to in the Summary of Indicative Terms and Conditions must be satisfied.

The Board will continue to perform business and legal due diligence as the transaction progresses. The Board's willingness to issue the guarantee, and the specific terms it may require in the loan documents, are subject, therefore, to on-going due diligence and the Board's satisfaction with the results thereof, in particular, with respect to the Applicant's participation in the CRAF program. In the event that the Board discovers any materially negative information concerning the Applicant not currently known to it, the Board in its sole discretion may decline to issue its guarantee. The issuance of the Board's guarantee is subject also to the absence, in the sole judgement of the Board, of any material adverse change in the condition (financial or otherwise), business, property, operations, prospects, assets or liabilities of the Applicant, or in the Applicant's ability to repay the loan, or in the value of the collateral between the date of the Application and the date the guarantee is issued.

The Board and Board staff look forward to working with you toward the successful completion of this transaction.

Sincerely,

Daniel G. Montgomery
Executive Director

Cc: Edward Gramlich
Kirk Van Tine
Peter Fisher

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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December 20, 2002
PO-3714

ATSB Decision on Great Plains Airlines

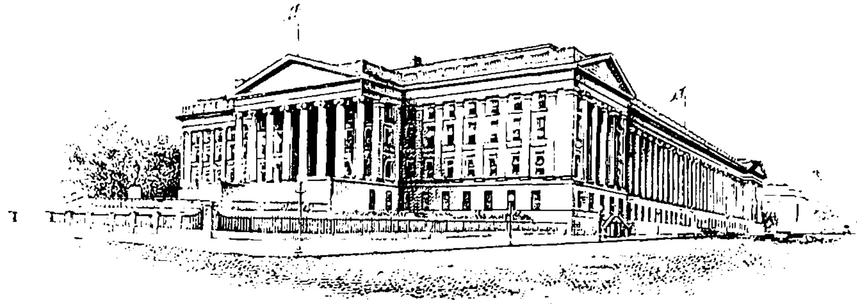
WASHINGTON, DC – The Air Transportation Stabilization Board (Board) announced today that it has denied the application of Great Plains Airlines for a Federal guarantee of $17.0 million on an $25.0 million loan pursuant to the Air Transportation Safety and System Stabilization Act (Act) and implementing regulations promulgated by the Office of Management and Budget (Regulations).

The Board concluded its review based on the standards set out in the Act and the Regulations and determined that Great Plains' application did not meet the applicable standards for the reasons described in the attached letter. The vote to deny the application was unanimous.

Additional information about the ATSB is available on its web site, www.ustreas.gov/offices/domestic-finance/atsb/.

Related Documents:

- Great Plains Airlines Decision Letter



DEPARTMENT OF THE TREASURY
OFFICE OF PUBLIC AFFAIRS
AIR TRANSPORTATION STABILIZATION BOARD

December 20, 2002

Mr. Jack Knight
President and Chief Executive Officer
Ozark Airlines, Inc. d.b.a. Great Plains Airlines
6501 E. Apache Street
Tulsa, Oklahoma 74115

Dear Mr. Knight:

In accordance with the Air Transportation Safety and System Stabilization Act, Pub. L. No. 107-42, 115 Stat. 230 (the "Act") and the regulations promulgated thereunder, 14 CFR Part 1300 (the "Regulations"), the Air Transportation Stabilization Board (the "Board") has considered the application of Ozark Airlines, Inc. d.b.a. Great Plains Airlines ("Great Plains") dated June 28, 2002, as supplemented (the "Application"), for a Federal loan guarantee of $17 million on a loan of $25 million.

During the process of reviewing the Application, the Board staff held telephone calls with you and communicated requests for additional information. The Board staff met with you and your advisors during the summer and this fall on October 21, November 7 and December 11. Representatives of each Board member attended the meeting on October 21. Following these meetings and communications, the Board staff and representatives of each Board member fully briefed the Board members on the Application.

The Board has carefully considered the Application under the standards set out under the Act and the Regulations. The Board's consideration included a review and analysis of the Application by the Board's staff and the Board's financial and industry consultants. The Board staff has repeatedly requested details of the proposed transaction, but such information has not been submitted. Based on its review, the Board determined that the Application did

not meet the applicable standards, and, accordingly, the Board unanimously voted to deny the Application.

The Board determined that Great Plains' proposal did not provide a reasonable assurance that Great Plains would be able to repay the loan, an important evaluation criteria that the Board is required to consider in assessing loan applications. The Board's financial consultant assigned Great Plains' proposed financing an extremely low credit rating. Such a rating implies a high probability of default. For all government-guaranteed loan applications, a credit subsidy is computed, which represents the expected cost to the U.S. taxpayers of guaranteeing the loan. The figures for Great Plains implied a high probability of default and related credit subsidy that the Board deemed too high to impose on the U.S. taxpayers. In addition, based upon Great Plains' past financial results and the Board's concerns about Great Plains' optimistic expansion strategy and the financial projections related thereto, the Board was unable to conclude that the loan by Great Plains was prudently incurred.

If you have any questions regarding this matter, please do not hesitate to contact me.

Sincerely,

Daniel G. Montgomery
Executive Director

Cc: Edward Gramlich
Kirk Van Tine
Peter Fisher

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

December 20, 2002
PO-3715

Statement Regarding Discussions Between the Government of Argentina and the IMF

The United States welcomes the IMF Board's agreement to support a framework for completing negotiations on a transitional program for Argentina. Such a transitional program can help strengthen stabilization of the economic and financial situation in the period leading up to the election and installation of a new government. In January, the Argentine authorities and the IMF are expected to finalize a suitable monetary and fiscal framework. If approved by the IMF Board, the program will provide resources during the political transition, but will not increase Argentina's debt to the IMF. As strong implementation is critical to program success, we welcome Argentina's commitment to strictly adhere to the agreed framework. Argentina is also expected to clear its arrears and service its obligations to the World Bank and Inter-American Development Bank. Over the coming months, the international community will continue to work with Argentina to develop a longer-term program geared toward restoring a path of sustainable growth.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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December 23, 2002
PO-3716

OLSON STATEMENT ON THE HOME SALE RULES

Today the Treasury Department and the Internal Revenue Service issued final, temporary and proposed regulations under section 121 regarding the exclusion of gain on the sale of a principal residence.

Treasury Assistant Secretary for Tax Policy Pam Olson made the following statement:

"These rules will help people who do not meet the two year residency requirement because of unforeseen circumstances, such as divorce or loss of job, by allowing them a proportion of the exclusion that would otherwise be available. The regulations provide the relief and clarity needed by taxpayers whose circumstances change to continue on with their lives."

The texts of the final, temporary and proposed regulations are attached and will be published by the Federal Register December 24, 2002.

The IRS press release is also attached.

Related Documents:

- IRS Press Release
- Final Regulations
- Temporary Regulations

INTERNAL REVENUE SERVICE

www.irs.gov

IRS News Release

Media Relations Office | Washington, D.C. | Tel. 202.622.4000

For Release: 12/23/02 | Release No: IR-2002-142

IRS ISSUES HOME SALE EXCLUSION RULES

WASHINGTON – The Internal Revenue Service today issued guidance in the form of both final and temporary regulations related to excluding gain on the sale of a principal residence. A 1997 law substituted an exclusion of up to $250,000 ($500,000 for a married couple filing jointly) for the old "replacement residence" rules. Unlike a previous once-in-a-lifetime exclusion for senior citizens, the new exclusion may be claimed repeatedly, but usually only once every two years.

The final regulations cover such topics as:

- how to determine if a home is a principal residence;
- when gain from the sale of vacant land that was used as part of the residence may be excluded;
- when and how to allocate the gain between residential and business use of the property;
- how the exclusion applies to joint owners who are not married; and
- how to fulfill the requirement that the taxpayer own and use the home as a principal residence for two of the five years before the sale.

For taxpayers with multiple homes, the regulations list several factors relevant to determining which home is the principal residence. Among these are amount of time used; place of employment; where other family members live; the address used for tax returns, driver's license, car and voter registration, bills and correspondence; and the location of the taxpayer's banks, religious organizations or recreational clubs.

The home sale exclusion may include gain from the sale of vacant land that has been used as part of the residence, if the land sale occurs within two years before or after the sale of the residence.

Taxpayers need not allocate gain between business and residential use if the business use occurred within the same dwelling unit as the residential use. They must pay tax on the gain equal to the total depreciation they took after May 5, 1997, but may exclude any additional gain on the residence, up to the maximum amount. If the business use property was separate from the dwelling unit, they would allocate the gain and be able to exclude only the gain on the residential unit.

(more)

For joint owners who are not married, up to $250,000 of gain is tax-free for each qualifying owner.

To exclude gain, a taxpayer must both own and use the home as a principal residence for two of the five years before the sale. The ownership and use periods need not be concurrent. The two years may consist of 24 full months or 730 days. Short absences, such as for a summer vacation, count as periods of use, but longer breaks, such as a one-year sabbatical, do not. The taxpayer also must not have excluded gain on another home sold during the two years before the current sale.

The IRS made these final regulations available for public comment in October 2000. Several changes resulted from the comments received, including the treatment of gain on property used for both business and residential purposes.

Today, the IRS invited comments on new temporary regulations on the subject of excluding gain, but with a reduced maximum amount, when the seller does not satisfy one of the time rules. The tax law provides an exception to the two-year rules for use, ownership and claimed exclusion when the primary reason for the sale is health, change in place of employment, or, to the extent provided in IRS regulations, "unforeseen circumstances."

Taxpayers may establish by the facts and circumstances of their situations that their home sales were for one of these reasons. To make things easier, the IRS has identified various "safe harbors" that will automatically establish that the sale is for one of these reasons.

The temporary regulations provide that a home sale will be considered related to a change in employment if a qualified person's new place of work is at least 50 miles farther from the old home than the old workplace was from that home. This is the same distance rule that applies for the moving expense deduction. The employment change must occur during the taxpayer's ownership and use of the home as a residence. A qualified person is the taxpayer, the taxpayer's spouse, a co-owner of the home, or a member of the taxpayer's household.

A sale will be considered because of health if the primary reason is related to a disease, illness, or injury of a qualified person. If a physician recommends a change in residence for health reasons, that will suffice. In addition to the persons listed above, a qualified person for health reasons includes certain close relatives, so that sales related to caring for sick family members will qualify.

(more)

A sale will be considered as occurring primarily because of "unforeseen circumstances" if any of these events occur during the taxpayer's period of use and ownership of the residence:

- death,
- divorce or legal separation,
- becoming eligible for unemployment compensation,
- a change in employment that leaves the taxpayer unable to pay the mortgage or reasonable basic living expenses,
- multiple births resulting from the same pregnancy,
- damage to the residence resulting from a natural or man-made disaster, or an act of war or terrorism, and
- condemnation, seizure or other involuntary conversion of the property.

Any of the first five situations listed must involve the taxpayer, spouse, co-owner, or a member of the taxpayer's household to qualify. The regulations also give the IRS Commissioner the discretion to determine other circumstances as unforeseen.

For qualifying sellers, the maximum exclusion amount of $250,000 ($500,000 for a married couple filing jointly) is limited to the percentage of the two years that the person fulfilled the requirements. Thus, a qualifying seller who owns and occupies a home for one year (half of two years) – and who has not excluded gain on another home in that time – may exclude half the regular maximum amount, or up to $125,000 of gain ($250,000 for most joint returns). The proportion may be figured in days or months.

A taxpayer who now qualifies for a reduced maximum exclusion and has already reported a gain from the sale of a residence on a prior year's tax return may use Form 1040X to file an amended return claiming the exclusion. Taxpayers may generally amend returns until three years from the original due date. The law did not require taxpayers to meet one of the exceptions before using the reduced maximum exclusion for homes owned on August 5, 1997, and sold within two years after that date. Thus, nearly all taxpayers qualifying under these regulations should be able to use them by amending a recent year's return.

Treasury Decision 9030, the final home sale regulations, and T.D. 9031, the temporary and proposed regulations on the reduced maximum exclusion, will be published in the *Federal Register* on December 24, 2002, and will be available at *www.federalregister.gov*. These regulations will also be published in Internal Revenue Bulletin. The proposed regulations will also be available for comment soon on the IRS Web site at *www.irs.gov*.

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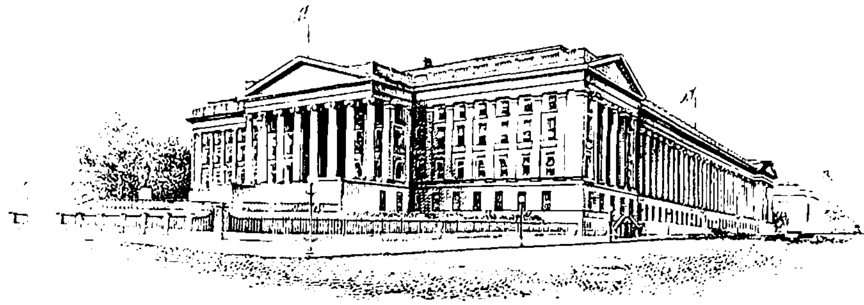


DEPARTMENT OF THE TREASURY

OFFICE OF PUBLIC AFFAIRS

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1
[TD 9030]
RIN 1545-AX28

Exclusion of Gain from Sale or Exchange of a Principal Residence

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the exclusion of gain from the sale or exchange of a taxpayer's principal residence. These regulations reflect changes to the law made by the Taxpayer Relief Act of 1997, as amended by the Internal Revenue Service Restructuring and Reform Act of 1998.

DATES: Effective Date: These regulations are effective December 24, 2002.

Applicability Date: For dates of applicability, see §§1.121-1(f), 1.121-2(c), 1.121-3(l), 1.121-4(l), and 1.1398-3(d).

FOR FURTHER INFORMATION CONTACT: Sara Paige Shepherd, (202) 622-4960 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On October 10, 2000, the IRS and the Treasury Department published in the Federal Register (65 FR 60136) a notice of proposed rulemaking (REG-105235-99) under section 121 of the Internal Revenue Code. Comments were specifically requested regarding what circumstances should qualify as unforeseen for purposes of the reduced maximum exclusion under section 121(c). Written and electronic comments responding to the notice of proposed rulemaking were received. A public hearing was held on January 26, 2001.

After considering all of the comments, the proposed regulations are adopted as amended by this Treasury decision. Proposed and temporary regulations regarding the reduced maximum exclusion are also published in this issue of the Federal Register.

On September 9, 2002, the IRS published Notice 2002-60 (2002-36 I.R.B. 482), which provides that certain taxpayers affected by the September 11, 2001, terrorist attacks may claim a reduced maximum exclusion for a sale or exchange of the taxpayer's principal residence by reason of unforeseen circumstances.

Explanation and Summary of Comments

1. Exclusion of Gain from the Sale or Exchange of a Principal Residence

Under section 121 and the proposed regulations, a taxpayer may exclude up to $250,000 ($500,000 for certain joint returns) of gain realized on the sale or exchange of the taxpayer's principal residence if the taxpayer owned and used the property as the taxpayer's principal residence for at least two years during the five-year period ending on the date of the sale or exchange.

a. Principal residence

The proposed regulations provide that whether property is used by the taxpayer as the taxpayer's residence, and whether the property is used as the taxpayer's principal residence, depends upon all the facts and circumstances. The proposed regulations further provide that if a taxpayer alternates between two properties, the property that the taxpayer uses a majority of the time during the year will ordinarily be considered the taxpayer's principal residence.

Commentators requested a bright line test or a list of factors to identify a property as the taxpayer's principal residence in the case of a taxpayer with multiple residences. Other commentators questioned whether the property that a taxpayer uses a majority of the time during the year should generally be considered the taxpayer's principal residence, arguing that the determination of the taxpayer's principal residence should be judged on a day-by-day, rather than a year-by-year, basis.

The final regulations continue to provide that the residence that the taxpayer uses a majority of the time during the year will ordinarily be considered the taxpayer's principal residence. However, this test is not dispositive. The final regulations also include a nonexclusive list of factors that are relevant in identifying a property as a taxpayer's principal residence.

b. Vacant land

Commentators requested clarification of the circumstances in which vacant land surrounding a residential structure would be treated as part of the residence for purposes of section 121. Several commentators maintained that a taxpayer who sells vacant land should be entitled to the section 121 exclusion if the taxpayer used the vacant land in conjunction with a dwelling unit as the taxpayer's principal residence for at least two years.

Under section 1034 and former section 121, a sale of vacant land that did not include a dwelling unit did not qualify as a sale of the taxpayer's residence. See Rev. Rul. 56-420 (1956-2 C.B. 519); Rev. Rul. 83-50 (1983-1 C.B. 41); O'Barr v. Commissioner, 44 T.C. 501 (1965); Roy v. Commissioner, T.C. Memo. 1995-23; Hale v. Commissioner, T.C. Memo. 1982-527. However, if the sale of vacant land was one of a series of transactions that included the sale of the house, and the series of transactions all occurred during the replacement period provided by section 1034 (two years before or

after the date of the taxpayer's purchase of a replacement residence), the sale of vacant land and the sale of the house were treated as one sale. See Bogley v. Commissioner, 263 F.2d 746 (4th Cir. 1959); Rev. Rul. 76-541 (1976-2 C.B. 246).

Consequently, the final regulations provide that section 121 applies to the sale or exchange of vacant land that the taxpayer has owned and used as part of the taxpayer's principal residence if the sale or exchange of the dwelling unit occurs within two years before or after the sale or exchange of the vacant land. The vacant land must be adjacent to land containing the dwelling unit and the sale or exchange of the vacant land must otherwise satisfy the requirements of section 121.

For purposes of section 121(b)(1) and (2) (regarding the maximum limitation amount of the section 121 exclusion), sales or exchanges of the dwelling unit and vacant land are treated as one sale or exchange. Therefore, only one maximum limitation amount of $250,000 ($500,000 for certain joint returns) applies to the combined sales or exchanges of the vacant land and dwelling unit. In applying the maximum limitation amount to sales or exchanges that occur in different taxable years, gain from the sale or exchange of the dwelling unit, up to the maximum limitation amount under section 121(b)(1) or (2), is excluded first, and each spouse is treated as excluding one-half of the gain from a sale or exchange to which section 121(b)(2)(A) and §1.121-2(a)(3)(i)(relating to the limitation for certain joint returns) apply. Sales or exchanges of the dwelling unit and adjacent vacant land in separate transactions are disregarded in applying section 121(b)(3) (restricting the application of section 121 to only 1 sale or exchange every 2 years) to each other but are taken into account as a sale or exchange of a principal residence on the date of each transaction in applying section 121(b)(3) to that transaction and the sale or exchange of any other principal residence.

2. Use as a Principal Residence

a. Occupancy requirement

Numerous commentators asserted that the two-year use requirement of section 121 should not require actual occupancy. Instead, they argued for a facts and circumstances test similar to the test employed under section 1034. Under that test, a taxpayer's non-occupancy of a residence would count as use if the taxpayer did not intend to abandon the property as the taxpayer's principal residence. The final regulations do not adopt this suggestion because it is inconsistent with the statutory approach under section 121 of aggregating periods of use over a five-year period, and with the legislative history that provides that "a taxpayer must have owned the residence and occupied it as a principal residence for at least two of the five years prior to the sale or exchange." See H.R. Rep. No. 148, 105th Cong., 1st Sess. 348 (1997), 1997-4 (Vol. 1) C.B. 319, 670; S. Rep. No. 33, 105th Cong., 1st Sess. 37 (1997), 1997-4 (Vol. 2) C.B. 1067, 1117; H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. 386 (1997), 1997-4 (Vol. 2) C.B. 1457, 1856.

Commentators proposed a special exception to the occupancy requirement for taxpayers who are absent from the home for an extended period of time due to employment but have not purchased a replacement residence. Other commentators suggested that members of the uniformed services and the United States Foreign Service should be accorded a special exception because they are often away from home for extended periods of time. A commentator also requested that the home daycare industry be exempted from the occupancy requirement because calculating the days of actual

occupancy presents a particular difficulty for home daycare providers who often use the same space for residential and business purposes.

The final regulations do not adopt these comments because there is no specific authority under section 121 to provide exceptions to the use requirement except in the cases of property of a deceased spouse (section 121(d)(2)), property of a former spouse (section 121(d)(3)(B)), and out-of-residence care (section 121(d)(7)). Moreover, section 1034 contained a special rule for members of the Armed Forces, which Congress did not include in enacting section 121.

b. Short temporary absences

Commentators requested that the regulations specify a maximum period of time that would constitute a short temporary absence from the residence and be considered use for purposes of satisfying the two-year use requirement. One commentator suggested that periods of up to five years away from home due to international employment assignments should be considered short temporary absences.

Because the determination of whether an absence is short and temporary depends on the facts and circumstances, the final regulations do not adopt these suggestions.

c. Property used in part as a principal residence

The proposed regulations provide that if a taxpayer satisfies the use requirement with respect to only a portion of the property sold or exchanged, section 121 will apply only to the gain allocable to that portion. Thus, if the residence was used partially for residential purposes and partially for business purposes (mixed-use property), only that part of the gain allocable to the residential portion is excludable under section 121.

Under section 121(d)(6), the exclusion does not apply to so much of the gain from the sale of the property as does not exceed depreciation attributable to periods after May 6, 1997. Commentators suggested that the enactment of section 121(d)(6) illustrates legislative intent to eliminate the allocation requirement for mixed-use property that existed under prior law.

The IRS and Treasury Department have reconsidered the allocation rules of the proposed regulations. The final regulations provide that section 121 will not apply to the gain allocable to any portion of property sold or exchanged with respect to which a taxpayer does not satisfy the use requirement if the non-residential portion is separate from the dwelling unit. Additionally, if the depreciation for periods after May 6, 1997, attributable to the non-residential portion of the property exceeds the gain allocable to the non-residential portion of the property, the excess will not reduce the section 121 exclusion applicable to gain allocable to the residential portion of the property. No allocation of gain is required if both the residential and non-residential portions of the property are within the same dwelling unit, however, section 121 will not apply to the gain to the extent of any post-May 6, 1997, depreciation adjustments. The final regulations provide that the term dwelling unit has the same meaning as in section 280A(f)(1), but does not include appurtenant structures or other property.

A commentator asked for clarification regarding how to allocate the basis and the amount realized under the allocation rules between the portions of the property used for business and residential purposes. The commentator suggested that the regulations should require allocation on the same basis used to determine previous depreciation deductions. The regulations adopt this comment and provide that the taxpayer must use the same method to allocate the basis and the amount realized between the business and

residential portions of the property as the taxpayer used to allocate the basis for purposes of depreciation, if applicable.

3. Ownership by Trusts

Commentators suggested that the regulations adopt the holdings of Rev. Rul. 66-159 (1966-1 C.B. 162) and Rev. Rul. 85-45 (1985-1 C.B. 183) regarding treatment of sales of property by certain trusts. Rev. Rul. 66-159 holds that, in cases in which the grantor is treated as the owner of the entire trust under sections 676 and 671, gain realized from the sale of trust property used by the grantor as the grantor's principal residence qualifies under section 1034 for the rollover of gain into a replacement residence. Because the grantor is treated as the owner of the entire trust, the sale by the trust will be treated for federal income tax purposes as if made by the grantor.

Rev. Rul. 85-45 holds that, in cases in which the beneficiary of a trust is treated as the owner of the entire trust under sections 678 and 671, gain realized from the sale of trust property used by the beneficiary as the beneficiary's principal residence qualifies for the one-time exclusion of gain from the sale of a residence under former section 121. For the period that the beneficiary is treated as the owner of the entire trust, the beneficiary will be treated as owning the property for section 121 purposes, and the sale by the trust will be treated for federal income tax purposes as if made by the beneficiary.

The final regulations adopt these suggestions and provide that, if a residence is held by a trust, a taxpayer is treated as the owner and the seller of the residence during the period that the taxpayer is treated as the owner of the trust or the portion of the trust that includes the residence under sections 671 through 679. The regulations provide similar treatment for certain single-owner entities.

4. Dollar Limitations Applicable to Jointly Owned Property

Commentators requested further clarification of the application of the dollar limitations of section 121(b) to non-married taxpayers who are joint owners of a residence. In response, the final regulations provide that each unmarried taxpayer who jointly owns a principal residence may be eligible to exclude from gross income up to $250,000 of gain that is attributable to each taxpayer's interest in the property.

5. Reduced Maximum Exclusion

Section 121(c) provides an exclusion of gain in a reduced maximum amount for taxpayers who have owned or used a principal residence for less than two of the five years preceding the sale or exchange or who have excluded gain from another sale or exchange during the last two years. Taxpayers who fail to meet any of these conditions may qualify for the reduced maximum exclusion if the sale or exchange is by reason of a change in place of employment, health, or unforeseen circumstances.

The proposed regulations explain the general rule and the computation of the reduced maximum exclusion but do not provide rules clarifying what is a sale or exchange by reason of a change in place of employment, health, or unforeseen circumstances. Comments were requested regarding what circumstances should qualify as unforeseen. Because the rules formulated in response to the comments are extensive, the IRS and Treasury Department have concluded that it is appropriate to publish proposed and temporary regulations to provide the public with adequate notice and opportunity to comment. These proposed and temporary regulations are published elsewhere in this issue of the Federal Register. The final regulations provide guidance regarding the computation of the reduced maximum exclusion.

6. Property of Deceased Spouse

Commentators suggested that the regulations allow a surviving spouse to exclude up to $500,000 of gain if the sale or exchange of the marital home occurs within one year of the death of the decedent spouse and the requirements of section 121 are otherwise met. Under section 121(b)(2), the $500,000 exclusion is only available to spouses who file a joint return. A surviving spouse is eligible to file a joint return with the decedent spouse only for the year of the decedent spouse's death. Therefore, the final regulations do not adopt this suggestion.

Commentators also requested clarification regarding the computation of basis and gain for surviving spouses. They asked for guidance regarding the advantages of titling the marital home in the names of both spouses so that a surviving spouse can obtain a step-up in basis and, consequently, realize less gain from the disposition of the marital home. Because the rules regarding the computation ofbasis and gain are outside the scope of these regulations, the final regulations do not address these issues.

7. Partial Interests

Commentators suggested that the regulations clarify that a taxpayer who sells a partial interest in the taxpayer's principal residence and more than two years later sells the remaining interest in the same property is entitled to use up to the full exclusion for each sale.

The final regulations provide that a taxpayer may exclude gain from the sale or exchange of partial interests (other than interests remaining after the sale or exchange of a remainder interest) in the taxpayer's principal residence if the interest sold or exchanged includes an interest in the dwelling unit. However, the IRS and Treasury Department believe that allowing more than the maximum limitation amount with respect to the same principal residence is contrary to the language and intent of section 121. Therefore, only one maximum limitation amount of $250,000 ($500,000 for certain joint returns) applies to the combined sales or exchanges of partial interests.

In this regard, for purposes of determining the maximum limitation amount under section 121(b)(1) and (2), the sales or exchanges of partial interests in the same principal residence are treated as one sale or exchange. In applying the maximum limitation amount to sales or exchanges that occur in different taxable years, a taxpayer may exclude gain from the first sale or exchange of a partial interest up to the taxpayer's full maximum limitation amount and may exclude gain from the sale or exchange of any other partial interest in the same principal residence to the extent of any remaining maximum limitation amount, and each spouse is treated as excluding one-half of the gain from a sale or exchange to which section 121(b)(2)(A) and §1.121-2(a)(3)(i)(relating to the limitation for certain joint returns) apply.

For purposes of applying section 121(b)(3) (restricting the application of section 121 to only 1 sale or exchange every 2 years), each sale or exchange of a partial interest is disregarded with respect to other sales or exchanges of partial interests in the same principal residence, but is taken into account as of the date of the sale or exchange in applying section 121(b)(3) to that sale or exchange and the sale or exchange of any other principal residence.

8. Elections Under Sections 121(d)(8) and (f)

Commentators asked for clarification regarding when a taxpayer may make or revoke an election under section 121(d)(8)(election to have the section 121 exclusion

apply to a sale or exchange of a remainder interest in the taxpayer's principal residence) or section 121(f)(election to have the section 121 exclusion not apply to a sale or exchange of the taxpayer's principal residence). The final regulations adopt and clarify the provisions of the proposed regulations and provide that a taxpayer may make or revoke either election at any time before the expiration of a three-year period beginning on the last date prescribed by law (determined without regard to extensions) for the filing of the return for the taxable year in which the sale or exchange occurred.

9. Reporting Sales or Exchanges

Commentators recommended the creation of a form for taxpayers to use to report the sale or exchange of a principal residence even if the gain is entirely excludable under section 121. The final regulations do not adopt this suggestion because, unlike sales or exchanges under section 1034, no tax attributes of the sold residence carry over to a new residence. Therefore the reporting of excluded gain is unnecessary and would be unduly burdensome for taxpayers.

10. Election to Apply Regulations Retroactively

The regulations provide that taxpayers who would otherwise qualify under the provisions of §§1.121-1 through 1.121-4 of the final regulations to exclude gain from a sale or exchange before the effective date of the regulations but on or after May 7, 1997, may elect to apply the provisions of the final regulations for any years for which the period of limitation under section 6511 has not expired. A taxpayer may make the election by filing a return for the taxable year of the sale or exchange that does not include the gain from the sale or exchange of the taxpayer's principal residence in the taxpayer's gross income. Taxpayers who have filed a return for the taxable year of the sale or exchange may elect to apply the provisions of the final regulations for any years for which the period of limitation under section 6511 has not expired by filing an amended return.

11. Audit Protection

The regulations provide that the IRS will not challenge a taxpayer's position that a sale or exchange before the effective date of these regulations but on or after May 7, 1997, qualifies for the section 121 exclusion if the taxpayer has made a reasonable, good faith effort to comply with the requirements of section 121. Compliance with the provisions of the proposed regulations that preceded these final regulations generally will be considered a reasonable, good faith effort.

12. Section 121 Exclusion in Individuals' Title 11 Cases

The regulations provide that the bankruptcy estate of an individual in a chapter 7 or 11 bankruptcy case under title 11 of the United States Code succeeds to and takes into account the individual's section 121 exclusion if the individual satisfies the requirements of section 121. Although the effective date for this provision is on or after publication of final regulations in the Federal Register, in view of the IRS's acquiescence in the case of Internal Revenue Service v. Waldschmidt (In re Bradley), 222 B.R. 313 (M.D. Tenn. 1998), AOD CC-1999-009 (August 30, 1999), and Chief Counsel Notice (35)000-162 (August 10, 1999), the IRS will not challenge a position taken prior to the effective date of these regulations that a bankruptcy estate may use the section 121 exclusion if the debtor would otherwise satisfy the section 121 requirements.

13. Effective Date

These regulations apply to sales or exchanges on or after December 24, 2002.

Special Analyses

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

Drafting Information

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

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

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

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

Section 1.1398-3 also issued under 26 U.S.C. 1398(g) * * *

Par. 2. Sections 1.121-1, 1.121-2, 1.121-3 and 1.121-4 are revised to read as follows:

§1.121-1 Exclusion of gain from sale or exchange of a principal residence.

(a) In general. Section 121 provides that, under certain circumstances, gross income does not include gain realized on the sale or exchange of property that was owned and used by a taxpayer as the taxpayer's principal residence. Subject to the other provisions of section 121, a taxpayer may exclude gain only if, during the 5-year period ending on the date of the sale or exchange, the taxpayer owned and used the property as the taxpayer's principal residence for periods aggregating 2 years or more.

(b) Residence--(1) In general. Whether property is used by the taxpayer as the taxpayer's residence depends upon all the facts and circumstances. A property used by the taxpayer as the taxpayer's residence may include a houseboat, a house trailer, or the house or apartment that the taxpayer is entitled to occupy as a tenant-stockholder in a cooperative housing corporation (as those terms are defined in section 216(b)(1) and (2)). Property used by the taxpayer as the taxpayer's residence does not include personal property that is not a fixture under local law.

(2) Principal residence. In the case of a taxpayer using more than one property as a residence, whether property is used by the taxpayer as the taxpayer's principal residence depends upon all the facts and circumstances. If a taxpayer alternates between 2 properties, using each as a residence for successive periods of time, the property that the taxpayer uses a majority of the time during the year ordinarily will be considered the taxpayer's principal residence. In addition to the taxpayer's use of the property, relevant factors in determining a taxpayer's principal residence, include, but are not limited to--

(i) The taxpayer's place of employment;

(ii) The principal place of abode of the taxpayer's family members;

(iii) The address listed on the taxpayer's federal and state tax returns, driver's license, automobile registration, and voter registration card;

(iv) The taxpayer's mailing address for bills and correspondence;

(v) The location of the taxpayer's banks; and

(vi) The location of religious organizations and recreational clubs with which the taxpayer is affiliated.

(3) Vacant land--(i) In general. The sale or exchange of vacant land is not a sale or exchange of the taxpayer's principal residence unless--

(A) The vacant land is adjacent to land containing the dwelling unit of the taxpayer's principal residence;

(B) The taxpayer owned and used the vacant land as part of the taxpayer's principal residence;

(C) The taxpayer sells or exchanges the dwelling unit in a sale or exchange that meets the requirements of section 121 within 2 years before or 2 years after the date of the sale or exchange of the vacant land; and

(D) The requirements of section 121 have otherwise been met with respect to the vacant land.

(ii) Limitations--(A) Maximum limitation amount. For purposes of section 121(b)(1) and (2) (relating to the maximum limitation amount of the section 121 exclusion), the sale or exchange of the dwelling unit and the vacant land are treated as one sale or exchange. Therefore, only one maximum limitation amount of $250,000 ($500,000 for certain joint returns) applies to the combined sales or exchanges of vacant land and the dwelling unit. In applying the maximum limitation amount to sales or exchanges that occur in different taxable years, gain from the sale or exchange of the dwelling unit, up to the maximum limitation amount under section 121(b)(1) or (2), is excluded first and each spouse is treated as excluding one-half of the gain from a sale or exchange to which section 121(b)(2)(A) and §1.121-2(a)(3)(i) (relating to the limitation for certain joint returns) apply.

(B) Sale or exchange of more than one principal residence in 2-year period. If a dwelling unit and vacant land are sold or exchanged in separate transactions that qualify for the section 121 exclusion under this paragraph (b)(3), each of the transactions is disregarded in applying section 121(b)(3) (restricting the application of section 121 to only 1 sale or exchange every 2 years) to the other transactions but is taken into account as a sale or exchange of a principal residence on the date of the transaction in applying section 121(b)(3) to that transaction and the sale or exchange of any other principal residence.

(C) Sale or exchange of vacant land before dwelling unit. If the sale or exchange of the dwelling unit occurs in a later taxable year than the sale or exchange of the vacant land and after the date prescribed by law (including extensions) for the filing of the return for the taxable year of the sale or exchange of the vacant land, any gain from the sale or exchange of the vacant land must be treated as taxable on the taxpayer's return for the taxable year of the sale or exchange of the vacant land. If the taxpayer has reported gain from the sale or exchange of the vacant land as taxable, after satisfying the requirements of this paragraph (b)(3) the taxpayer may claim the section 121 exclusion with regard to

the sale or exchange of the vacant land (for any period for which the period of limitation under section 6511 has not expired) by filing an amended return.

(4) Examples. The provisions of this paragraph (b) are illustrated by the following examples:

Example 1. Taxpayer A owns 2 residences, one in New York and one in Florida. From 1999 through 2004, he lives in the New York residence for 7 months and the Florida residence for 5 months of each year. In the absence of facts and circumstances indicating otherwise, the New York residence is A's principal residence. A would be eligible for the section 121 exclusion of gain from the sale or exchange of the New York residence, but not the Florida residence.

Example 2. Taxpayer B owns 2 residences, one in Virginia and one in Maine. During 1999 and 2000, she lives in the Virginia residence. During 2001 and 2002, she lives in the Maine residence. During 2003, she lives in the Virginia residence. B's principal residence during 1999, 2000, and 2003 is the Virginia residence. B's principal residence during 2001 and 2002 is the Maine residence. B would be eligible for the 121 exclusion of gain from the sale or exchange of either residence (but not both) during 2003.

Example 3. In 1991 Taxpayer C buys property consisting of a house and 10 acres that she uses as her principal residence. In May 2005 C sells 8 acres of the land and realizes a gain of $110,000. C does not sell the dwelling unit before the due date for filing C's 2005 return, therefore C is not eligible to exclude the $110,000 of gain. In March 2007 C sells the house and remaining 2 acres realizing a gain of $180,000 from the sale of the house. C may exclude the $180,000 of gain. Because the sale of the 8 acres occurred within 2 years from the date of the sale of the dwelling unit, the sale of the 8 acres is treated as a sale of the taxpayer's principal residence under paragraph (b)(3) of this section. C may file an amended return for 2005 to claim an exclusion for $70,000 ($250,000 - $180,000 gain previously excluded) of the $110,000 gain from the sale of the 8 acres.

Example 4. In 1998 Taxpayer D buys a house and 1 acre that he uses as his principal residence. In 1999 D buys 29 acres adjacent to his house and uses the vacant land as part of his principal residence. In 2003 D sells the house and 1 acre and the 29 acres in 2 separate transactions. D sells the house and 1 acre at a loss of $25,000. D realizes $270,000 of gain from the sale of the 29 acres. D may exclude the $245,000 gain from the 2 sales.

(c) Ownership and use requirements--(1) In general. The requirements of ownership and use for periods aggregating 2 years or more may be satisfied by establishing ownership and use for 24 full months or for 730 days (365 x 2). The requirements of ownership and use may be satisfied during nonconcurrent periods if both the ownership and use tests are met during the 5-year period ending on the date of the sale or exchange.

(2) Use. (i) In establishing whether a taxpayer has satisfied the 2-year use requirement, occupancy of the residence is required. However, short temporary

absences, such as for vacation or other seasonal absence (although accompanied with rental of the residence), are counted as periods of use.

(ii) Determination of use during periods of out-of-residence care. If a taxpayer has become physically or mentally incapable of self-care and the taxpayer sells or exchanges property that the taxpayer owned and used as the taxpayer's principal residence for periods aggregating at least 1 year during the 5-year period preceding the sale or exchange, the taxpayer is treated as using the property as the taxpayer's principal residence for any period of time during the 5-year period in which the taxpayer owns the property and resides in any facility (including a nursing home) licensed by a State or political subdivision to care for an individual in the taxpayer's condition.

(3) Ownership--(i) Trusts. If a residence is owned by a trust, for the period that a taxpayer is treated under sections 671 through 679 (relating to the treatment of grantors and others as substantial owners) as the owner of the trust or the portion of the trust that includes the residence, the taxpayer will be treated as owning the residence for purposes of satisfying the 2-year ownership requirement of section 121, and the sale or exchange by the trust will be treated as if made by the taxpayer.

(ii) Certain single owner entities. If a residence is owned by an eligible entity (within the meaning of
§301.7701-3(a) of this chapter) that has a single owner and is disregarded for federal tax purposes as an entity separate from its owner under §301.7701-3 of this chapter, the owner will be treated as owning the residence for purposes of satisfying the 2-year ownership requirement of section 121, and the sale or exchange by the entity will be treated as if made by the owner.

(4) Examples. The provisions of this paragraph (c) are illustrated by the following examples. The examples assume that §1.121-3 (relating to the reduced maximum exclusion) does not apply to the sale of the property. The examples are as follows:

Example 1. Taxpayer A has owned and used his house as his principal residence since 1986. On January 31, 1998, A moves to another state. A rents his house to tenants from that date until April 18, 2000, when he sells it. A is eligible for the section 121 exclusion because he has owned and used the house as his principal residence for at least 2 of the 5 years preceding the sale.

Example 2. Taxpayer B owns and uses a house as her principal residence from 1986 to the end of 1997. On January 4, 1998, B moves to another state and ceases to use the house. B's son moves into the house in March 1999 and uses the residence until it is sold on July 1, 2001. B may not exclude gain from the sale under section 121 because she did not use the property as her principal residence for at least 2 years out of the 5 years preceding the sale.

Example 3. Taxpayer C lives in a townhouse that he rents from 1993 through 1996. On January 18, 1997, he purchases the townhouse. On February 1, 1998, C moves into his daughter's home. On May 25, 2000, while still living in his daughter's home, C sells his townhouse. The section 121 exclusion will apply to gain from the sale because C owned the townhouse for at least 2 years out of the 5 years preceding the sale (from January 19, 1997 until May 25, 2000) and he used the townhouse as his principal

residence for at least 2 years during the 5-year period preceding the sale (from May 25, 1995 until February 1, 1998).

Example 4. Taxpayer D, a college professor, purchases and moves into a house on May 1, 1997. He uses the house as his principal residence continuously until September 1, 1998, when he goes abroad for a 1-year sabbatical leave. On October 1, 1999, 1 month after returning from the leave, D sells the house. Because his leave is not considered to be a short temporary absence under paragraph (c)(2) of this section, the period of the sabbatical leave may not be included in determining whether D used the house for periods aggregating 2 years during the 5-year period ending on the date of the sale. Consequently, D is not entitled to exclude gain under section 121 because he did not use the residence for the requisite period.

Example 5. Taxpayer E purchases a house on February 1, 1998, that he uses as his principal residence. During 1998 and 1999, E leaves his residence for a 2-month summer vacation. E sells the house on March 1, 2000. Although, in the 5-year period preceding the date of sale, the total time E used his residence is less than 2 years (21 months), the section 121 exclusion will apply to gain from the sale of the residence because, under paragraph (c)(2) of this section, the 2-month vacations are short temporary absences and are counted as periods of use in determining whether E used the residence for the requisite period.

(d) Depreciation taken after May 6, 1997--(1) In general. The section 121 exclusion does not apply to so much of the gain from the sale or exchange of property as does not exceed the portion of the depreciation adjustments (as defined in section 1250(b)(3)) attributable to the property for periods after May 6, 1997. Depreciation adjustments allocable to any portion of the property to which the section 121 exclusion does not apply under paragraph (e) of this section are not taken into account for this purpose.

(2) Example. The provisions of this paragraph (d) are illustrated by the following example:

Example. On July 1, 1999, Taxpayer A moves into a house that he owns and had rented to tenants since July 1, 1997. A took depreciation deductions totaling $14,000 for the period that he rented the property. After using the residence as his principal residence for 2 full years, A sells the property on August 1, 2001. A's gain realized from the sale is $40,000. A has no other section 1231 or capital gains or losses for 2001. Only $26,000 ($40,000 gain realized - $14,000 depreciation deductions) may be excluded under section 121. Under section 121(d)(6) and paragraph (d)(1) of this section, A must recognize $14,000 of the gain as unrecaptured section 1250 gain within the meaning of section 1(h).

(e) Property used in part as a principal residence--(1) Allocation required. Section 121 will not apply to the gain allocable to any portion (separate from the dwelling unit) of property sold or exchanged with respect to which a taxpayer does not satisfy the use requirement. Thus, if a portion of the property was used for residential purposes and a portion of the property (separate from the dwelling unit) was used for non-residential purposes, only the gain allocable to the residential portion is excludable under section 121. No allocation is required if both the residential and non-residential

portions of the property are within the same dwelling unit. However, section 121 does not apply to the gain allocable to the residential portion of the property to the extent provided by paragraph (d) of this section.

(2) Dwelling unit. For purposes of this paragraph (e), the term dwelling unit has the same meaning as in section 280A(f)(1), but does not include appurtenant structures or other property.

(3) Method of allocation. For purposes of determining the amount of gain allocable to the residential and non-residential portions of the property, the taxpayer must allocate the basis and the amount realized between the residential and the non-residential portions of the property using the same method of allocation that the taxpayer used to determine depreciation adjustments (as defined in section 1250(b)(3)), if applicable.

(4) Examples. The provisions of this paragraph (e) are illustrated by the following examples:

Example 1. Non-residential use of property not within the dwelling unit. (i) Taxpayer A owns a property that consists of a house, a stable and 35 acres. A uses the stable and 28 acres for non-residential purposes for more than 3 years during the 5-year period preceding the sale. A uses the entire house and the remaining 7 acres as his principal residence for at least 2 years during the 5-year period preceding the sale. For periods after May 6, 1997, A claims depreciation deductions of $9,000 for the non-residential use of the stable. A sells the entire property in 2004, realizing a gain of $24,000. A has no other section 1231 or capital gains or losses for 2004.

(ii) Because the stable and the 28 acres used in the business are separate from the dwelling unit, the allocation rules under this paragraph (e) apply and A must allocate the basis and amount realized between the portion of the property that he used as his principal residence and the portion of the property that he used for non-residential purposes. A determines that $14,000 of the gain is allocable to the non-residential-use portion of the property and that $10,000 of the gain is allocable to the portion of the property used as his residence. A must recognize the $14,000 of gain allocable to the non-residential-use portion of the property ($9,000 of which is unrecaptured section 1250 gain within the meaning of section 1(h), and $5,000 of which is adjusted net capital gain). A may exclude $10,000 of the gain from the sale of the property.

Example 2. Non-residential use of property not within the dwelling unit and rental of the entire property. (i) In 1998 Taxpayer B buys a property that includes a house, a barn, and 2 acres. B uses the house and 2 acres as her principal residence and the barn for an antiques business. In 2002, B moves out of the house and rents it to tenants. B sells the property in 2004, realizing a gain of $21,000. Between 1998 and 2004 B claims depreciation deductions of $4,800 attributable to the antiques business. Between 2002 and 2004 B claims depreciation deductions of $3,000 attributable to the house. B has no other section 1231 or capital gains or losses for 2004.

(ii) Because the portion of the property used in the antiques business is separate from the dwelling unit, the allocation rules under this paragraph (e) apply. B must allocate basis and amount realized between the portion of the property that she used as her principal residence and the portion of the property that she used for non-residential

purposes. B determines that $4,000 of the gain is allocable to the non-residential portion of the property and that $17,000 of the gain is allocable to the portion of the property that she used as her principal residence.

(iii) B must recognize the $4,000 of gain allocable to the non-residential portion of the property (all of which is unrecaptured section 1250 gain within the meaning of section 1(h)). In addition, the section 121 exclusion does not apply to the gain allocable to the residential portion of the property to the extent of the depreciation adjustments attributable to the residential portion of the property for periods after May 6, 1997 ($3,000). Therefore, B may exclude $14,000 of the gain from the sale of the property.

Example 3. Non-residential use of a separate dwelling unit. (i) In 2002 Taxpayer C buys a 3-story townhouse and converts the basement level, which has a separate entrance, into a separate apartment by installing a kitchen and bathroom and removing the interior stairway that leads from the basement to the upper floors. After the conversion, the property constitutes 2 dwelling units within the meaning of paragraph (e)(2) of this section. C uses the first and second floors of the townhouse as his principal residence and rents the basement level to tenants from 2003 to 2007. C claims depreciation deductions of $2,000 for that period with respect to the basement apartment. C sells the entire property in 2007, realizing gain of $18,000. C has no other section 1231 or capital gains or losses for 2007.

(ii) Because the basement apartment and the upper floors of the townhouse are separate dwelling units, C must allocate the gain between the portion of the property that he used as his principal residence and the portion of the property that he used for non-residential purposes under paragraph (e) of this section. After allocating the basis and the amount realized between the residential and non-residential portions of the property, C determines that $6,000 of the gain is allocable to the non-residential portion of the property and that $12,000 of the gain is allocable to the portion of the property used as his residence. C must recognize the $6,000 of gain allocable to the non-residential portion of the property ($2,000 of which is unrecaptured section 1250 gain within the meaning of section 1(h), and $4,000 of which is adjusted net capital gain). C may exclude $12,000 of the gain from the sale of the property.

Example 4. Separate dwelling unit converted to residential use. The facts are the same as in Example 3 except that in 2007 C incorporates the basement of the townhouse into his principal residence by eliminating the kitchen and building a new interior stairway to the upper floors. C uses all 3 floors of the townhouse as his principal residence for 2 full years and sells the townhouse in 2010, realizing a gain of $20,000. Under section 121(d)(6) and paragraph (d) of this section, C must recognize $2,000 of the gain as unrecaptured section 1250 gain within the meaning of section 1(h). Because C used the entire 3 floors of the townhouse as his principal residence for 2 of the 5 years preceding the sale of the property, C may exclude the remaining $18,000 of the gain from the sale of the house.

Example 5. Non-residential use within the dwelling unit, property depreciated. Taxpayer D, an attorney, buys a house in 2003. The house constitutes a single dwelling unit but D uses a portion of the house as a law office. D claims depreciation deductions of $2,000 during the period that she owns the house. D sells the house in 2006, realizing a gain of $13,000. D has no other section 1231 or capital gains or losses for 2006. Under section 121(d)(6) and paragraph (d) of this section, D must recognize $2,000 of the gain as unrecaptured section 1250 gain within the meaning of section 1(h). D may exclude the remaining $11,000 of the gain from the sale of her house because, under paragraph (e)(1) of this section, she is not required to allocate gain to the business use within the dwelling unit.

Example 6. Non-residential use within the dwelling unit, property not depreciated. The facts are the same as in Example 5, except that D is not entitled to claim any depreciation deductions with respect to her business use of the house. D may exclude $13,000 of the gain from the sale of her house because, under paragraph (e)(1) of this section, she is not required to allocate gain to the business use within the dwelling unit.

(f) Effective date. This section is applicable for sales and exchanges on or after December 24, 2002. For rules on electing to apply the provisions of this section retroactively, see §1.121-4(j).

§1.121-2 Limitations.

(a) Dollar limitations--(1) In general. A taxpayer may exclude from gross income up to $250,000 of gain from the sale or exchange of the taxpayer's principal residence. A taxpayer is eligible for only one maximum exclusion per principal residence.

(2) Joint owners. If taxpayers jointly own a principal residence but file separate returns, each taxpayer may exclude from gross income up to $250,000 of gain that is attributable to each taxpayer's interest in the property, if the requirements of section 121 have otherwise been met.

(3) Special rules for joint returns--(i) In general. A husband and wife who make a joint return for the year of the sale or exchange of a principal residence may exclude up to $500,000 of gain if--

(A) Either spouse meets the 2-year ownership requirements of §1.121-1(a) and (c);

(B) Both spouses meet the 2-year use requirements of §1.121-1(a) and (c); and

(C) Neither spouse excluded gain from a prior sale or exchange of property under section 121 within the last 2 years (as determined under paragraph (b) of this section).

(ii) Other joint returns. For taxpayers filing jointly, if either spouse fails to meet the requirements of paragraph (a)(3)(i) of this section, the maximum limitation amount to be claimed by the couple is the sum of each spouse's limitation amount determined on a separate basis as if they had not been married. For this purpose, each spouse is treated as owning the property during the period that either spouse owned the property.

(4) Examples. The provisions of this paragraph (a) are illustrated by the following examples. The examples assume that §1.121-3 (relating to the reduced

maximum exclusion) does not apply to the sale of the property. The examples are as follows:

Example 1. Unmarried Taxpayers A and B own a house as joint owners, each owning a 50 percent interest in the house. They sell the house after owning and using it as their principal residence for 2 full years. The gain realized from the sale is $256,000. A and B are each eligible to exclude $128,000 of gain because the amount of realized gain allocable to each of them from the sale does not exceed each taxpayer's available limitation amount of $250,000.

Example 2. The facts are the same as in Example 1, except that A and B are married taxpayers who file a joint return for the taxable year of the sale. A and B are eligible to exclude the entire amount of realized gain ($256,000) from gross income because the gain realized from the sale does not exceed the limitation amount of $500,000 available to A and B as taxpayers filing a joint return.

Example 3. During 1999, married Taxpayers H and W each sell a residence that each had separately owned and used as a principal residence before their marriage. Each spouse meets the ownership and use tests for his or her respective residence. Neither spouse meets the use requirement for the other spouse's residence. H and W file a joint return for the year of the sales. The gain realized from the sale of H's residence is $200,000. The gain realized from the sale of W's residence is $300,000. Because the ownership and use requirements are met for each residence by each respective spouse, H and W are each eligible to exclude up to $250,000 of gain from the sale of their individual residences. However, W may not use H's unused exclusion to exclude gain in excess of her limitation amount. Therefore, H and W must recognize $50,000 of the gain realized on the sale of W's residence.

Example 4. Married Taxpayers H and W sell their residence and file a joint return for the year of the sale. W, but not H, satisfies the requirements of section 121. They are eligible to exclude up to $250,000 of the gain from the sale of the residence because that is the sum of each spouse's dollar limitation amount determined on a separate basis as if they had not been married ($0 for H, $250,000 for W).

Example 5. Married Taxpayers H and W have owned and used their principal residence since 1998. On February 16, 2001, H dies. On September 24, 2001, W sells the residence and realizes a gain of $350,000. Pursuant to section 6013(a)(3), W and H's executor make a joint return for 2001. All $350,000 of the gain from the sale of the residence may be excluded.

Example 6. Assume the same facts as Example 5, except that W does not sell the residence until January 31, 2002. Because W's filing status for the taxable year of the sale is single, the special rules for joint returns under paragraph (a)(3) of this section do not apply and W may exclude only $250,000 of the gain.

(b) Application of section 121 to only 1 sale or exchange every 2 years--(1) In general. Except as otherwise provided in §1.121-3 (relating to the reduced maximum

exclusion), a taxpayer may not exclude from gross income gain from the sale or exchange of a principal residence if, during the 2-year period ending on the date of the sale or exchange, the taxpayer sold or exchanged other property for which gain was excluded under section 121. For purposes of this paragraph (b)(1), any sale or exchange before May 7, 1997, is disregarded.

(2) Example. The following example illustrates the rules of this paragraph (b). The example assumes that §1.121-3 (relating to the reduced maximum exclusion) does not apply to the sale of the property. The example is as follows:

Example. Taxpayer A owns a townhouse that he uses as his principal residence for 2 full years, 1998 and 1999. A buys a house in 2000 that he owns and uses as his principal residence. A sells the townhouse in 2002 and excludes gain realized on its sale under section 121. A sells the house in 2003. Although A meets the 2-year ownership and use requirements of section 121, A is not eligible to exclude gain from the sale of the house because A excluded gain within the last 2 years under section 121 from the sale of the townhouse.

(c) Effective date. This section is applicable for sales and exchanges on or after December 24, 2002. For rules on electing to apply the provisions of this section retroactively, see §1.121-4(j).

§1.121-3 Reduced maximum exclusion for taxpayers failing to meet certain requirements.

(a) In general. In lieu of the limitation under section 121(b) and §1.121-2, a reduced maximum exclusion limitation may be available for a taxpayer who sells or exchanges property used as the taxpayer's principal residence but fails to satisfy the ownership and use requirements described in §1.121-1(a) and (c) or the 2-year limitation described in §1.121-2(b).

(b) through (f) [Reserved]. For further guidance, see §1.121-3T(b) through (f).

(g) Computation of reduced maximum exclusion. (1) The reduced maximum exclusion is computed by multiplying the maximum dollar limitation of $250,000 ($500,000 for certain joint filers) by a fraction. The numerator of the fraction is the shortest of the period of time that the taxpayer owned the property during the 5-year period ending on the date of the sale or exchange; the period of time that the taxpayer used the property as the taxpayer's principal residence during the 5-year period ending on the date of the sale or exchange; or the period of time between the date of a prior sale or exchange of property for which the taxpayer excluded gain under section 121 and the date of the current sale or exchange. The numerator of the fraction may be expressed in days or months. The denominator of the fraction is 730 days or 24 months (depending on the measure of time used in the numerator).

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

Example 1. Taxpayer A purchases a house that she uses as her principal residence. Twelve months after the purchase, A sells the house due to a change in place of her employment. A has not excluded gain under section 121 on a prior sale or exchange of property within the last 2 years. A is eligible to exclude up to $125,000 of the gain from the sale of her house (12/24 x $250,000).

Example 2. (i) Taxpayer H owns a house that he has used as his principal residence since 1996. On January 15, 1999, H and W marry and W begins to use H's house as her principal residence. On January 15, 2000, H sells the house due to a change in W's place of employment. Neither H nor W has excluded gain under section 121 on a prior sale or exchange of property within the last 2 years.

(ii) Because H and W have not each used the house as their principal residence for at least 2 years during the 5-year period preceding its sale, the maximum dollar limitation amount that may be claimed by H and W will not be $500,000, but the sum of each spouse's limitation amount determined on a separate basis as if they had not been married. (See §1.121-2(a)(3)(ii).)

(iii) H is eligible to exclude up to $250,000 of gain because he meets the requirements of section 121. W is not eligible to exclude the maximum dollar limitation amount. Instead, because the sale of the house is due to a change in place of employment, W is eligible to claim a reduced maximum exclusion of up to $125,000 of the gain (365/730 x $250,000). Therefore, H and W are eligible to exclude up to $375,000 of gain ($250,000 + $125,000) from the sale of the house.

(h) [Reserved]. For further guidance, see §1.121-3T(h).

(i) through (k) [Reserved].

(l) Effective date. This section is applicable for sales and exchanges on or after December 24, 2002. For rules on electing to apply the provisions of this section retroactively, see §1.121-4(j).

§1.121-4 Special rules.

(a) Property of deceased spouse--(1) In general. For purposes of satisfying the ownership and use requirements of section 121, a taxpayer is treated as owning and using property as the taxpayer's principal residence during any period that the taxpayer's deceased spouse owned and used the property as a principal residence before death if--

(i) The taxpayer's spouse is deceased on the date of the sale or exchange of the property; and

(ii) The taxpayer has not remarried at the time of the sale or exchange of the property.

(2) Example. The provisions of this paragraph (a) are illustrated by the following example. The example assumes that §1.121-3 (relating to the reduced maximum exclusion) does not apply to the sale of the property. The example is as follows:

Example. Taxpayer H has owned and used a house as his principal residence since 1987. H and W marry on July 1, 1999 and from that date they use H's house as their principal residence. H dies on August 15, 2000, and W inherits the property. W sells the property on September 1, 2000, at which time she has not remarried. Although W has owned and used the house for less than 2 years, W will be considered to have satisfied the ownership and use requirements of section 121 because W's period of ownership and use includes the period that H owned and used the property before death.

(b) Property owned by spouse or former spouse--(1) Property transferred to individual from spouse or former spouse. If a taxpayer obtains property from a spouse or former spouse in
a transaction described in section 1041(a), the period that the taxpayer owns the property will include the period that the spouse or former spouse owned the property.

(2) Property used by spouse or former spouse. A taxpayer is treated as using property as the taxpayer's principal residence for any period that the taxpayer has an ownership interest in the property and the taxpayer's spouse or former spouse is granted use of the property under a divorce or separation instrument (as defined in section 71(b)(2)), provided that the spouse or former spouse uses the property as his or her principal residence.

(c) Tenant-stockholder in cooperative housing corporation. A taxpayer who holds stock as a tenant-stockholder in a cooperative housing corporation (as those terms are defined in section 216(b)(1) and (2)) may be eligible to exclude gain under section 121 on the sale or exchange of the stock. In determining whether the taxpayer meets the requirements of section 121, the ownership requirements are applied to the holding of the stock and the use requirements are applied to the house or apartment that the taxpayer is entitled to occupy by reason of the taxpayer's stock ownership.

(d) Involuntary conversions--(1) In general. For purposes of section 121, the destruction, theft, seizure, requisition, or condemnation of property is treated as a sale of the property.

(2) Application of section 1033. In applying section 1033 (relating to involuntary conversions), the amount realized from the sale or exchange of property used as the taxpayer's principal residence is treated as being the amount determined without regard to section 121, reduced by the amount of gain excluded from the taxpayer's gross income under section 121.

(3) Property acquired after involuntary conversion. If the basis of the property acquired as a result of an involuntary conversion is determined (in whole or in part) under section 1033(b) (relating to the basis of property acquired through an involuntary conversion), then for purposes of satisfying the requirements of section 121, the taxpayer will be treated as owning and using the acquired property as the taxpayer's principal residence during any period of time that the taxpayer owned and used the converted property as the taxpayer's principal residence.

(4) Example. The provisions of this paragraph (d) are illustrated by the following example:

Example. (i) On February 18, 1999, fire destroys Taxpayer A's house which has an adjusted basis of $80,000. A had owned and used this property as her principal residence for 20 years prior to its destruction. A's insurance company pays A $400,000 for the house. A realizes a gain of $320,000 ($400,000 - $80,000). On August 27, 1999, A purchases a new house at a cost of $100,000.

(ii) Because the destruction of the house is treated as a sale for purposes of section 121, A will exclude $250,000 of the realized gain from A's gross income. For purposes of section 1033, the amount realized is then treated as being $150,000 ($400,000 - $250,000) and the gain realized is $70,000 ($150,000 amount realized - $80,000 basis). A elects under section 1033 to recognize only $50,000 of the gain

($150,000 amount realized - $100,000 cost of new house). The remaining $20,000 of gain is deferred and A's basis in the new house is $80,000 ($100,000 cost - $20,000 gain not recognized).

(iii) A will be treated as owning and using the new house as A's principal residence during the 20-year period that A owned and used the destroyed house.

(e) Sales or exchanges of partial interests--(1) Partial interests other than remainder interests--(i) In general. Except as provided in paragraph (e)(2) of this section (relating to sales or exchanges of remainder interests), a taxpayer may apply the section 121 exclusion to gain from the sale or exchange of an interest in the taxpayer's principal residence that is less than the taxpayer's entire interest if the interest sold or exchanged includes an interest in the dwelling unit. For rules relating to the sale or exchange of vacant land, see §1.121-1(b)(3).

(ii) Limitations--(A) Maximum limitation amount. For purposes of section 121(b)(1) and (2) (relating to the maximum limitation amount of the section 121 exclusion), sales or exchanges of partial interests in the same principal residence are treated as one sale or exchange. Therefore, only one maximum limitation amount of $250,000 ($500,000 for certain joint returns) applies to the combined sales or exchanges of the partial interests. In applying the maximum limitation amount to sales or exchanges that occur in different taxable years, a taxpayer may exclude gain from the first sale or exchange of a partial interest up to the taxpayer's full maximum limitation amount and may exclude gain from the sale or exchange of any other partial interest in the same principal residence to the extent of any remaining maximum limitation amount, and each spouse is treated as excluding one-half of the gain from a sale or exchange to which section 121(b)(2)(A) and §1.121-2(a)(3)(i)(relating to the limitation for certain joint returns) apply.

(B) Sale or exchange of more than one principal residence in 2-year period. For purposes of applying section 121(b)(3) (restricting the application of section 121 to only 1 sale or exchange every 2 years), each sale or exchange of a partial interest is disregarded with respect to other sales or exchanges of partial interests in the same principal residence, but is taken into account as of the date of the sale or exchange in applying section 121(b)(3) to that sale or exchange and the sale or exchange of any other principal residence.

(2) Sales or exchanges of remainder interests--(i) In general. A taxpayer may elect to apply the section 121 exclusion to gain from the sale or exchange of a remainder interest in the taxpayer's principal residence.

(ii) Limitations--(A) Sale or exchange of any other interest. If a taxpayer elects to exclude gain from the sale or exchange of a remainder interest in the taxpayer's principal residence, the section 121 exclusion will not apply to a sale or exchange of any other interest in the residence that is sold or exchanged separately.

(B) Sales or exchanges to related parties. This paragraph (e)(2) will not apply to a sale or exchange to any person that bears a relationship to the taxpayer that is described in section 267(b) or 707(b).

(iii) Election. The taxpayer makes the election under this paragraph (e)(2) by filing a return for the taxable year of the sale or exchange that does not include the gain

from the sale or exchange of the remainder interest in the taxpayer's gross income. A taxpayer may make or revoke the election at any time before the expiration of a 3-year period beginning on the last date prescribed by law (determined without regard to extensions) for the filing of the return for the taxable year in which the sale or exchange occurred.

(4) Example. The provisions of this paragraph (e) are illustrated by the following example:

Example. In 1991 Taxpayer A buys a house that A uses as his principal residence. In 2004 A's friend B moves into A's house and A sells B a 50% interest in the house realizing a gain of $136,000. A may exclude the $136,000 of gain. In 2005 A sells his remaining 50% interest in the home to B realizing a gain of $138,000. A may exclude $114,000 ($250,000 - $136,000 gain previously excluded) of the $138,000 gain from the sale of the remaining interest.

(f) No exclusion for expatriates. The section 121 exclusion will not apply to any sale or exchange by an individual if the provisions of section 877(a) (relating to the treatment of expatriates) applies to the individual.

(g) Election to have section not apply. A taxpayer may elect to have the section 121 exclusion not apply to a sale or exchange of property. The taxpayer makes the election by filing a return for the taxable year of the sale or exchange that includes the gain from the sale or exchange of the taxpayer's principal residence in the taxpayer's gross income. A taxpayer may make an election under this paragraph (g) to have section 121 not apply (or revoke an election to have section 121 not apply) at any time before the expiration of a 3-year period beginning on the last date prescribed by law (determined without regard to extensions) for the filing of the return for the taxable year in which the sale or exchange occurred.

(h) Residences acquired in rollovers under section 1034. If a taxpayer acquires property in a transaction that qualifies under section 1034 (section 1034 property) for the nonrecognition of gain realized on the sale or exchange of another property and later sells or exchanges such property, in determining the period of the taxpayer's ownership and use of the property under section 121 the taxpayer may include the periods that the taxpayer owned and used the section 1034 property as the taxpayer's principal residence (and each prior residence taken into account under section 1223(7) in determining the holding period of the section 1034 property).

(i) [Reserved].

(j) Election to apply regulations retroactively. Taxpayers who would otherwise qualify under §§1.121-1 through 1.121-4 to exclude gain from a sale or exchange of a principal residence before December 24, 2002 but on or after May 7, 1997, may elect to apply §§1.121-1 through 1.121-4 for any years for which the period of limitation under section 6511 has not expired. The taxpayer makes the election under this paragraph (j) by filing a return for the taxable year of the sale or exchange that does not include the gain from the sale or exchange of the taxpayer's principal residence in the taxpayer's gross income. Taxpayers who have filed a return for the taxable year of the sale or exchange may elect to apply the provisions of these regulations for any years for which the period of limitation under section 6511 has not expired by filing an amended return.

(k) Audit protection. The Internal Revenue Service will not challenge a taxpayer's position that a sale or exchange of a principal residence occurring before December 24, 2002 but on or after May 7, 1997, qualifies for the section 121 exclusion if the taxpayer has made a reasonable, good faith effort to comply with the requirements of section 121. Compliance with the provisions of the regulations project under section 121 (REG-105235-99 (2000-2 C.B. 447)) generally will be considered a reasonable, good faith effort to comply with the requirements of section 121.

(l) Effective date. This section is applicable for sales and exchanges on or after December 24, 2002. For rules on electing to apply the provisions retroactively, see paragraph (j) of this section.

§1.121-5 [Removed]

Par. 3. Section 1.121-5 is removed.

Par. 4. Section 1.1398-3 is added to read as follows:

§1.1398-3 Treatment of section 121 exclusion in individuals' title 11 cases.

(a) Scope. This section applies to cases under chapter 7 or chapter 11 of title 11 of the United States Code, but only if the debtor is an individual.

(b) Definition and rules of general application. For purposes of this section, section 121 exclusion means the exclusion of gain from the sale or exchange of a debtor's principal residence available under section 121.

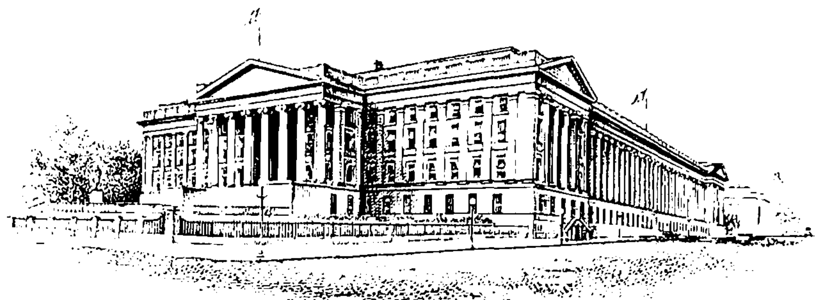
(c) Estate succeeds to exclusion upon commencement of case. The bankruptcy estate succeeds to and takes into account the section 121 exclusion with respect to the property transferred into the estate.

(d) Effective date. This section is applicable for sales or exchanges on or after December 24, 2002.

Robert E. Wenzel,
Assistant Deputy Commissioner of Internal Revenue.

Approved: December 11, 2002.

Pamela F. Olson,
Assistant Secretary of the Treasury.



DEPARTMENT OF THE TREASURY

OFFICE OF PUBLIC AFFAIRS

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1
[TD 9031]
RIN 1545-BB02
Reduced Maximum Exclusion of Gain from Sale or Exchange of Principal Residence

AGENCY: Internal Revenue Service (IRS), Treasury.
ACTION: Temporary regulations.
SUMMARY: This document contains temporary regulations relating to the exclusion of gain from the sale or exchange of a taxpayer's principal residence in the case of a taxpayer who has not owned and used the property as the taxpayer's principal residence for two of the preceding five years or who has excluded gain from the sale or exchange of a principal residence within the preceding two years. The text of these temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in the Proposed Rules section in this issue of the Federal Register.
DATES: Effective Date: These regulations are effective December 24, 2002.
Applicability Date: For dates of applicability, see §1.121-3T(l).
FOR FURTHER INFORMATION CONTACT: Sara Paige Shepherd, (202) 622-4960 (not a toll-free number).
SUPPLEMENTARY INFORMATION:
Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) under section 121(c) relating to the exclusion of gain from the sale or exchange of the principal residence of a taxpayer who has not owned and used the property as the taxpayer's principal residence for two of the preceding five years or who has excluded gain on the sale or exchange of a principal residence within the preceding two years.

Under section 121(a), a taxpayer may exclude up to $250,000 ($500,000 for certain joint returns) of gain realized on the sale or exchange of the taxpayer's principal residence if the taxpayer owned and used the property as the taxpayer's principal residence for at least two years during the five-year period ending on the date of the sale or exchange. Section 121(b)(3) allows the taxpayer to apply the maximum exclusion to only one sale or exchange during the two-year period ending on the date of the sale or

exchange. Section 121(c) provides that a taxpayer who fails to meet any of these conditions by reason of a change in place of employment, health, or, to the extent provided in regulations, unforeseen circumstances, may be entitled to an exclusion in a reduced maximum amount.

On October 10, 2000, a notice of proposed rulemaking (REG-105235-99) under section 121 was published in the Federal Register (65 FR 60136). The proposed regulations did not define change in place of employment, health, or unforeseen circumstances for purposes of the reduced maximum exclusion. Comments were specifically requested regarding what circumstances should qualify as unforeseen. A public hearing was held on January 26, 2001.

The IRS and Treasury Department received numerous comments regarding the reduced maximum exclusion and have concluded that many of these comments should be adopted. However, because the rules formulated in response to these comments are extensive, the IRS and Treasury Department have concluded that the rules relating to the reduced maximum exclusion should be issued as proposed and temporary regulations to provide the public with adequate notice and opportunity to comment. Final regulations under section 121 addressing provisions other than the reduced maximum exclusion are set forth elsewhere in this edition of the Federal Register.

Explanation of Provisions

1. General Provisions

Under the temporary regulations, a reduced maximum exclusion limitation is available to a taxpayer who has sold or exchanged property owned and used as the taxpayer's principal residence for less than two of the preceding five years or who has excluded gain on the sale or exchange of a principal residence within the preceding two years. This reduced maximum exclusion applies only if the sale or exchange is by reason of a change in place of employment, health, or unforeseen circumstances. A sale or exchange is by reason of a change in place of employment, health, or unforeseen circumstances only if the taxpayer's primary reason for the sale or exchange is a change in place of employment, health, or unforeseen circumstances. The taxpayer's primary reason for the sale or exchange is determined based on the facts and circumstances. The temporary regulations provide a list of factors that may be relevant in determining the taxpayer's primary reason. These factors are suggestive only. No single fact or particular combination of facts is determinative of the taxpayer's entitlement to the reduced maximum exclusion.

In addition, for each of the three grounds for claiming a reduced maximum exclusion, the temporary regulations provide a general definition and one or more safe harbors. If a safe harbor applies, the taxpayer's primary reason for the sale or exchange is deemed to be a change in place of employment, health, or unforeseen circumstances.

2. Change in Place of Employment

The temporary regulations provide that a sale or exchange is by reason of a change in place of employment if the taxpayer's primary reason for the sale or exchange is a change in the location of the employment of a qualified individual. Employment is defined as the commencement of employment with a new employer, the continuation of employment with the same employer, or the commencement or continuation of self-employment. A qualified individual is defined as the taxpayer, the taxpayer's spouse, a

co-owner of the residence, or a person whose principal place of abode is in the same household as the taxpayer.

The temporary regulations adopt a safe harbor, suggested by commentators, that provides that the primary reason for the sale or exchange is deemed to be a change in place of employment if the new place of employment of a qualified individual is at least fifty miles farther from the residence sold or exchanged than was the former place of employment. If the individual was unemployed, the distance between the new place of employment and the residence sold or exchanged must be at least fifty miles. This standard is derived from section 217(c)(1) relating to the moving expense deduction. The safe harbor applies only if the change in place of employment occurs during the period of the taxpayer's ownership and use of the property as the taxpayer's principal residence. If a sale or exchange does not satisfy this safe harbor, a taxpayer may still qualify for the reduced maximum exclusion by reason of a change in place of employment if the facts and circumstances indicate that a change in place of employment is the primary reason for the sale or exchange.

3. Sale or Exchange by Reason of Health

Commentators proposed that, for purposes of determining whether a sale or exchange is by reason of health, the regulations adopt standards similar to those for the deductibility of medical expenses under section 213(a). Commentators also suggested that the regulations provide that the reduced maximum exclusion by reason of health apply to sales and exchanges due to (1) advanced age-related infirmities, (2) the taxpayer's need to move in order to care for a family member, (3) severe allergies, and (4) emotional problems.

In response to these comments, the temporary regulations provide the general rule that a sale or exchange is by reason of health if the taxpayer's primary reason for the sale or exchange is (1) to obtain, provide, or facilitate the diagnosis, cure, mitigation, or treatment of disease, illness, or injury of a qualified individual, or (2) to obtain or provide medical or personal care for a qualified individual suffering from a disease, illness, or injury. A sale or exchange that is merely beneficial to the general health or well-being of the individual is not a sale or exchange by reason of health

One commentator suggested that the regulations establish a safe harbor allowing a taxpayer to claim a reduced maximum exclusion if the taxpayer obtains documentation of a specific medical condition from a licensed physician. The temporary regulations provide a safe harbor that the primary reason for the sale or exchange is deemed to be health if a physician (as defined in section 213(d)(4)) recommends a change of residence for reasons of health.

For purposes of the reduced maximum exclusion by reason of health, the term qualified individual includes the taxpayer, the taxpayer's spouse, a co-owner of the residence, a person whose principal place of abode is in the same household as the taxpayer, and certain family members of these individuals. The definition of qualified individual in the case of health is broader than the definition that applies to the exclusions by reason of change in place of employment and unforeseen circumstances to encompass taxpayers who sell or exchange their residence in order to care for sick family members.4. Sale or Exchange by Reason of Unforeseen Circumstances

The temporary regulations provide that a sale or exchange is by reason of unforeseen circumstances if the primary reason for the sale or exchange is the occurrence

of an event that the taxpayer does not anticipate before purchasing and occupying the residence.

Many commentators provided suggestions regarding circumstances that should qualify as unforeseen. A large number of commentators suggested that unforeseen circumstances should encompass divorce or the termination of a permanent residential relationship. Others suggested that unforeseen circumstances should include death, birth, marriage, bankruptcy, the loss of employment, incarceration, admission to an institution of higher learning, natural and man-made disasters, involuntary conversions, and a substantial increase in medical or living expenses leading to a significant change in economic circumstances. One commentator suggested that any delay of over three years in selling the residence due to a decline in the real estate market should be deemed an unforeseen circumstance. A few commentators suggested that unforeseen circumstances should include unfavorable changes affecting the desirability of the property, such as environmental problems, zoning-law changes, slovenly neighbors, and serious nuisance or safety concerns.

The temporary regulations adopt many of these suggestions as safe harbors. A taxpayer's primary reason for the sale or exchange is deemed to be unforeseen circumstances if one of the safe harbor events occurs during the taxpayer's ownership and use of the property. The safe harbor events include the involuntary conversion of the residence, a natural or man-made disaster or act of war or terrorism resulting in a casualty to the residence, and, in the case of a qualified individual: (1) death, (2) the cessation of employment as a result of which the individual is eligible for unemployment compensation, (3) a change in employment or self-employment status that results in the taxpayer's inability to pay housing costs and reasonable basic living expenses for the taxpayer's household, (4) divorce or legal separation under a decree of divorce or separate maintenance, and (5) multiple births resulting from the same pregnancy. The Commissioner may designate other events or situations as unforeseen circumstances in published guidance of general applicability or in a ruling directed to a specific taxpayer. A taxpayer who does not qualify for a safe harbor may demonstrate that the primary reason for the sale or exchange is unforeseen circumstances, under a facts and circumstances test.

For purposes of the reduced maximum exclusion by reason of unforeseen circumstances, a qualified individual includes the taxpayer, the taxpayer's spouse, a co-owner of the residence, and a person whose principal place of abode is in the same household as the taxpayer.

The regulations include examples illustrating the application of the safe harbors and the facts and circumstances test.

5. Election to Apply Regulations Retroactively

The regulations provide that taxpayers who would otherwise qualify under these temporary regulations to exclude gain from a sale or exchange that occurred before the effective date of the regulations but on or after May 7, 1997, may elect to apply all of the provisions of the temporary regulations to the sale or exchange. A taxpayer may make the election by filing a return for the taxable year of the sale or exchange that does not include the gain from the sale or exchange of the taxpayer's principal residence in the taxpayer's gross income. Taxpayers who have filed a return for the taxable year of the sale or exchange may elect to apply all of the provisions of these regulations for any

years for which the period of limitations under section 6511 has not expired by filing an amended return.

6. Audit Protection

The temporary regulations provide that the IRS will not challenge a taxpayer's position that a sale or exchange before the effective date of these regulations but on or after May 7, 1997, qualifies for the reduced maximum exclusion under section 121(c) if the taxpayer has made a reasonable, good faith effort to comply with the requirements of section 121(c) and if the sale or exchange otherwise qualifies under section 121.

7. Effective Date

These temporary regulations apply to sales and exchanges on or after December 24, 2002.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. For the applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6) refer to the Special Analyses section of the preamble to the cross-reference notice of proposed rulemaking published in the Proposed Rules section in this issue of the Federal Register. 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 these regulations is Sara Paige Shepherd, Office of Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and the Treasury Department participated in the development of the regulations.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

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

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

Par. 2. Section 1.121-3T is added to read as follows:

§1.121-3T Reduced maximum exclusion for taxpayers failing to meet certain requirements (temporary).

(a) [Reserved] For further guidance, see §1.121-3(a).

(b) Primary reason for sale or exchange. In order for a taxpayer to claim a reduced maximum exclusion under section 121(c), the sale or exchange must be by reason of a change in place of employment, health, or unforeseen circumstances. A sale or exchange is by reason of a change in place of employment, health, or unforeseen circumstances only if the primary reason for the sale or exchange is a change in place of employment (within the meaning of paragraph (c) of this section), health (within the meaning of paragraph (d) of this section), or unforeseen circumstances (within the meaning of paragraph (e) of this section). Whether the requirements of this section are satisfied depends upon all the facts and circumstances. If the taxpayer qualifies for a safe

harbor described in this section, the taxpayer's primary reason is deemed to be a change in place of employment, health, or unforeseen circumstances. If the taxpayer does not qualify for a safe harbor, factors that may be relevant in determining the taxpayer's primary reason for the sale or exchange include (but are not limited to) the extent to which--

(1) The sale or exchange and the circumstances giving rise to the sale or exchange are proximate in time;

(2) The suitability of the property as the taxpayer's principal residence materially changes;

(3) The taxpayer's financial ability to maintain the property materially changes;

(4) The taxpayer uses the property as the taxpayer's residence during the period of the taxpayer's ownership of the property;

(5) The circumstances giving rise to the sale or exchange are not reasonably foreseeable when the taxpayer begins using the property as the taxpayer's principal residence; and

(6) The circumstances giving rise to the sale or exchange occur during the period of the taxpayer's ownership and use of the property as the taxpayer's principal residence.

(c) Sale or exchange by reason of a change in place of employment--(1) In general. A sale or exchange is by reason of a change in place of employment if, in the case of a qualified individual described in paragraph (f) of this section, the primary reason for the sale or exchange is a change in the location of the individual's employment.

(2) Distance safe harbor. The primary reason for the sale or exchange is deemed to be a change in place of employment (within the meaning of paragraph (c)(1) of this section) if--

(i) The change in place of employment occurs during the period of the taxpayer's ownership and use of the property as the taxpayer's principal residence; and

(ii) The individual's new place of employment is at least 50 miles farther from the residence sold or exchanged than was the former place of employment, or, if there was no former place of employment, the distance between the individual's new place of employment and the residence sold or exchanged is at least 50 miles.

(3) Employment. For purposes of this paragraph (c), employment includes the commencement of employment with a new employer, the continuation of employment with the same employer, and the commencement or continuation of self-employment.

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

Example 1. A is unemployed and owns a townhouse that she has owned and used as her principal residence since 2002. In 2003 A obtains a job that is 54 miles from her townhouse, and she sells the townhouse. Because the distance between A's new place of employment and the townhouse is at least 50 miles, the sale is within the safe harbor of paragraph (c)(2) of this section and A is entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 2. B is an officer in the United States Air Force stationed in Florida. B purchases a house in Florida in 2001. In May 2002 B moves out of his house to take a 3-year assignment in Germany. B sells his house in January 2003. Because B's new place of employment in Germany is at least 50 miles farther from the residence sold than is B's

former place of employment in Florida, the sale is within the safe harbor of paragraph (c)(2) of this section and B is entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 3. C is employed by Employer R at R's Philadelphia office. C purchases a house in February 2001 that is 35 miles from R's Philadelphia office. In May 2002 C begins a temporary assignment at R's Wilmington office that is 72 miles from C's house, and moves out of the house. In June 2004 C is assigned to work in R's London office, and as a result, sells her house in August 2004. The sale of the house is not within the safe harbor of paragraph (c)(2) of this section by reason of the change in place of employment from Philadelphia to Wilmington because the Wilmington office is not 50 miles farther from C's house than is the Philadelphia office. Furthermore, the sale is not within the safe harbor by reason of the change in place of employment to London because C is not using the house as her principal residence when she moves to London. However, C is entitled to claim a reduced maximum exclusion under section 121(c)(2) because, under the facts and circumstances, the primary reason for the sale is the change in C's place of employment.

Example 4. In July 2002 D buys a condominium that is 5 miles from her place of employment and uses it as her principal residence. In February 2003 D, who works as an emergency medicine physician, obtains a job that is located 51 miles from D's condominium. D may be called in to work unscheduled hours and, when called, must be able to arrive at work quickly. Therefore, D sells her condominium and buys a townhouse that is 4 miles from her new place of employment. Because D's new place of employment is only 46 miles farther from the condominium than is D's former place of employment, the sale is not within the safe harbor of paragraph (c)(2) of this section. However, D is entitled to claim a reduced maximum exclusion under section 121(c)(2) because, under the facts and circumstances, the primary reason for the sale is the change in D's place of employment.

(d) Sale or exchange by reason of health--(1) In general. A sale or exchange is by reason of health if the primary reason for the sale or exchange is to obtain, provide, or facilitate the diagnosis, cure, mitigation, or treatment of disease, illness, or injury of a qualified individual described in paragraph (f) of this section, or to obtain or provide medical or personal care for a qualified individual suffering from a disease, illness, or injury. A sale or exchange that is merely beneficial to the general health or well-being of the individual is not a sale or exchange by reason of health.

(2) Physician's recommendation safe harbor. The primary reason for the sale or exchange is deemed to be health if a physician (as defined in section 213(d)(4)) recommends a change of residence for reasons of health (as defined in paragraph (d)(1) of this section).

(3) Examples. The following examples illustrate the rules of this paragraph (d):

Example 1. In 2002 A buys a house that she uses as her principal residence. A is injured in an accident and is unable to care for herself. As a result, A sells her house in 2003 and moves in with her daughter so that the daughter can provide the care that A requires as a result of her injury. Because, under the facts and circumstances, the primary

reason for the sale of A's house is A's health, A is entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 2. H's father has a chronic disease. In 2002 H and W purchase a house that they use as their principal residence. In 2003 H and W sell their house in order to move into the house of H's father so that they can provide the care he requires as a result of his disease. Because, under the facts and circumstances, the primary reason for the sale of their house is the health of H's father, H and W are entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 3. H and W purchase a house in 2002 that they use as their principal residence. Their son suffers from a chronic illness that requires regular medical care. Later that year their doctor recommends that their son begin a new treatment that is available at a medical facility 100 miles away from their residence. In 2003 H and W sell their house to be closer to the medical facility. Because, under the facts and circumstances, the primary reason for the sale is to facilitate the treatment of their son's chronic illness, H and W are entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 4. B, who has chronic asthma, purchases a house in Minnesota in 2002 that he uses as his principal residence. B's doctor tells B that moving to a warm, dry climate would mitigate B's asthma symptoms. In 2003 B sells his house and moves to Arizona to relieve his asthma symptoms. The sale is within the safe harbor of paragraph (d)(2) of this section and B is entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 5. In 2002 H and W purchase a house in Michigan that they use as their principal residence. H's doctor tells H that he should get more exercise, but H is not suffering from any disease that can be treated or mitigated by exercise. In 2003 H and W sell their house and move to Florida so that H can increase his general level of exercise by playing golf year-round. Because the sale of the house is merely beneficial to H's general health, the sale of the house is not by reason of H's health. H and W are not entitled to claim a reduced maximum exclusion under section 121(c)(2).

(e) Sale or exchange by reason of unforeseen circumstances
--(1) In general. A sale or exchange is by reason of unforeseen circumstances if the primary reason for the sale or exchange is the occurrence of an event that the taxpayer does not anticipate before purchasing and occupying the residence.

(2) Specific event safe harbors. The primary reason for the sale or exchange is deemed to be unforeseen circumstances (within the meaning of paragraph (e)(1) of this section) if any of the events specified in paragraphs (e)(2)(i) through (iii) of this section occur during the period of the taxpayer's ownership and use of the residence as the taxpayer's principal residence--

(i) The involuntary conversion of the residence;

(ii) Natural or man-made disasters or acts of war or terrorism resulting in a casualty to the residence (without regard to deductibility under section 165(h));

(iii) In the case of a qualified individual described in paragraph (f) of this section-

(A) Death;

(B) The cessation of employment as a result of which the individual is eligible for unemployment compensation (as defined in section 85(b));

(C) A change in employment or self-employment status that results in the taxpayer's inability to pay housing costs and reasonable basic living expenses for the taxpayer's household (including amounts for food, clothing, medical expenses, taxes, transportation, court-ordered payments, and expenses reasonably necessary to the production of income, but not for the maintenance of an affluent or luxurious standard of living);

(D) Divorce or legal separation under a decree of divorce or separate maintenance; or

(E) Multiple births resulting from the same pregnancy; or

(iv) An event determined by the Commissioner to be an unforeseen circumstance to the extent provided in published guidance of general applicability or in a ruling directed to a specific taxpayer.

(3) Examples. The following examples illustrate the rules of this paragraph (e):

Example 1. In 2003 A buys a house in California. After A begins to use the house as her principal residence, an earthquake causes damage to A's house. A sells the house in 2004. The sale is within the safe harbor of paragraph (e)(2)(ii) of this section and A is entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 2. H works as a teacher and W works as a pilot. In 2003 H and W buy a house that they use as their principal residence. Later that year W is furloughed from her job for six months. H and W are unable to pay their mortgage during the period W is furloughed. H and W sell their house in 2004. The sale is within the safe harbor of paragraph (e)(2)(iii)(C) of this section and H and W are entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 3. In 2003 H and W buy a two-bedroom condominium that they use as their principal residence. In 2004 W gives birth to twins and H and W sell their condominium and buy a four-bedroom house. The sale is within the safe harbor of paragraph (e)(2)(iii)(E) of this section, and H and W are entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 4. B buys a condominium in 2003 and uses it as his principal residence. B's monthly condominium fee is $X. Three months after B moves into the condominium, the condominium association decides to replace the building's roof and heating system. Six months later, B's monthly condominium fee doubles. B sells the condominium in 2004 because B is unable to pay the new condominium fee along with the monthly mortgage payment. The safe harbors of paragraph (e)(2) of this section do not apply. However, under the facts and circumstances, the primary reason for the sale is unforeseen circumstances, and B is entitled to claim a reduced maximum exclusion under section 121(c)(2).

Example 5. In 2003 C buys a house that he uses as his principal residence. The property is located on a heavily trafficked road. C sells the property in 2004 because the traffic is more disturbing than he expected. C is not entitled to claim a reduced maximum exclusion under section 121(c)(2) because the safe harbors of paragraph (e)(2) of this section do not apply and, under the facts and circumstances, the traffic is not an unforeseen circumstance.

Example 6. In 2003 D and her fiancé E buy a house and live in it as their principal residence. In 2004 D and E cancel their wedding plans and E moves out of the house. Because D cannot afford to make the monthly mortgage payments alone, D and E sell the house in 2004. The safe harbors of paragraph (e)(2) of this section do not apply. However, under the facts and circumstances, the primary reason for the sale is unforeseen circumstances, and D and E are each entitled to claim a reduced maximum exclusion under section 121(c)(2).

(f) Qualified individual. For purposes of this section, qualified individual means-

(1) The taxpayer;
(2) The taxpayer's spouse;
(3) A co-owner of the residence;
(4) A person whose principal place of abode is in the same household as the taxpayer; or
(5) For purposes of paragraph (d) of this section, a person bearing a relationship specified in sections 152(a)(1) through 152(a)(8) (without regard to qualification as a dependent) to a qualified individual described in paragraphs (f)(1) through (4) of this section, or a descendant of the taxpayer's grandparent.

(g) [Reserved]. For further guidance, see §1.121-3(g).

(h) Election to apply regulations retroactively. Taxpayers who would otherwise qualify under this section to exclude gain from a sale or exchange before December 24, 2002 but on or after May 7, 1997, may elect to apply all of the provisions of this section for any years for which the period of limitations under section 6511 has not expired. The taxpayer makes the election under this paragraph (h) by filing a return for the taxable year of the sale or exchange that does not include the gain from the sale or exchange of the taxpayer's principal residence in the taxpayer's gross income. Taxpayers who have filed a return for the taxable year of the sale or exchange may elect to apply all the provisions of this section for any years for which the period of limitations under section 6511 has not expired by filing an amended return.

(i) through (j) [Reserved]. See §1.121-3(i) through (j).

(k) Audit protection. The Internal Revenue Service will not challenge a taxpayer's position that a sale or exchange of a principal residence that occurred before December 24, 2002 but on or after May 7, 1997, qualifies for the reduced maximum exclusion under section 121(c) if the taxpayer has made a reasonable, good faith effort to comply with the requirements of section 121(c) and if the sale or exchange otherwise qualifies under section 121.

(l) Effective date. For the applicability of this

section, see §1.121-3(l).

Robert E. Wenzel
Deputy Commissioner of Internal Revenue.

Approved: December 11, 2002.

Pamela F. Olson
Assistant Secretary of the Treasury.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

December 23, 2002
PO-3717

Air Transportation Stabilization Board Issues Federal Guarantee On Behalf of Aloha Airlines

The Air Transportation Stabilization Board today announced it has closed on a $45 million loan on behalf of Aloha Airlines. The loan is backed by a $40.5 million federal guarantee issued under the Air Transportation Safety and System Stabilization Act and implementing regulations promulgated by the Office of Management and Budget.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

December 24, 2002
PO-3718

Treasury Letter to Congress on the Debt Ceiling

December 24, 2002

The Honorable J. Dennis Hastert
Speaker
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Speaker:

Due to the ongoing response to the September 11, 2001, terrorist attack and the economic slowdown which began in the summer of 2000, the Administration now projects that debt subject to limit may reach the statutory ceiling in the latter half of February 2003. This is consistent with estimates made when the statutory ceiling was raised earlier this year.

The federal government's debt subject to limit continues to be driven largely by required investments of government trust fund balances. The remainder reflects the impact of waging the war on terrorism and restoring economic performance.

Accordingly, I am writing to request that Congress act promptly next year to ensure the government's ability to finance its operations. This action is necessary to ensure success in our efforts to combat terrorism, continue the economic recovery and create jobs, and maintain the soundness of federal government securities. The Department of the Treasury stands ready to work with Congress to make this possible. Thank you for your attention to this matter.

Yours sincerely,

Kenneth Dam
Deputy Secretary

ESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

December 24, 2002
po3719

U.S. International Reserve Position

The Treasury Department today released U.S. reserve assets data for the latest week. As indicated in this table, U.S. reserve assets totaled $76,967 million as of the end of that week, compared to $75,943 million as of the end of the prior week.

I. Official U.S. Reserve Assets *(in US millions)*

	December 13, 2002			December 20, 2002		
TOTAL		77,044			77,258	
1. Foreign Currency Reserves [1]	**Euro**	**Yen**	**TOTAL**	**Euro**	**Yen**	**TOTAL**
a. Securities	6,625	13,031	19,656	6,660	13,052	19,712
Of which, issuer headquartered in the U.S.			0			0
b. Total deposits with:						
b.i. Other central banks and BIS	10,905	2,616	13,521	10,956	2,620	13,576
b.ii. Banks headquartered in the U.S.			0			0
b.ii. Of which, banks located abroad			0			0
b.iii. Banks headquartered outside the U.S.			0			0
b.iii. Of which, banks located in the U.S.			0			0
2. IMF Reserve Position [2]			20,820			20,885
3. Special Drawing Rights (SDRs) [2]			12,004			12,042
4. Gold Stock [3]			11,042			11,042
5. Other Reserve Assets			0			0

II. Predetermined Short-Term Drains on Foreign Currency Assets

	December 13, 2002			December 20, 2002		
	Euro	**Yen**	**TOTAL**	**Euro**	**Yen**	**TOTAL**
1. Foreign currency loans and securities			0			0
2. Aggregate short and long positions in forwards and futures in foreign currencies vis-à-vis the U.S. dollar:						

2.a. Short positions	0	0
2.b. Long positions	0	0
3. Other	0	0

III. Contingent Short-Term Net Drains on Foreign Currency Assets

	December 13, 2002			December 20, 2002		
	Euro	Yen	TOTAL	Euro	Yen	TOTAL
1. Contingent liabilities in foreign currency			0			0
1.a. Collateral guarantees on debt due within 1 year						
1.b. Other contingent liabilities						
2. Foreign currency securities with embedded options			0			0
3. Undrawn, unconditional credit lines			0			0
3.a. With other central banks						
3.b. With banks and other financial institutions						
Headquartered in the U.S.						
3.c. With banks and other financial institutions						
Headquartered outside the U.S.						
4. Aggregate short and long positions of options in foreign						
Currencies vis-à-vis the U.S. dollar			0			0
4.a. Short positions						
4.a.1. Bought puts						
4.a.2. Written calls						
4.b. Long positions						
4.b.1. Bought calls						
4.b.2. Written puts						

Notes:

1/ Includes holdings of the Treasury's Exchange Stabilization Fund (ESF) and the Federal Reserve's System Open Market Account (SOMA), valued at current market exchange rates. Foreign currency holdings listed as securities reflect marked-to-market values, and deposits reflect carrying values. Foreign Currency Reserves for the latest week may be subject to revision. Foreign Currency

Reserves for the prior week are final.

2/ The items, "2. IMF Reserve Position" and "3. Special Drawing Rights (SDRs)," are based on data provided by the IMF and are valued in dollar terms at the official SDR/dollar exchange rate for the reporting date. The entries for the latest week reflect any necessary adjustments, including revaluation, by the U.S. Treasury to the prior week's IMF data. IMF data for the latest week may be subject to revision. IMF data for the prior week are final.

3/ Gold stock is valued monthly at $42.2222 per fine troy ounce.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

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December 30, 2002
PO-3720

TREASURY ISSUES PROPOSED REGULATIONS REGARDING PENALTY DEFENSES

Today the Treasury Department issued proposed rules limiting the penalty defenses for transactions that taxpayers do not disclose on their returns.

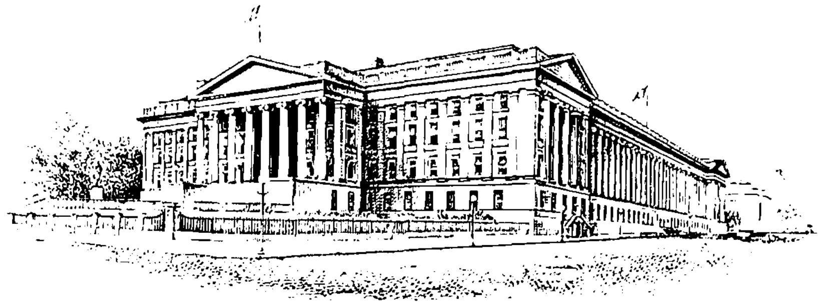
"We are raising the stakes for taxpayers who fail to disclose potentially abusive transactions to the IRS. Taxpayers who choose to hide their transactions from the IRS will lose their ability to rely on a tax opinion as a penalty defense," stated Treasury Assistant Secretary for Tax Policy Pam Olson. "This regulatory change is necessitated by the fact that too many tax advisors have counseled clients against disclosing their transactions with the expectation that the advisors' opinions will allow the clients to avoid penalties. With this change and the regulatory changes aimed at increasing disclosure to the IRS, we believe we will alter taxpayers' risk/reward calculations and reduce the use of inappropriate tax avoidance transactions," Olson added.

These proposed regulations prohibit taxpayers from relying upon an opinion or advice from a tax practitioner as a defense to the accuracy-related penalty for potentially abusive transactions that are not disclosed. Under these proposed regulations, taxpayers will not be allowed to rely upon a tax opinion as a penalty defense if they fail to disclose transactions that are based on a position that a regulation is invalid.

These proposed regulations carry out two of the administrative actions announced in the Treasury Department's Enforcement Proposals for Abusive Tax Avoidance Transactions, issued on March 20, 2002. The Treasury Department already has issued regulations that provide revised rules for identifying transactions that must be disclosed on a tax return. These proposed changes to the penalty regulations will reinforce the disclosure rules, allowing the IRS and the Treasury Department to respond quickly to abusive transactions.

Related Documents:

- The text of the final regulations is attached.



DEPARTMENT OF THE TREASURY

OFFICE OF PUBLIC AFFAIRS

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-126016-01]

RIN 1545-AY97

Establishing Defenses to the Imposition of the Accuracy-Related Penalty

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations that limit the defenses available to the imposition of the accuracy-related penalty when taxpayers fail to disclose reportable transactions or fail to disclose that they have taken a position on a return based upon a regulation being invalid. By limiting a taxpayer's ability to use an opinion or advice from a tax professional as a basis for a defense, the proposed regulations are intended to promote the disclosure of reportable transactions and positions by taxpayers that conflict with regulations issued by the Secretary. The proposed regulations also clarify the existing regulations with respect to the facts and circumstances that the IRS will consider in determining whether a taxpayer acted with reasonable cause and in good faith in relying on an opinion or

advice.

DATES: Written or electronically generated comments and requests for a public hearing must be received by March 31, 2003.

ADDRESSES: Send submissions to CC:IT&A:RU (REG-126016-01), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:IT&A:RU (REG-126016-01), Courier's Desk, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit comments electronically directly to the IRS Internet site at: www.irs.gov/regs.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Jamie G. Bernstein or Heather L. Dostaler at (202)622-4940; concerning submissions of comments and requests for a public hearing, Ms. LaNita Van Dyke of the Regulations Unit at (202)622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed regulations amending the regulations promulgated pursuant to sections 6662 and 6664, relating to the accuracy-related penalty. Section 6662 provides for the imposition of an accuracy-related penalty for underpayments of tax, including underpayments due to negligence or disregard of rules or regulations and understatements that are substantial within the meaning of the statute. Taxpayers, however, can avoid the accuracy-related penalty if they can establish, among other things, that there was reasonable cause for the underpayment and that they acted in good faith within the meaning of section 6664(c).

Temporary regulations issued under section 6011 require taxpayers to disclose reportable transactions on their returns within the meaning of those temporary regulations. Treas. Reg. §1.6011-4T. Reportable transactions may be abusive tax avoidance transactions. The early identification of potentially abusive tax avoidance transactions is a high priority for the IRS and Treasury. On October 22, 2002, the IRS and Treasury published proposed and temporary regulations that significantly revise the definition of certain types of reportable transactions. See Tax Shelter Disclosure Statements, [67 FR 64799 and 67 FR 64840 (October 22, 2002)] (to be codified in 26 CFR parts 1, 20, 25, 31, 53, 54, 56, and 301). The proposed amendments to the disclosure rules under section 6011 generally will apply to transactions entered into on or after January 1, 2003.

The IRS and Treasury believe that taxpayers have improperly relied on opinions or advice issued by tax advisors to establish reasonable cause and good faith as a basis for avoiding the accuracy-related penalty, even when the opinion or advice relates to a reportable transaction that the taxpayer should have, but did not, disclose pursuant to §1.6011-4T. The IRS and Treasury also believe that taxpayers have improperly relied upon opinions or advice that a regulation is invalid without disclosing on their returns their position that the regulation is invalid.

Accordingly, the IRS and Treasury have concluded that the regulations under sections 6662 and 6664 should be amended and clarified so that (1) a taxpayer who takes a position that a regulation is invalid cannot rely on an opinion or advice to satisfy the reasonable cause and good faith exception under section 6664(c) with respect to any underpayment attributable to such position if the position was not disclosed on a return; and (2) a taxpayer who engages in a reportable transaction cannot rely on an opinion or advice to satisfy the reasonable cause and good faith exception under section 6664(c) with

respect to any underpayment attributable to the transaction if the transaction was not disclosed pursuant to the regulations promulgated under section 6011. Further, a taxpayer who engages in a reportable transaction cannot rely on the realistic possibility standard under section 6662 to avoid the accuracy-related penalty for negligence or disregard of rules or regulations if the position regarding the reportable transaction is contrary to a revenue ruling or notice.

Explanation of Provisions

These proposed regulations amend 26 CFR part 1 relating to the defenses available to the imposition of the accuracy-related penalty under section 6662(b)(1) (underpayments of tax attributable to negligence or disregard of rules or regulations) and the general exception to the accuracy- related penalty under section 6664(c).

Under these proposed regulations, the adequate disclosure exception to the accuracy-related penalty for underpayments of tax attributable to negligence or disregard of rules or regulations (see §1.6662-3(a)) will not apply to underpayments relating to a reportable transaction unless the reportable transaction also is disclosed under §1.6011-4T. In addition, if a position relates to a reportable transaction and is contrary to a revenue ruling or notice (other than a notice of proposed rulemaking), a taxpayer may not rely upon the fact that the position has a realistic possibility of being sustained on the merits as a defense to the penalty imposed under section 6662(b)(1). The taxpayer instead would be required to satisfy the adequate disclosure exception under §1.6662-3(c)(1), including the disclosure of the reportable transaction under §1.6011-4T.

The proposed regulations also clarify and modify the standards for, and limits on, the use of opinions and advice to satisfy the reasonable cause and good faith exception under section 6664(c) as a

defense to the imposition of the accuracy-related penalty under section 6662. The proposed regulations, for instance, clarify that a taxpayer's education, sophistication and business experience will be relevant in determining whether the taxpayer's reliance on the opinion or advice was reasonable and made in good faith. The IRS currently takes these facts and circumstances into account in determining whether a taxpayer has satisfied the reasonable cause and good faith exception under section 6664(c).

These proposed regulations amend §1.6664-4(c) to specify when a taxpayer cannot rely upon an opinion or advice to satisfy the reasonable cause and good faith exception. Taxpayers who do not disclose positions based upon a regulation being invalid (see §1.6662-3(c)(2)) cannot use an opinion or advice concerning the invalidity of the regulation as a basis for satisfying the reasonable cause and good faith exception under section 6664(c). Similarly, the proposed regulations prohibit taxpayers from using an opinion or advice as a basis for satisfying the reasonable cause and good faith exception under section 6664(c) with respect to a reportable transaction that the taxpayer did not disclose in accordance with §1.6011-4T.

Under these proposed regulations, a taxpayer, in order to properly disclose a transaction, may be required to file with the taxpayer's return more than one disclosure form for the same transaction in order to satisfy the requirements in the regulations under sections 6662 and 6664 (as modified by these proposed regulations), and section 6011. The IRS and Treasury may consider permitting taxpayers to use a single disclosure document to satisfy those regulations, provided that all required information is provided by the taxpayer and provided that the taxpayer files a copy of the document with the Office of Tax Shelter Analysis as required under §1.6011-4T (or as may be otherwise provided in any successor regulations).

Proposed Effective Date

These regulations are proposed to apply to returns filed after December 30, 2002, with respect to transactions entered into on or after January 1, 2003, to coincide with the temporary regulations relating to disclosure, promulgated under section 6011 and applicable for transactions entered into on or after January 1, 2003. The IRS, however, cautions taxpayers and tax practitioners that it will rigorously apply the existing facts and circumstances standard under §1.6664-4(c) regarding a taxpayer's reasonable reliance in good faith on advice from a tax professional, as well as the other provisions of the regulations under sections 6662 and 6664, including §1.6664-4(c) relating to special rules for the substantial understatement penalty attributable to tax shelter items of a corporation. In addition to the modifications contained in these proposed regulations, and regardless of when a transaction was entered into, the IRS, in appropriate circumstances, may consider a taxpayer's failure to disclose a reportable transaction or failure to disclose a position that a regulation is invalid as a factor in determining whether the taxpayer has satisfied the reasonable cause and good faith exception under section 6664(c) to the accuracy-related penalty.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory 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 regulation does 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 their impact on small businesses.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and 8 copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed regulations and how they can be made easier to understand. All comments will be available for public inspection and copying. A public hearing may be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal authors of these regulations are Jamie G. Bernstein and Heather L. Dostaler of the Office of Associate of Chief Counsel (Procedure and Administration), Administrative Provisions and Judicial Practice Division.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

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 1.6662-3 is amended by:

1. Revising paragraph (a).

2. Revising the last sentence of paragraph (b)(2)

3. Revising the first sentence of paragraph (c)(1).

The revisions read as follows:

§1.6662-3 Negligence or disregard of rules or regulations.

(a) In general. If any portion of an underpayment, as defined in section 6664(a) and §1.6664-2, of any income tax imposed under subtitle A of the Internal Revenue Code that is required to be shown on a return is attributable to negligence or disregard of rules or regulations, there is added to the tax an amount equal to 20 percent of such portion. The penalty for disregarding rules or regulations does not apply, however, if the requirements of paragraph (c)(1) of this section are satisfied and the position in question is adequately disclosed as provided in paragraph (c)(2) of this section (and, if the position relates to a reportable transaction as defined in §1.6011-4T(b), the transaction is disclosed in accordance with §1.6011-4T), or to the extent that the reasonable cause and good faith exception to this penalty set forth in §1.6664-4 applies. In addition, if a position with respect to an item (other than with respect to a reportable transaction, as defined in §1.6011-4T(b)) is contrary to a revenue ruling or notice (other than a notice of proposed rulemaking) issued by the Internal Revenue Service and published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter), this penalty does not apply if the position has a realistic possibility of being sustained on its merits. See §1.6694-2(b) of the income tax return preparer penalty regulations for a description of the realistic possibility standard.

(b) * * *

(2) * * * Nevertheless, a taxpayer who takes a position (other than with respect to a reportable transaction, as defined in §1.6011-4T(b)) contrary to a revenue ruling or a notice has not disregarded the ruling or notice if the contrary position has a realistic possibility of being sustained on its merits.

* * * * *

(c) * * * (1) * * * No penalty under section 6662(b)(1) may be imposed on any portion of an underpayment that is attributable to a position contrary to a rule or regulation if the position is disclosed in accordance with the rules of paragraph (c)(2) of this section (and, if the position relates to a reportable transaction as defined in §1.6011-4T(b), the transaction is disclosed in accordance with §1.6011-4T) and, in case of a position contrary to a regulation, the position represents a good faith challenge to the validity of the regulation.

Par. 3. Section 1.6664-0 is amended by:

1. Adding an entry for §1.6664-4(c)(1)(iii).

2. Redesignating the entries for §1.6664-4(c)(2) and (c)(3) as §1.6664-4(c)(3) and (c)(4), respectively.

3. Adding a new entry for §1.6664-4(c)(2).

The additions read as follows:

<u>§1.6664-0 Table of contents.</u>

* * * * *

<u>§1.6664-4 Reasonable cause and good faith exception to section 6662 penalties.</u>
* * * * *
(c) * * *
(1) * * *
(iii) Reliance on the invalidity of a regulation.

(2) Opinions or advice relating to reportable transactions.
* * * * *

Par. 4. Section 1.6664-4 is amended by:

1. Revising paragraph (c)(1) introductory text.

2. Revising the last sentence of paragraph (c)(1)(i).

3. Adding paragraph (c)(1)(iii).

4. Redesignating paragraphs (c)(2) and (c)(3) as paragraphs (c)(3) and (c)(4), respectively.

5. Adding a new paragraph (c)(2).

The revision and additions read as follows:

§1.6664-4 Reasonable cause and good faith exception to section 6662 penalties.

(c) Reliance on opinion or advice -- (1) Facts and circumstances; minimum requirements. All facts and circumstances must be taken into account in determining whether a taxpayer has reasonably relied in good faith on advice (including the opinion of a professional tax advisor) as to the treatment of the taxpayer (or any entity, plan, or arrangement) under Federal tax law. For example, the taxpayer's education, sophistication and business experience will be relevant in determining whether the taxpayer's reliance on the advice was reasonable and made in good faith. In no event will a taxpayer be considered to have reasonably relied in good faith on advice (including an opinion) unless the requirements of this paragraph (c)(1) are satisfied and the advice is not disqualified under paragraph (c)(2) of this section. The fact that these requirements are satisfied, however, will not necessarily establish that the taxpayer reasonably relied on the advice (including the opinion of a professional tax advisor) in good faith. For example, reliance may not be reasonable or in good faith if the taxpayer

knew, or reasonably should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law.

(i) * * * In addition, the requirements of this paragraph (c)(1) are not satisfied if the taxpayer fails to disclose a fact that it knows, or reasonably should know, to be relevant to the proper tax treatment of an item.

* * * * *

(iii) Reliance on the invalidity of a regulation. A taxpayer may not rely on an opinion or advice that a regulation is invalid to establish that the taxpayer acted with reasonable cause and good faith unless the taxpayer adequately disclosed, in accordance with §1.6662-3(c)(2), including the disclosure of the position that the regulation in question is invalid, and, if the position relates to a reportable transaction as defined in §1.6011-4T(b), the transaction is disclosed in accordance with §1.6011-4T.

(2) Opinions or advice relating to reportable transactions. Taxpayers may not reasonably rely on an opinion or advice of a tax advisor if the opinion or advice is disqualified under this

ICE OF PUBLIC AFFAIRS

page, download the free Adobe Acrobat Reader.

ınd Federal Reserve Submit
ɔn Investment Companies to Congress

ırities and Exchange Commission, and the
Reserve System today released a report to
Act containing recommendations for applying
ıvestment companies.

/e discussion of the many types of investment
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uch as hedge funds. Such regulations are

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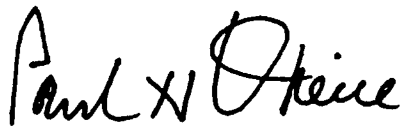
United States Department of the Treasury
Board of Governors of the Federal Reserve System
Securities and Exchange Commission

The Honorable Michael G. Oxley
Chairman
Committee on Financial Services
U.S. House of Representatives
Washington, DC 20515

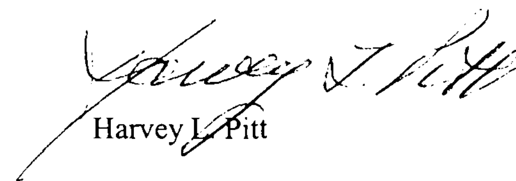
Dear Chairman Oxley:

As directed by section 356(c) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT ACT) Act of 2001 (Public Law 107-56), we enclose a report containing recommendations for effective regulations to apply the requirements of the Bank Secrecy Act to investment companies. The report first outlines the development of anti-money laundering controls under the Bank Secrecy Act as well as the ways in which investment companies can be used to launder money. The report then analyzes the various forms of investment companies, including those not registered with the SEC, identifying their characteristics and any limitations on their operation. Finally, the report contains recommendations for applying BSA regulations to these various forms of investment companies.

Sincerely,


Paul H. O'Neill

Alan Greenspan


Harvey L. Pitt

Enclosure

United States Department of the Treasury
Board of Governors of the Federal Reserve System
Securities and Exchange Commission

The Honorable John J. LaFalce
Ranking Member
Committee on Financial Services
U.S. House of Representatives
Washington, DC 20515

Dear Congressman LaFalce:

As directed by section 356(c) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT ACT) Act of 2001 (Public Law 107-56), we enclose a report containing recommendations for effective regulations to apply the requirements of the Bank Secrecy Act to investment companies. The report first outlines the development of anti-money laundering controls under the Bank Secrecy Act as well as the ways in which investment companies can be used to launder money. The report then analyzes the various forms of investment companies, including those not registered with the SEC, identifying their characteristics and any limitations on their operation. Finally, the report contains recommendations for applying BSA regulations to these various forms of investment companies.

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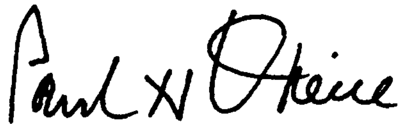
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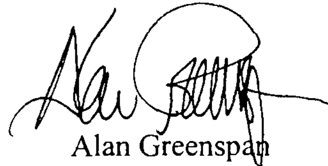
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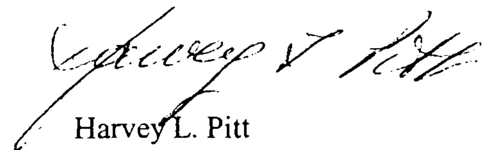
Harvey L. Pitt

Enclosure

United States Department of the Treasury
Board of Governors of the Federal Reserve System
Securities and Exchange Commission

The Honorable Paul S. Sarbanes
Chairman
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, DC 20510

Dear Chairman Sarbanes:

As directed by section 356(c) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT ACT) Act of 2001 (Public Law 107-56), we enclose a report containing recommendations for effective regulations to apply the requirements of the Bank Secrecy Act to investment companies. The report first outlines the development of anti-money laundering controls under the Bank Secrecy Act as well as the ways in which investment companies can be used to launder money. The report then analyzes the various forms of investment companies, including those not registered with the SEC, identifying their characteristics and any limitations on their operation. Finally, the report contains recommendations for applying BSA regulations to these various forms of investment companies.

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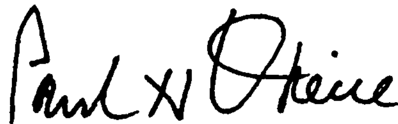
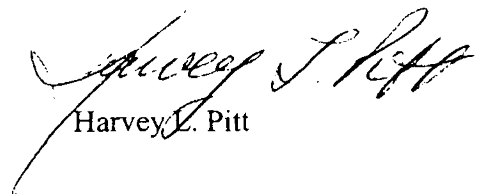

Paul H. O'Neill

Alan Greenspan


Harvey L. Pitt

Enclosure

United States Department of the Treasury
Board of Governors of the Federal Reserve System
Securities and Exchange Commission

The Honorable Phil Gramm
Ranking Member
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, DC 20510

Dear Senator Gramm:

As directed by section 356(c) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT ACT) Act of 2001 (Public Law 107-56), we enclose a report containing recommendations for effective regulations to apply the requirements of the Bank Secrecy Act to investment companies. The report first outlines the development of anti-money laundering controls under the Bank Secrecy Act as well as the ways in which investment companies can be used to launder money. The report then analyzes the various forms of investment companies, including those not registered with the SEC, identifying their characteristics and any limitations on their operation. Finally, the report contains recommendations for applying BSA regulations to these various forms of investment companies.

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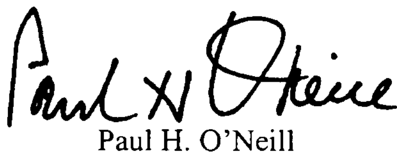
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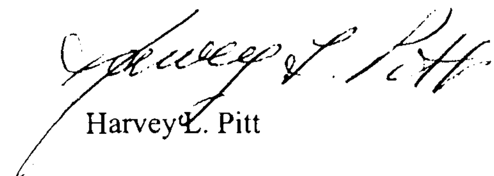
Harvey L. Pitt

Enclosure

A REPORT TO CONGRESS
IN ACCORDANCE WITH § 356(c)

OF THE

UNITING AND STRENGTHENING AMERICA BY PROVIDING APPROPRIATE TOOLS REQUIRED TO INTERCEPT AND OBSTRUCT TERRORISM ACT OF 2001
(USA PATRIOT ACT)

SUBMITTED BY

THE SECRETARY OF THE TREASURY,
THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM,
THE SECURITIES AND EXCHANGE COMMISSION

The staff of the Commodity Futures Trading Commission also assisted in the preparation of this Report.

December 31, 2002

A REPORT TO CONGRESS
IN ACCORDANCE WITH § 356(c) OF THE USA PATRIOT ACT

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I. Introduction

On October 26, 2001, the President signed into law the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act (USA PATRIOT Act) of 2001, Pub. L. No. 107-56 ("USA Patriot Act"). Section 356(c) of the USA Patriot Act calls for a report to Congress ("Report") within one year from the date of enactment containing recommendations for effective regulations to apply the record keeping and reporting requirements of the Bank Secrecy Act, Titles I and II of Pub.L. 91-508, (the "BSA") to investment companies and personal holding companies.[1]

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[1] Section 356(c) of the USA Patriot Act provides:

Section 356 – Reporting of Suspicious Activities by Securities Brokers and Dealers; Investment Company Study

* * *

(c) REPORT ON INVESTMENT COMPANIES.–

(1) IN GENERAL. – Not later than 1 year after the date of enactment of this Act, the Secretary, the Board of Governors of the Federal Reserve System, and the Securities and Exchange Commission shall jointly submit a report to the Congress on recommendations for effective regulations to apply the requirements of subchapter II of chapter 53 of title 31, United States Code, to investment companies pursuant to section 5312(a)(2)(I) of title 31, United States Code.

(2) DEFINITION. – For purposes of this subsection, the term "investment company" –

(A) has the same meaning as in section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a-3); and

(B) includes any person that, but for the exceptions provided for in paragraph (1) or (7) of section 3(c) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(c)), would be an investment company.

(3) ADDITIONAL RECOMMENDATIONS. – The report required by paragraph (1) may make different recommendations for different types of entities covered by this subsection.

(4) BENEFICIAL OWNERSHIP OF PERSONAL HOLDING COMPANIES. – The report described in paragraph (1) shall also include recommendations as to whether the Secretary should promulgate regulations to treat any corporation or business or other grantor trust whose assets are predominantly securities, bank certificates of deposit, or other securities or investment instruments (other than such as relate to operating subsidiaries of such corporation or trust) and that has 5 or fewer common shareholders or holders of beneficial or other equity interest, as a financial institution within the meaning of that phrase in section 5312(a)(2)(I) and whether to require such corporations or trusts to disclose their beneficial owners when opening accounts or initiating funds transfers at any domestic financial institution.

In accordance with section 356(c) of the USA Patriot Act, the Secretary of the Treasury (the "Treasury"), the Board of Governors of the Federal Reserve System (the "Federal Reserve Board"), and the Securities and Exchange Commission (the "SEC") submit this Report. The staff of the Financial Crimes Enforcement Network ("FinCEN") and the Commodity Futures Trading Commission (the "CFTC") also assisted in the preparation ofthis Report. Specifically, we address three questions raised by section 356(c) of the USA Patriot Act: (1) what are the appropriate "effective regulations" to apply the requirements of the BSA to investment companies; (2) which of those regulations should be applied to investment companies to best achieve the goals of the BSA; and (3) what investment companies should be subject to the BSA regulatory scheme?

II. Background

A. Evolution of the Bank Secrecy Act as a Tool to Combat Money Laundering and Terrorist Financing

Congress passed the BSA in 1970 to prevent the use of cash payrolls for tax evasion and to provide tools to fight organized crime. Until last year, the stated purpose of the BSA was "to require certain reports or records where they have a high degree of usefulness in criminal, tax, or regulatory investigations or proceedings."[2] The original focus of the BSA was on banks, which are the main financial institutions that deal in cash.

As the nature and sophistication of financial institutions have grown, new and creative ways to hide sources of illegally obtained profits have been devised. To protect the U.S. financial system from criminal activity and to promote the detection and prosecution of financial crimes, Congress added anti-money laundering provisions to the BSA in 1992, which authorized

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[2] 31 U.S.C. 5311. Language expanding the scope of the BSA to intelligence or counter-intelligence activities to protect against international terrorism was added by section 358 of the USA Patriot Act.

Treasury to apply the law to many different types of financial institutions.[3] Prior to the passage of the USA Patriot Act, regulations applying the anti-money laundering provisions of the BSA were issued only for banks and certain other institutions that offer bank-like services or that regularly deal in cash. These regulations require such financial institutions to take the following actions:

- Keep records related to certain monetary instrument purchases and funds transfers;[4]
- Report currency transactions of more than $10,000 by, through, or to the financial institution;[5]
- Report the transport of currency across U.S. borders;[6]
- Report certain accounts that United States citizens and residents hold at foreign financial institutions;[7] and
- Report suspicious transactions relevant to possible violations of the law.[8]

Title III of the USA Patriot Act amends the BSA to make it easier to prevent, detect, and prosecute international money laundering and the financing of terrorism by:

- Requiring that every financial institution establish an anti-money laundering program that includes, at a minimum, (i) the development of internal policies, procedures, and controls; (ii) the designation of a compliance officer; (iii) an ongoing employee training program; and (iv) an independent audit function to test the program;[9]

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[3] 31 U.S.C. 5312(a)(2). Treasury also has broad authority to adopt rules requiring other types of businesses to adopt anti-money laundering programs if those businesses deal in cash (31 U.S.C. 5312(a)(2)(Z)) or engage in activities that Treasury determines to be "similar to, related to, or a substitute for" activities engaged in by one of the listed businesses. 31 U.S.C. 5312(a)(2)(Y).

[4] *See* 31 CFR 103.29, 103.33.

[5] *See* 31 CFR 103.22.

[6] *See* 31 CFR 103.23.

[7] *See* 31 CFR 103.24 and 103.25.

[8] *See* 31 CFR 103.18, 103.19, 103.20, and 103.21.

[9] *See* section 352 of the USA Patriot Act.

- Requiring Treasury to prescribe, jointly with the federal functional regulators, regulations setting forth minimum standards regarding the verification of the identity of any person seeking to open an account;[10]

- Requiring each U.S. financial institution that establishes, maintains, administers, or manages a private banking account or correspondent account in the United States for a non-U.S. person to take certain anti-money laundering measures with respect to such accounts;[11]

- Prohibiting certain financial institutions from establishing, maintaining, administering, or managing a correspondent account in the U.S. for a foreign shell bank (other than certain foreign shell banks with regulated affiliates);[12] and

- Permitting financial institutions, their regulatory authorities, and law enforcement authorities to share information regarding persons engaged or reasonably suspected, based on credible evidence, of engaging in terrorist acts or money laundering activities.[13]

The USA Patriot Act required the extension of the anti-money laundering requirements to financial institutions, such as investment companies, that had not previously been subjected to BSA regulations.[14] The USA Patriot Act also added new entities to the statutory definition of financial institution, such as futures commission merchants, commodity trading advisors ("CTAs"), and commodity pool operators ("CPOs").[15]

In accordance with the USA Patriot Act, FinCEN, in conjunction with other federal financial regulators, has adopted or has proposed for adoption rules to implement the amendments to the BSA. These rules prescribe anti-money laundering program requirements for certain financial institutions[16] and require certain financial institutions to implement reasonable

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10 *See* section 326 of the USA Patriot Act.

11 *See* section 312 of the USA Patriot Act.

12 *See* section 313 of the USA Patriot Act.

13 *See* section 314 of the USA Patriot Act.

14 *See* section 352 of the USA Patriot Act.

15 *See* section 321 of the USA Patriot Act.

16 *See, e.g.,* Anti-Money Laundering Programs for Financial Institutions, 67 FR 21110 (April 29, 2002); Anti-Money Laundering Programs for Money Services Businesses, 67 FR 21114 (April 29, 2002); Anti-Money Laundering Programs for Mutual Funds, 67 FR 21117 (April 29, 2002);

procedures to verify the identity of persons seeking to open accounts.[17] The regulations also prohibit certain financial institutions from establishing, maintaining, administering, or managing a correspondent account in the U.S. for a foreign shell bank (other than certain foreign shell banks with regulated affiliates)[18] and require certain financial institutions to implement due diligence programs for certain correspondent as well as private banking accounts.[19] In addition, FinCEN promulgated a rule that sets forth procedures for information sharing between federal law enforcement agencies and financial institutions and voluntary information sharing among financial institutions.[20]

B. The Crimes of Money Laundering and Terrorist Financing

1. Codification as Federal Crimes

In 1984, Congress passed the Money Laundering Control Act ("MLCA"), which made money laundering a federal crime.[21] The financing of terrorist activities or of designated foreign

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Anti-Money Laundering Programs for Operators of a Credit Card System, 67 FR 21121 (April 29, 2002); Anti-Money Laundering Programs for Unregistered Investment Companies, 67 FR 60617 (September 26, 2002); Anti-Money Laundering Programs for Insurance Companies, 67 FR 60625 (September 26, 2002).

17 *See* Customer Identification Programs for Banks, Savings Associations, and Credit Unions, 67 FR 48290 (July 23, 2002); Customer Identification Programs for Certain Banks (Credit Unions, Private Banks and Trust Companies) That Do Not Have a Federal Functional Regulator, 67 FR 48299 (July 23, 2002); Customer Identification Programs for Broker-Dealers, 67 FR 48306 (July 23, 2002); Customer Identification Programs for Mutual Funds, 67 FR 48318 (July 23, 2002); Customer Identification Programs for Futures Commission Merchants and Introducing Brokers, 67 FR 48328 (July 23, 2002).

18 *See* Anti-Money Laundering Requirements -- Correspondent Accounts for Foreign Shell Banks: Recordkeeping and Termination of Correspondent Accounts for Foreign Banks, 67 FR 60562 (September 26, 2002).

19 *See* Anti-Money Laundering Programs; Special Due Diligence Programs for Certain Foreign Accounts, 67 FR 48348 (July 23, 2002).

20 *See* Special Information Sharing Procedures to Deter Money Laundering & Terrorist Activity, 67 FR 60579 (September 26, 2002).

21 18 U.S.C. 1956 and 1957.

terrorist organizations is also a federal crime.[22] These crimes, like the vast majority of federal white-collar crimes and offenses traditionally associated with organized crime, also serve as predicate acts for the crime of money laundering.

One section of the MLCA criminalized the conduct of a "financial transaction" involving proceeds that are known to derive from some "specified unlawful activity."[23] A transaction is a "financial transaction" under the statute if it involves monetary instruments, the movement of funds, the transfer of title to property, or the use of a financial institution.[24] To be guilty of money laundering under this section of the MLCA, the defendant must act with the intent to (1) promote the carrying on of a specified unlawful activity, (2) engage in tax fraud, (3) conceal or disguise the nature, location, source, ownership or control of the property, or (4) avoid a transaction reporting requirement.[25] Thus, this section criminalized "smurfing" – the practice of intentionally structuring transactions to avoid reporting requirements by splitting the total amount of funds available for deposit into amounts below the $10,000 reporting threshold.

Another section of the MLCA criminalized the engagement in a "monetary transaction" involving property of a value greater than $10,000 that is known to derive from a criminal offense, and that is actually derived from a "specified unlawful activity."[26] The term monetary transaction is defined broadly to cover almost any transaction by, through, or to a financial institution, including the deposit, withdrawal, transfer, or exchange of funds or a monetary instrument.[27] Unlike the section of the MLCA discussed in the paragraph above, this section

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[22] 18 U.S.C. 2339A and 2339B.

[23] 18 U.S.C. 1956.

[24] 18 U.S.C. 1956(c)(4).

[25] 18 U.S.C. 1956(a)(1).

[26] 18 U.S.C. 1957.

[27] 18 U.S.C. 1957(f)(1).

does not require the defendant to know that the property was derived from a specified unlawful activity. Rather, this section requires the defendant to know only that the property was derived from some criminal offense. Therefore, a defendant cannot rely on willful blindness to avoid liability under this section of the MLCA.

2. Stages of the Money Laundering Process

The process of money laundering is accomplished in three stages. The first stage in the process is placement. The placement stage involves the physical movement of currency or other funds derived from illegal activities to a place or into a form that is less suspicious to law enforcement authorities and more convenient to the criminal. The proceeds are introduced into traditional or nontraditional financial institutions or into the retail economy. The second stage is layering. The layering stage involves the separation of proceeds from their illegal source by using multiple complex financial transactions (*e.g.*, wire transfers, monetary instruments) to obscure the audit trail and hide the proceeds. The third stage in the money laundering process is integration. During the integration stage, illegal proceeds are converted into apparently legitimate business earnings through normal financial or commercial operations.

3. Use of Investment Companies in Money Laundering

For purposes of the Report, an investment company is defined broadly to include those entities listed in the definition of the term in the 1940 Act, entities that would be investment companies under the 1940 Act but for the exceptions provided in certain sections of the 1940 Act, and certain other pooled investment vehicles that are not subject to the 1940 Act because they do not invest primarily in securities. The money laundering risks associated with investment companies generally are discussed below.

a. Placement Stage

Investment companies can be used by criminals at every stage of the money laundering process. Investment companies are less likely than other types of financial institutions (*e.g.*, banks) to be used during the placement stage because they rarely receive from or disburse to investors significant amounts of currency. However, money launderers appear to have used investment companies at this initial stage. FinCEN has received a number of reports concerning the use of a stolen, altered check to establish an account with an investment company. Other suspicious activity observed in the purchase of investment company interests includes the use of money orders and travelers checks in structured amounts to avoid currency reporting by the financial institution issuing such instruments. Similarly, money launderers have purchased an initial interest in an investment company with several wire transfers, each in an amount under $10,000 and from different banks and brokerage firms.

b. Layering Stage

Money launderers are most likely to use investment companies in the layering stage of the money laundering process. Money launderers can use investment company accounts to layer their assets by sending and receiving money and rapidly wiring it through several accounts and multiple institutions, or by redeeming an interest in a company originally purchased with illegal proceeds and then reinvesting the proceeds received in another investment company. In fact, a number of reports have described the use of wire transfers, checks, cash, and money orders to deposit money into an investment company account, followed by withdrawals from the account on the same day or during the same week.[28]

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[28] *Cf. Correspondent Services Corp. v. J.V.W. Investments Ltd.*, 120 F. Supp. 2d 401 (S.D.N.Y. 2000) (noting that account was frozen by financial services firm due to concerns with possible money laundering involving purchases of mutual funds and other investments).

Layering may also entail the purchase of an interest in an investment company in the name of a fictitious corporation or an entity designed to conceal the true owner. Beyond that, criminals themselves may even create investment companies to conceal further the source and ownership of illicit proceeds. For example, the facts of a case decided by the Court of Appeals for the Eleventh Circuit in 2001 demonstrate how drug smugglers created an elaborate money laundering operation utilizing three different investment companies to launder funds.[29] The defendants in this case converted cash obtained from drug sales into cashier's checks. They then deposited the cashier's checks in a shell company located in Liechtenstein. Through a web of other sham investment companies, the defendants were able to move the funds to the United States and "loan" it back to themselves. The deposit of the cashier's checks in Liechtenstein prevented authorities from tracing the drug proceeds to their final destination. Similarly, any attempt to trace the source of the loan in the United States would reveal only that the loan was from a foreign entity protected by bank secrecy laws.

c. Integration Stage

Finally, investment companies may be used in the last stage of the money laundering process: the integration of illicit income into legitimate assets. For example, if an individual redeems an interest in an investment company that was purchased with illegal proceeds and directs the investment company to wire the cash from the redemption to a bank account in the individual's own name, the wire transfer would appear legitimate to the receiving bank. Moreover, money launderers sometimes organize a sham investment company to defraud investors or clients and to make payments from the company's account to their personal accounts appear legitimate. For example, in one case a defendant organized a venture capital firm to

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[29] *U.S. v. Gilbert*, 244 F.3d 888, 893-897 (11th Cir. 2001).

defraud clients seeking capital for business ventures.[30] He used the venture capital firm to operate an advance-fee scheme by which he would agree to obtain funding for a client within a certain time frame in exchange for a sizable up-front fee. Never intending to fund the business projects or return the advance fees, the defendant deposited the money in the firm's account and then proceeded to write large checks on the account made out to third parties and himself.[31]

III. Effective Regulations to Apply the BSA to Investment Companies

Different types of investment companies have different susceptibilities to money laundering, requiring variations in the regulatory approaches to them. To be effective, regulations applying the requirements of the BSA to investment companies must reflect the particular investment company's structure and vulnerability to being used in one or more stages of the money laundering process. In this section of the Report, we provide a description of the types of investment companies that currently exist, any special vulnerabilities that a certain type of investment company may have to being used for money laundering or terrorist financing, and the action taken or recommended to apply the provisions of the BSA to these companies.

The first step in drafting the regulations that would apply the requirements of the BSA to investment companies is to define the term "investment companies." A broad definition of "investment company" could include a large range of entities from small investment clubs to large corporate holding companies and, in between, an array of financing vehicles many of which are unlikely to be used for money laundering purposes. The discussion below reviews the various types of investment companies within two categories—those registered with the SEC under the 1940 Act and all others.

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30 *U.S. v. Davis*, 226 F.3d 346, 348-349 (5th Cir. 2000).

31 *See also U.S. v. Mullens*, 65 F.3d 1560 (11th Cir. 1995) (using an investment company to operate a Ponzi scheme).

A. Registered Investment Companies

Section 356(c)(2) of the USA Patriot Act indicated that the definition of "investment company" provided in the 1940 Act should be the starting point in crafting an appropriate definition. The 1940 Act defines "investment company" to include any issuer of securities that is, or holds itself out as being, engaged primarily in the business of investing, reinvesting, or trading in securities.[32] Most investment companies offered to the public are registered with the SEC under the 1940 Act, which subjects them to a comprehensive scheme of regulation.

The 1940 Act classifies almost all registered investment companies as either "management companies" or "unit investment trusts."[33] Management companies, which often adjust (or "manage") their portfolios in an active manner, are subclassified as "open-end" and

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32 Section 3(a)(1) of the 1940 Act defines "investment company" as any issuer that (A) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting or trading in securities; (B) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or (C) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis. 15 U.S.C. 80a-3(a)(1).

33 A "management company" is any investment company other than a unit investment trust or a face-amount certificate company. 15 U.S.C. 80a-4(3). A "unit investment trust" is an "investment company which (A) is organized under a trust indenture, contract of custodianship or agency, or similar instrument, (B) does not have a board of directors, and (C) issues only redeemable securities, each of which represents an undivided interest in a unit of specified securities, but does not include a voting trust." 15 U.S.C. 80a-4(2). A "face-amount certificate company" is "an investment company which is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or which has been engaged in such business and has any such certificate outstanding." 15 U.S.C. 80a-4(1). A "face amount certificate" is "any certificate, investment contract, or other security which represents an obligation on the part of its issuer to pay a stated or determinable sum or sums at a fixed or determinable date or dates more than twenty-four months after the date or issuance, in consideration of the payment of periodic installments or a stated or determinable amount" or "any security which represents a similar obligation on the part of a face-amount certificate company, the consideration for which is the payment of a single lump sum." 15 U.S.C. 80a-2(a)(15).

"closed-end" companies. An open-end investment company is a management company that is offering or has outstanding any redeemable securities that it issued.[34] Open-end investment companies, which are more commonly called "mutual funds," are by far the most prevalent type of registered investment company and may be the most susceptible to being used for money laundering.[35]

1. Mutual Funds

Mutual funds are today one of the most popular ways individual investors participate in the securities markets. In 2001, more than 8,300 active mutual funds, with approximately $7 trillion in assets, were registered with the SEC.[36] Mutual funds are held by more than half of U.S. households.[37] A mutual fund, like any other investment company, is a trust, partnership, or corporation whose assets consist of a portfolio of securities, interests in which are represented by the shares that the fund issues. A mutual fund raises money from shareholders and invests it in accordance with the fund's stated objectives. Mutual funds are generally grouped into stock

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[34] 15 U.S.C. 80a-5(a)(1).

[35] The staff of the SEC estimates, based on filings with the SEC, that as of December 2001, approximately $6.97 trillion was invested in U.S. mutual funds (including $741 billion invested in open-end management companies that fund variable life insurance and variable annuity contracts, and $23 billion invested in open-end management companies that are exchange-traded funds), $130 billion was invested in closed-end funds, and $121 billion was invested in unit investment trusts other than insurance company separate accounts (including $59.5 billion invested in unit investment trusts that are exchange-traded funds). As to investment companies that fund variable life insurance and variable annuity contracts, *see infra* pp. 20-21. As to investment companies that are exchange-traded funds, *see infra* note 50.

[36] Investment Company Institute, Mutual Fund Fact Book (2002) ("ICI Fact Book") 7. The SEC staff estimates that as of December 2001, there were approximately 3000 registered investment companies that were open-end management companies. The staff further estimates that 1400 of these investment companies are "series companies" with an aggregate 7200 portfolios. A "series company" is a registered investment company that issues two or more classes or series of preferred or special stock, each of which is preferred over all other classes or series with respect to assets specifically allocated to that class or series. 17 CFR 270.18f-2. The assets allocated to such a class or series are commonly known as a "portfolio." The series or portfolios of a series company operate, for many purposes, as separate investment companies.

[37] *See* ICI Fact Book, *supra* note 36, at 24.

funds, bond funds, and money market funds.[38] In addition, like most investment companies, mutual funds usually do not have their own employees. One or more third-party service providers (which may or may not be affiliated with the mutual fund) conduct all of a mutual fund's operations.[39]

Unlike other investment companies, a mutual fund typically offers its shares continuously to the public, and redeems its shares on demand by investors, at a price based on the fund's net asset value.[40] A mutual fund usually offers its shares to the public through a principal underwriter, which is a registered broker-dealer.[41] Shares also may be purchased directly from some funds (called "direct-sold funds"). In addition, they may be purchased through a variety of alternative distribution channels, such as fund "supermarkets" (through which investors may purchase shares of several different mutual funds), insurance agents, financial planners, and banks.[42] Mutual funds employ transfer agents to conduct recordkeeping and related functions.[43]

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[38] Mutual funds also may specialize their investment objectives in certain ways, such as by geographic location, industry sector, or the type of security in which they invest.

[39] A mutual fund may be organized or sponsored by an entity such as an investment adviser that provides other financial services. Thus, a mutual fund's investment adviser may simultaneously provide investment advice to individual clients, act as the investment adviser for other registered investment companies, and provide investment advice to unregistered pooled investment vehicles such as hedge funds. Mutual funds may also be part of larger complexes of entities that provide financial services. Other entities in the complex (*e.g.*, broker-dealers and investment advisers) will, of course, have employees.

[40] Mutual funds issue "redeemable securities," which entitle the holder to receive, upon presentation to the fund, the holder's approximate proportionate share of the issuer's current net assets, or the cash such share represents. 15 U.S.C. 80a-2(a)(32).

[41] On April 22, 2002, the SEC approved NASD Regulation Rule 3011 and New York Stock Exchange rule 445, which require their member broker-dealers to develop, and a member of the firm's senior management to approve, programs designed to achieve and monitor compliance with the BSA and related regulations. *See* Order Approving Proposed Rule Changes Relating to Anti-Money Laundering Compliance Programs, Securities Exchange Act Release No. 45798 (April 22, 2002) [67 FR 20854 (April 26, 2002)].

[42] Generally, insurance agents, financial planners, and banks that sell mutual fund shares must also be registered as broker-dealers. The alternative distribution channels for mutual funds usually maintain omnibus accounts with the mutual fund whose shares they distribute. In such case,

Because mutual funds typically offer and redeem their shares continuously, money launderers may invest in mutual funds due to the ability to obtain access to their money. To ensure that mutual funds take adequate precautions against such risks, FinCEN issued an interim final rule on April 29, 2002 that requires mutual funds to develop and implement an anti-money laundering program ("AML") reasonably designed to prevent them from being used to launder money or finance terrorist activities.[44] In addition, FinCEN and the SEC jointly published in July 2002 a notice of proposed rulemaking that would require mutual funds to establish customer identification programs ("CIPs").[45]

These rules, in mandating mutual funds' BSA obligations, recognize the particular way in which mutual funds are organized. They permit mutual funds to delegate responsibilities for implementation of an anti-money laundering program to one or more service providers or

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neither the fund nor its transfer agent typically knows the identities of the individual investors. *See* note 43 *infra,* discussing the duties of transfer agents.

[43] Transfer agents maintain records of shareholder accounts, calculate and disburse dividends, and prepare and mail shareholder account statements, federal income tax information, and other shareholder notices. Some transfer agents prepare and mail statements confirming shareholder transactions and account balances, and maintain customer service departments to respond to shareholder inquiries.

[44] *See* 67 FR 21117, *supra* note 16. The program must meet four minimum standards. First, it must establish and implement policies, procedures, and internal controls reasonably designed to prevent the mutual fund from being used to launder money or finance terrorist activities, including, but not limited to, achieving compliance with the applicable provisions of the BSA and the implementing regulations thereunder. Second, the mutual fund must provide for independent testing by fund personnel or by a qualified outside party of its program to ensure compliance with the applicable portions of the BSA and implementing regulations. Third, the mutual fund must designate a person or persons responsible for implementing and monitoring the operations and internal controls of the program. Fourth, the fund must provide ongoing training to appropriate persons regarding the BSA requirements relevant to their functions and the recognition of possible signs of money laundering that could arise in the course of their duties.

[45] *See* 67 FR 48318, *supra* note 17. The proposed regulation would require mutual funds to implement reasonable procedures to (1) verify the identity of any person seeking to open an account, to the extent reasonable and practicable, (2) maintain records of the information used to verify the person's identity, and (3) determine whether the person appears on any lists of known or suspected terrorists or terrorist organizations provided to investment companies by any government agency. The comment period for the proposed rule ended on September 6, 2002.

intermediaries. These intermediaries, through which investors purchase interests in mutual funds, include broker-dealers and banks, which are required to have their own anti-money laundering and customer identification programs.[46]

2. Closed-End Funds

A closed-end investment company (or "closed-end fund") is a management company other than an open-end investment company.[47] Like a mutual fund, a closed-end fund is a trust, partnership, or corporation whose assets consist of a portfolio of securities, interests in which are represented by the shares that the fund issues.[48] Closed-end funds differ from mutual funds in that they do not offer their shares continuously, nor do they redeem their shares on demand.[49] Instead, a closed-end fund issues a fixed number of shares, which typically trade on a stock exchange or in the over-the-counter market.[50] Investors seeking to buy or sell these shares must

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[46] Virtually all intermediaries that can hold mutual fund shares in an omnibus account are or may be subject to various anti-money laundering or SAR requirements. For example, a broker-dealer or investment adviser can hold shares for customers in omnibus accounts. Broker-dealers are already covered by the BSA's anti-money laundering provisions (including SAR reporting), and Treasury may extend these provisions to investment advisers.

[47] 15 U.S.C. 80a-5(a)(2). The staff of the SEC estimates, based on filings with the SEC, that as of December 2001 there were 632 registered closed-end funds, with aggregate assets of approximately $130 billion. The majority of these funds are publicly traded. The SEC staff estimates that as of December 2001 there were 54 closed-end funds, with assets of approximately $11.4 billion, that were not publicly traded. These funds are registered with the SEC solely under the 1940 Act.

[48] Recently some closed-end funds have registered with the SEC that invest predominantly in securities issued by hedge funds. *See* Robert H. Rosenblum & Leigh M.P. Freund, *A Primer on Structuring Registered Funds of Hedge Funds*, 9 Inv. Law 4 (Apr. 2002). As to hedge funds generally, *see* section III.B.1. *infra*.

[49] Section 23(c) of the 1940 Act [15 U.S.C. 80a-23(c)] generally prohibits a registered closed-end investment company from purchasing any security of which it is the issuer except on a securities exchange, pursuant to a tender, or under such other circumstances as the SEC may permit by rules, regulations, or orders designed to ensure that the purchases are made in a manner or on a basis which does not unfairly discriminate against any holders of the securities to be purchased. *See infra* notes 54 - 57 and accompanying text.

[50] Other types of registered investment companies may also be traded on a stock exchange. These "exchange-traded funds" or "ETFs" are registered with the SEC as open-end funds or unit investment trusts ("UITs"). Unlike typical open-end funds or UITs, ETFs do not sell or redeem

buy or sell them through a broker-dealer on the exchange. Like other publicly traded securities (and unlike the shares of a typical mutual fund), shares of a closed-end fund trade at a market price that fluctuates and is determined by supply and demand in the marketplace.[51]

Closed-end funds typically do not have an account relationship with their investors. As a result, those funds (and their service providers) are not in a position to detect and prevent money laundering. Purchases and sales of closed-end fund shares are effected through broker-dealers or banks, and these entities are already subject to anti-money laundering regulation.[52] For these reasons, closed-end funds do not appear to present a risk of money laundering that would be effectively addressed by subjecting them to additional regulation, and Treasury has not extended BSA regulatory requirements to closed-end funds.[53]

Although most closed-end funds do not redeem their shares, a category of closed-end funds – "interval funds" – do have limited redemption features. Interval funds rely on rule 23c-3

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their individual shares at net asset value. Instead, ETFs sell and redeem ETF shares at net asset value only in large blocks (*e.g.*, 50,000 ETF shares). National securities exchanges list ETF shares for trading, which allows investors to purchase and sell individual ETF shares at market prices throughout the day. ETFs therefore possess characteristics of traditional open-end funds and UITs, which issue redeemable shares, and of closed-end funds, which generally issue shares that trade at negotiated prices on national securities exchanges and are not redeemable. The SEC staff estimates, based on filings with the SEC, that as of December 2001, there were nine separately registered investment companies, four UITs and five open-end funds, offering such securities. The SEC staff further estimates that as of December 2001, the five open-end funds offered 98 series with aggregate assets of approximately $23 billion, and the UITs had aggregate assets of approximately $59.5 billion. The separate series of a registered investment company that is a series company operate, for many purposes, as separate investment companies. *See supra* note 36 (discussing registered investment companies that are series companies).

51 The price of closed-end fund shares may be above or below the fund's net asset value per share. This price differential is commonly referred to as a premium or discount, and reflects the market's assessment of the value and liquidity of the fund's portfolio assets, among other things.

52 *See* 67 FR 21110, *supra* note 16.

53 In April 2002, Treasury temporarily exempted investment companies other than mutual funds from the requirement that they establish anti-money laundering ("AML") programs. *Id.* Treasury stated its intention to continue to consider the type of AML program that would be appropriate for these companies, including the extent to which they pose a money laundering risk that is not more

under the 1940 Act to periodically offer to repurchase from shareholders a limited number of fund shares at net asset value.[54] Rule 23c-3 describes the intervals at which such repurchase offers may be made (three, six or twelve months)[55] and the amount of stock that may be the subject of a repurchase offer (not less than five percent nor more than twenty-five percent of the fund's outstanding stock).[56] There are currently an estimated 30 interval funds.[57]

Because investors in an interval fund control neither the timing nor the amount of the issuer's repurchase offer, the redemption features of interval funds do not appear to present significant money laundering risks. Accordingly, Treasury has not extended BSA regulatory requirements to interval funds, but it may reconsider this issue if the SEC were to liberalize the circumstances in which interval funds may make repurchase offers.

3. Unit Investment Trusts

A unit investment trust ("UIT") is a registered investment company that buys and holds a generally fixed, unmanaged[58] portfolio of securities and then sells redeemable shares (called "units") in the trust to investors. UIT investors receive a proportionate share of dividends or interest paid by the investments.[59]

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effectively covered by the AML program of another financial institution through which investors purchase and sell their interests (*e.g.*, a broker-dealer or insurance company). *Id.* at 21117-21118.

[54] 17 CFR 270.23c-3.

[55] 17 CFR 270.23c-3(a)(1).

[56] 17 CFR 270.23c-3(a)(3).

[57] This estimate is based on filings with the SEC on Form N-23C-3 [17 CFR 274.221] during 2001.

[58] A UIT has no investment adviser and no board of directors.

[59] The 1940 Act defines a "unit investment trust" as an investment company that (i) is organized under a trust indenture, contract or similar instrument, (ii) does not have a board of directors, and (iii) issues only redeemable securities that represent undivided interests in a unit of specified securities. *See* note 33 *supra*. As discussed above, in April 2002, FinCEN temporarily exempted investment companies other than mutual funds from the requirement that they establish AML programs. *See* 67 FR 21110, *supra* note 16. Therefore, UITs currently are not subject to BSA regulatory requirements.

There are two types of UITs. The "traditional" UIT is sponsored by a broker-dealer, which deposits securities into a trust and offers interests ("units") in the trust to brokerage customers. Although these units can be redeemed, sponsors typically support a secondary market into which redeeming shareholders sell. These traditional UITs have many of the same characteristics of mutual funds that can make them attractive to persons seeking to launder money. However, they are entirely creatures of their sponsoring brokerage firms, which are already required by the BSA to establish AML programs and report suspicious transactions in connection with such entities.[60] It does not appear that applying anti-money laundering rules to this type of UIT would appreciably decrease the UIT's risk of being used for money laundering, and thus such application has not been made.

The second type of UIT is an insurance company separate account.[61] These separate accounts issue variable annuity contracts and variable life insurance policies, and invest the premiums received by the insurance company in one or more mutual funds. In this arrangement, the UIT separate account functions as a conduit to the underlying mutual funds. These UITs are sponsored by insurance companies, which are likely to be required to establish anti-money laundering programs in accordance with the BSA once a proposed rule is finalized.[62] Applying

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60 *See* Amendment to Bank Secrecy Act Regulations; Requirement that Brokers or Dealers in Securities Report Suspicious Transactions, 67 FR 44048 (July 1, 2002); 67 FR 21110, *supra* note 16. Treasury and the SEC have jointly proposed a rule that would require broker-dealers to establish and implement customer identification programs. *See* 67 FR 48306, *supra* note 17.

61 Based on filings with the SEC, the SEC staff estimates that as of December 2001 there were approximately 683 unit investment trusts that were insurance company separate accounts, with aggregate assets of $650.5 billion.

62 Insurance companies have long been defined as financial institutions for purposes of the BSA. *See* 15 U.S.C. 5312(a)(2)(M). In April 2002, Treasury temporarily deferred the anti-money laundering program requirement contained in section 352 of the USA Patriot Act that would have applied to insurance companies, to enable it to consider how anti-money laundering controls could best be applied to that industry, taking into account differences in size, location, and services within the industry. *See* 67 FR 21110, *supra* note 16. On September 26, 2002, Treasury

another set of anti-money laundering rules to such separate accounts appears unlikely to increase protection against money laundering.

B. Unregistered Investment Companies

In addition to "investment companies" that are required to be registered under the 1940 Act, there are similar pooled investment vehicles that are not "investment companies" for purposes of the 1940 Act that should be considered to be "investment companies" for purposes of the BSA. Such entities may include (i) privately offered funds that have a limited number of investors that rely on the exception in section 3(c)(1) of the 1940 Act; (ii) funds that are privately offered to qualified purchasers that rely on the exception in section 3(c)(7) of the 1940 Act; and (iii) entities that are not subject to the 1940 Act because they do not invest primarily in securities. These types of investment vehicles would include hedge funds, private equity funds, venture capital funds, commodity pools, and real estate investment trusts.[63]

1. Hedge Funds

The term "hedge fund" refers generally to a privately offered investment vehicle that pools the contributions of its investors in order to invest in a variety of asset classes, such as securities, futures contracts, options, bonds, and currencies.[64] A precise figure for the size of the

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proposed a new rule that would prescribe minimum standards applicable to insurance companies pursuant to the BSA requirement that financial institutions establish anti-money laundering programs. *See* 67 FR 60625, *supra* note 16. The comment period on the proposed rule ends on November 25, 2002. *Id*

[63] As described in detail below, on September 26, 2002, FinCEN published a Notice of Proposed Rulemaking that would require many of these entities to establish anti-money laundering programs. 67 FR 60617, *supra* note 16, discussed at section III.B.4. of this report.

[64] The President's Working Group on Financial Markets describes a "hedge fund" as "any pooled investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public." Report of the President's Working Group on Financial Markets, "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management," at 1 (1999) ("Working Group Report"). It remains a matter of debate whether the term "hedge fund" refers only to funds that provide performance-based compensation for their managers, funds that actually hedge their exposure to the market, funds that engage in any investment strategy that is

hedge fund industry, in terms of the number of funds and the total value of assets managed, is unavailable because no official reporting organization exists for hedge funds. As of the last quarter of 2001, however, it was estimated that there were between 4,000 and 5,000 hedge funds worldwide that managed between $400 and $500 billion in capital.[65] Although the hedge fund industry remains small in relation to the mutual fund industry,[66] investment in hedge funds is growing.

Hedge funds domiciled in the United States are usually organized as limited partnerships or limited liability companies. The sponsor/general partner/manager usually holds an interest in the fund along with investors/limited partners/members,[67] who are, in most circumstances, either wealthy individuals or institutions such as savings associations, broker-dealers, investment companies, and employee benefit plans.[68] Further, hedge funds do not engage in "public offerings" of the interests in the funds. The sponsor often handles marketing and investor

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intended to be non-correlated with the overall securities markets, funds that are not required to be registered, or some combination of the foregoing.

65 *See* The Financial Stability Forum ("FSF") Recommendations and Concerns Raised by Highly Leveraged Institutions ("HLIs"): An Assessment, March 2002, at 1-2 (*http://www.fsforum.org/Reports/HLIreviewMar02.pdf*). The FSF is a 40-member organization convened in April 1999 by the Finance Ministers and Central Bank Governors of the G-7 countries.

66 As discussed previously, as of December 2001, there were an estimated 8300 mutual funds with approximately $7 trillion in assets. *See* note 36 *infra* and accompanying text.

67 The investors purchase interests in the hedge fund. These interests, whether denominated as units, shares or limited partnership interests, are securities. The Securities Act of 1933, however, provides an exemption from registration for securities that are not publicly offered. 15 U.S.C. 77d(2).

68 Generally, hedge funds offer and sell interests to persons who qualify as "accredited investors," "qualified purchasers," or "qualified clients" as those terms are defined respectively for purposes of the Securities Act of 1933, the Investment Company Act of 1940, and the Investment Advisers Act of 1940. *See* 15 U.S.C. 77b(a)(15), 17 CFR 230.215, and 17 CFR 230.501 (defining "accredited investor"), 15 U.S.C. 80a-2(a)(51) (defining "qualified purchaser") and 17 CFR 275.205-3(d) (defining "qualified client"). Limiting investors in this way enables a fund to avoid registering the securities issued by the fund under the Securities Act of 1933, avoid registering the

services, and often serves as the fund manager with responsibility for making decisions regarding operations and investment strategy. A hedge fund also may retain an investment adviser or multiple advisers. It is not uncommon, however, for the sponsor, manager, and investment adviser(s) to be either the same legal entity or separate legal entities that might be owned by the sponsor. A typical hedge fund is similar to a mutual fund in that it maintains several contractual relationships that are integral to the operation of the hedge fund, including relationships with prime brokers, executing brokers, custodians, administrators, placement agents, registrars and transfer agents.[69]

For various reasons arising from tax, administrative, and regulatory concerns, hedge funds often are established under U.S. law as partnerships ("U.S. domestic hedge funds") or as corporations in a foreign jurisdiction ("U.S. hedge funds with an offshore related fund").[70] Hedge funds that are offered to U.S. investors tend to be structured in ways to address the needs of either tax-exempt investors or taxable investors. U.S. domestic hedge funds are usually in the form of limited partnerships to accommodate taxable U.S. investors. Partnerships provide favorable tax treatment for individual investors because the partnership's income is taxed only at the level of the individual investors in the partnership, as opposed to a corporation's income that is taxed at both the entity and individual investors' levels.[71] In contrast, some U.S. hedge funds

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fund itself under the Investment Company Act of 1940, and enables the fund to pay its investment adviser a performance-based fee, even if the adviser is registered with the SEC.

69 Matthias Bekier, Marketing of Hedge Funds (1996), *excerpts available at* *http://209.130.127.8/aimasite/research/bekierhf/hfstru23.htm*.

70 In addition, any of the persons contractually affiliated with a hedge fund (*e.g.*, prime broker, administrator, custodian, adviser, or distributor) may be located offshore.

71 Some domestic hedge funds are organized as limited liability companies, which provide their investors with tax benefits identical to those of a limited partnership.

with an offshore related fund accommodate tax-exempt U.S. investors, such as pension funds and university endowments, and non-U.S. investors.[72]

Generally, all hedge funds require investors to complete subscription agreements that detail the investors' identity, domicile, and net worth, among other information.[73] The investor then returns the subscription agreement to the hedge fund manager or administrator and forwards his initial investment to the hedge fund's account with its custodian or its prime broker.[74] For the redemption of investment assets, U.S. domestic hedge funds usually rely on their custodian or prime broker to forward assets from the hedge fund's account to the investor's account. A U.S. hedge fund with an offshore related fund generally processes a redemption through its fund administrator, which sends the redeemed investment to the investor's bank account identified in the subscription documents.

A typical hedge fund often has a one-year "lock-up" period from the date of investment, during which the investor cannot redeem his investment.[75] Once the initial lock-up period is over, the right of an investor to redeem is governed by the partnership agreement. Most investors may demand a redemption during a set period that occurs on a quarterly, semi-annual,

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72 U.S. tax-exempt entities, such as university endowments and pension funds, are taxable on unrelated business taxable income ("UBIT") and therefore may seek to avoid the generation of income that the IRS may consider subject to UBIT by investing in an offshore fund that is a corporate entity.

73 A subscription agreement is an agreement to buy shares or interests in a hedge fund. It also outlines the terms and conditions of redemptions and transfers of such shares or interests.

74 Hedge funds rarely, if ever, receive or disburse currency to investors. Most investments are made by wire transfers from a financial institution, such as a bank, to the hedge fund's custodian or prime broker. When investors redeem their investments, most hedge funds forward the redemption proceeds to the account at the financial institution from which the initial investment was made.

75 *See* Lori R. Runquist, *Hedge Funds: Alternative Investment Choices,* Market Signals Supplement, The Northern Trust Co., (Feb. 2002), at www.northernfunds.com/library/personal/mrkt_newsletters/money_matters/020200.pdf

or annual basis. There is no formal domestic secondary market for hedge fund shares.

Of the unregistered investment companies, hedge funds may be the most susceptible to abuse by money launderers because of the liquidity of their interests and their structure. Compared to the lock-up period imposed upon an investment by other unregistered investment companies, the lock-up period imposed upon an investment by a hedge fund is relatively short. Because money laundering has become such an expensive activity (estimated to cost 8%-10% of the amount of the money laundered), money launderers may be willing to invest their assets for a limited period to launder them in a manner that generates a return rather than a loss.

The structure of hedge funds also makes them vulnerable to money laundering. A U.S. *domestic* hedge fund is comprised of a general partner and a limited partner that form a U.S. limited partnership to hold a portfolio of liquid securities. A limited partner, either an individual or a corporate limited partner, could easily transfer the proceeds of crime into the hedge fund. Without anti-money laundering compliance responsibilities, a hedge fund has no responsibility to determine the source of an investor's funds or to analyze whether the source of those funds is questionable.

The U.S. hedge fund with an *offshore* related fund has a complex structure that begins with a general partner and limited partners in a U.S. limited partnership. The limited partnership often provides funds to an offshore corporate master, which invests the funds in a portfolio of liquid securities. The corporate master has an investment manager and an offshore administrator. The offshore corporate master also receives funds to invest from an offshore corporate feeder. The beneficial owners of the offshore corporate feeder may be composed of offshore investors and U.S. tax-exempt entities that invest offshore for tax purposes.

Depending on the jurisdiction in which the offshore corporate feeder is organized, it may

be impossible to identify the beneficial owners of the money invested in the fund through the offshore corporate feeder or the source of the money being invested. The potential availability of "anonymous" investment and the inability of law enforcement to obtain information about the beneficial ownership of corporate entities in certain jurisdictions make this type of hedge fund particularly attractive to money launderers.[76] In fact, the Report of the President's Working Group on Financial Markets notes that a significant number of hedge funds have been established in offshore financial centers that are tax havens and may be engaged in or facilitating illegal tax avoidance and other inappropriate purposes.[77]

2. Commodity Pools

A commodity pool is an investment trust, syndicate or similar form of enterprise operated for trading commodity interests.[78] Commodity pool operators ("CPOs") are required to register with the CFTC as CPOs, and are subject to comprehensive regulation and oversight by the CFTC.[79] As of September 30, 2001, approximately 1,700 CPOs registered with the CFTC[80] operated an estimated 2,558 active commodity pools with $346 billion in assets.[81]

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[76] *See Gilbert, supra* note 29.

[77] *See* Working Group Report, app. B at B-3.

[78] A "pool" is defined in 17 CFR 4.10(d), a rule promulgated by the CFTC under the Commodity Exchange Act ("CEA"), as "any investment trust, syndicate or similar form of enterprise operated for the purpose of trading commodity interests." As a general matter, there are two types of commodity pools: public pools and private pools. Securities issued by public pools (*i.e.*, pools offered through public offerings) are registered with the SEC under the Securities Act of 1933 and the Securities Exchange Act of 1934. If those public pools are investment companies, they also are registered with the SEC under the 1940 Act. Private pools (*i.e.*, pools that are offered through private placements) also may register with the SEC under the 1940 Act as investment companies.

[79] The CEA defines the term "commodity pool operator" as "any person engaged in a business that is of the nature of an investment trust, syndicate, or similar form of enterprise, and who, in connection therewith, solicits, accepts, or receives from others, funds, securities, or property, either directly or through capital contributions, the sale of stock or other forms of securities, or otherwise, for the purpose of trading in any commodity for future delivery on or subject to the rules of any contract market or derivatives transaction execution facility, except that the term

Pursuant to the CFTC's rules and depending upon the amount of assets in the pool, a CPO must provide investors and the CFTC with monthly or quarterly financial statements,[82] distribute and file an annual report for each pool that it operates,[83] and maintain and make available for CFTC inspection certain books and records.[84] CPOs also are subject to the general and specific anti-fraud provisions of the CEA and CFTC regulations.[85] The CFTC and the National Futures Association ("NFA"), the futures industry's self-regulatory organization, review all of the commodity pools' annual financial statements. Further, each CPO must complete an annual self-audit questionnaire and undergo an onsite examination by NFA approximately once every 2.5 years. That examination covers the CPO itself and every commodity pool operated by the CPO. NFA maintains a publicly available database that can be used by both regulators and investors and contains the names, addresses, NFA identification numbers, regulatory history, and other pertinent information regarding the CPOs and commodity pools.[86]

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does not include such persons not within the intent of the definition of the term as the Commission may specify by rule, regulation, or order." 7 U.S.C. 1a(5).

80 CFTC 2001 Annual Report, "Futures Industry Registrants by Location as of September 30, 2001," at 150.

81 This information is based on estimates supplied to the staff of the CFTC by the National Futures Association.

82 17 CFR 4.22.

83 17 CFR 4.22(c). Before a commodity pool can accept funds or other property from investors in the pool, the CPO must distribute and file a disclosure document with the CFTC and National Futures Association. 17 CFR 4.21, 4.24-4.26.

84 17 CFR 4.23.

85 7 U.S.C. 6b prohibits fraudulent activity in or in connection with a futures contract. 7 U.S.C. 6o prohibits fraudulent transactions by CPOs and CTAs. 17 CFR 32.9 and 33.10 bar fraud by any person in connection with commodity option transactions.

86 The National Futures Association database can be searched on the Internet at http://www.nfa.futures.org/basic. As described in detail below, on September 26, 2002, FinCEN

3. Private Equity and Venture Capital Funds

Private equity funds are vehicles in which investors pool money to invest in unregistered securities of public or private companies that have been in existence for several years and have established products, customers, and operating records. A venture capital fund is a type of private equity fund[87] in which participants pool capital to invest in the seed, start-up or early stages of companies. These funds[88] do not engage in public offerings and generally have a small number of institutional and wealthy individual investors.[89]

There is little information on the number of private equity funds and the total value of assets managed by such funds because, like hedge funds, there is no official reporting organization that exists for private equity funds. However, in 2001, an estimated 1,627 venture capital funds were in existence with $250 billion in capital under management.[90]

Private equity funds are sponsored by private equity firms, which typically sponsor more than one fund. Each fund, however, is organized as a separate legal entity. Most private equity funds are structured as limited partnerships with the general partner being the private equity firm

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published a notice or proposed rulemaking that would require commodity pools, and therefore, CPOs indirectly, to establish anti-money laundering programs. 67 FR 60617, *supra* note 16, discussed at section III.B.4. of this report.

[87] There are other types of private equity funds including leveraged buyout funds, which finance the purchase of established companies; mezzanine funds, which are used to purchase and recapitalize private companies; and opportunity funds, which invest in distressed companies. However, most of the details and descriptions in this report focus on the practices of private equity funds generally and venture capital funds which are a subset of private equity funds.

[88] For purposes of this report, both types of funds will be referred to generally as "private equity funds."

[89] *See supra* note 77 regarding "accredited investors," "qualified purchasers," and "qualified clients."

[90] The NVCA 2002 Yearbook, National Venture Capital Association ("NVCA"), ("The NVCA 2002 Yearbook"), at *http://www.nvca.org*.

and the investors serving as limited partners.[91] Typically, the general partner serves as the fund's manager and is responsible for researching the companies in which the fund might invest.[92] In some instances, particularly in venture capital funds, the general partner plays an active role in the companies in which the fund invests, either by sitting on the board of directors or becoming involved in day-to-day management. The general partner establishes a management company to handle routine administrative matters such as administering payroll and benefits for the fund's employees, leasing office space, and recording the limited partners' investments in the fund.

Many private equity funds establish offshore mirror funds. These offshore funds have separate limited partners from the domestic fund, but the funds invest in the same or similar companies. Funds with an offshore element can be structured in a number of ways, but the general partner of the companion U.S. fund generally manages them.[93] As with hedge funds, the investors in offshore private equity funds are typically U.S. tax-exempt organizations and foreign persons or institutions.

The general partner of a private equity fund "solicits" investors directly—there is no general advertisement or public offering of the fund's securities.[94] Investors typically include

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[91] Some private equity funds are organized as limited liability companies and, occasionally, corporations.

[92] Depending on the size of the fund and the types of investors, the manager may be required to register as an investment adviser under the 1940 Act, 15 U.S.C. 80b-1 *et seq.* But, generally, private equity funds are subject to limited government regulation.

[93] Regardless of the structure of the onshore/offshore arrangement, the general partner's management company in the U.S. typically has custody of the records of all of the investors, although there is often a copy of the records for the offshore investors kept in the jurisdiction of the offshore fund. In the case of a fund that has some U.S. investors but is strictly an offshore fund (*i.e.*, organized by non-U.S. general partners), such records typically will be kept offshore.

[94] Private equity funds are not required to provide disclosure information to investors. Nonetheless, they typically provide offering memoranda to prospective investors. The general partners of private equity funds usually collect a large amount of information about prospective limited

high net worth individuals and families, pension funds, endowment organizations, banks and insurance companies.[95]

In most cases, private equity funds have a lifespan of 10 to 12 years, although the investment in each portfolio company usually lasts for a shorter period, such as 3 to 7 years.[96] Investors commit to invest a certain amount of money with the fund over the life of the fund. Investors make their contributions to the fund in response to "capital calls" from the general partner. Capital calls are made when the general partner has identified a portfolio company in which the private equity fund will invest and needs access to capital to make the investment. Once an investor meets the capital call, the private equity fund invests the new capital in the portfolio company almost immediately. The private equity fund typically does not retain a pool of uninvested capital.[97]

Private equity funds are long-term investments and provide little, if any, opportunity for investors to redeem their investments.[98] There is no formal secondary market for shares in a

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partners to confirm that the limited partners will be able to meet their capital commitments when required by the private equity fund.

95 Industry sources estimate that individuals and families account for less than 10% of the assets invested in private equity funds, pension funds account for about 30%, endowments account for about 20%, and banks and insurance companies account for about 40%. The NVCA estimates that individuals and families account for approximately 10% of the invested assets in venture capital funds, pension funds account for 40%, endowments account for 20%; and banks, insurance companies and corporations account for about 30%. The NVCA 2002 Yearbook, *supra* note 90

96 The term of existence of each private equity fund is found in the fund's partnership agreement.

97 Investors' contributions are wired to the private equity fund's bank account from which they are routed to the portfolio company. The administrative arm of the private equity fund is responsible for keeping records of investors' contributions and distributions.

98 Although a private equity fund rarely redeems its investors' shares in the fund, the fund may pay its investors dividends. A private equity fund may distribute a cash dividend to its investors when it profits from the sale of a particular portfolio investment or may distribute a stock dividend to its investors when it receives shares in a particular portfolio company after the company has

private equity fund, although there is a small informal secondary market that is comprised of private equity funds specializing in buying interests in established funds.[99]

4. Real Estate Investment Trusts ("REITs")

A REIT is an investment vehicle that allows investors to own interests in income-producing real estate properties or participate in mortgage financing.[100] There are three basic types of REITs: equity REITS, mortgage REITs and hybrid REITS. Equity REITs, which own and operate income-producing real estate, account for 96.1% of REITS. Mortgage REITs, which lend money directly to real estate owners and operators or extend credit indirectly through the acquisition of loan interests, account for 1.6% of REITS. Hybrid REITs, which both own properties and make loans to real estate owners and operators, account for 2.3% of REITS.[101]

The structure of a typical REIT is dictated by certain provisions of the Internal Revenue Code ("IRC").[102] A REIT must be organized as a corporation, trust or association that would be subject to U.S. corporate income taxation but for the REIT provisions of the IRC.[103] The IRC also requires that a REIT be managed by a board of directors or trustees, have shares that are fully transferable, have a minimum of 100 shareholders, have no more than 50% of its shares

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undergone an initial public offering. To facilitate the transfer of shares from the fund to its investors in the case of a stock dividend, the fund usually retains the services of a transfer agent.

99 In 1999, five private equity funds raised $1.6 billion for purchases of secondary interests in other private equity funds. *See* David M. Toll, "Private Equity Primer," in *Galante's Venture Capital & Private Equity Directory*.

100 A REIT is not an investment company under the 1940 Act. *See* 15 U.S.C. 80a-3(a)(1)(A) (defining investment companies to be in the business of investing, reinvesting, or trading in securities) and 15 U.S.C. 80a-3(c)(5)(C) (excluding from the definition of investment companies certain issuers that are engaged primarily in the business of purchasing or otherwise acquiring mortgages or other liens on an interests in real estate.)

101 These statistics are available from the National Association of Real Estate Investment Trusts ("NAREIT"), at www.nareit.com.

102 Subchapter M of the Internal Revenue Code, 26 U.S.C. 851 *et seq.*

103 26 U.S.C. 856.

held by five or fewer individuals during the last half of each taxable year, invest at least 75% of its total assets in real estate assets, derive at least 75% of its gross income from rents from real property or interest on mortgages on real property, have no more than 20% of its assets consist of stocks in taxable REIT subsidiaries, and pay at least 90% of its taxable income to investors in the form of dividends.[104]

According to industry sources, as of March 2001 there were approximately 300 REITs operating in the U.S. with assets totaling over $300 billion.[105] Currently, approximately 190 large REITs are registered with the SEC as public companies under the Securities Exchange Act of 1934 and trade on the national stock exchanges.[106] The securities of REITs registered with the SEC are traded through broker-dealers, which are already subject to anti-money laundering regulations promulgated under the BSA. Approximately 100 private REITs, entities whose securities are not listed on a securities exchange, are in existence. The typical life span of a private REIT is 10 to 15 years. They are similar to the publicly listed and traded REITS in terms of structure due to the requirements of the IRC. The securities of the private REIT may be registered with the SEC under the Securities Act of 1933 or may be private placements. In most cases, investors purchase private REIT securities through an SEC-registered broker-dealer. Most private REITs provide investors with the opportunity to purchase additional shares through a dividend reinvestment program. An investment in a private REIT tends to be illiquid because the

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[104] *Id.*

[105] *See* www.investinreits.com/faqtext.cfm?how%20many

[106] According to NAREIT, there are approximately 149 REITs listed on the New York Stock Exchange, 27 REITs listed on the American Stock Exchange, and 12 REITs listed on the NASDAQ National Market System. *See* "Frequently Asked Questions about REITs," *at http://www.nareit.com/aboutreits/faqtext.cfm*

investors usually have no right to redeem their interests and the REIT often restricts the transfer of interests to comply with other IRC requirements.

5. Proposed Rule for the Application of the BSA to Unregistered Investment Companies

The rule that temporarily exempts investment companies other than mutual funds from the BSA requirement that investment companies implement anti-money laundering programs, applies to all unregistered investment companies.[107] However, in that rule, FinCEN observed that a number of unregistered entities such as hedge funds are excluded from the 1940 Act definition of "investment company" and that those entities would likely be required to establish anti-money laundering programs under section 352 of the USA Patriot Act in the future.[108]

With respect to investment companies not registered under the 1940 Act, Treasury considered two different approaches in creating an appropriate definition. Treasury could have defined, to the extent possible, the various sub-categories of unregistered investment companies (such as hedge funds, private equity funds, and venture capital funds) and then could have fashioned regulations for each sub-category based on the extent to which that sub-category is vulnerable to money laundering. One disadvantage of such an approach is that the labels for many of these entities are somewhat colloquial in nature and are not susceptible to precise definition. Thus, this approach risked failing to capture companies that have characteristics that would enable them to be used for money laundering. At the other extreme, including every perceivable sub-category of entities would unnecessarily burden businesses that money launderers are unlikely to use. Moreover, an overly inclusive definition would bring within the scope of the BSA's anti-money laundering requirements so many entities as to tax resources of

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[107] 67 FR 21117, *supra* note 16.

[108] *Id.* at n.5.

the federal regulatory agencies charged with oversight of financial institutions and, thus, diminish the effectiveness of that oversight.

Treasury proposed an alternative approach in defining unregistered investment companies: consider the group as a whole and define the characteristics of such entities that present money laundering risks. This approach subjects entities to regulation under the BSA only if they possess those characteristics that present cognizable risks of money laundering.

On September 26, 2002, FinCEN issued a proposed rule that would require certain "unregistered investment companies," including certain entities that rely on the exceptions in sections 3(c)(1) and 3(c)(7) of the Investment Company Act, commodity pools, and REITs, to develop and implement anti-money laundering programs reasonably designed to prevent them from being used to launder money or finance terrorist activities.[109] The proposed rule was carefully designed to balance the need for a comprehensive national program to prevent money laundering against the burdens imposed by the BSA on businesses, including small businesses.

Under the proposed rule, an "unregistered investment company" is an issuer of securities that (i) would be an investment company under the 1940 Act, but for the exclusions provided in sections 3(c)(1) and 3(c)(7) of that Act; (ii) is a commodity pool; or (iii) invests primarily in real estate and/or interests therein.[110] Because of the broad scope of the type and nature of businesses that fall within these categories, FinCEN proposed to further narrow the definition of

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[109] *See* 67 FR 60617, 60618, *supra* note 16.

[110] This definition thus would include entities consisting of pools of three asset classes: securities, commodity futures contracts, and real estate. The notice of proposed rulemaking requests comment whether there are other entities, not covered by other rules requiring anti-money laundering programs, that pool assets and provide a similar opportunity for money laundering or terrorist financing, and whether such entities should be required by the final rule to establish anti-money laundering programs.

unregistered investment company by several limitations and exceptions from the definition, as described below.

Redemption Rights. FinCEN proposed to define "unregistered investment company" to include only those companies that permit an investor to redeem a portion of his or her investment within two years after that investment was made. Investment companies rarely receive from or disburse to investors significant amounts of currency. Therefore, if these companies are used to launder money, they are more likely to be used as a transition method of investment, in order to obscure the source and eventual use of tainted proceeds. The use of financial institutions at this stage of the process generally requires that the money launderer be able to redeem his or her interests in the company within a relatively short period. Conversely, companies whose shares are not redeemable, or whose shares are redeemable only after a lengthy holding (or "lock-up") period, generally lack the liquidity that makes them attractive to money launderers. The proposed rule's "redeemability" requirement will likely have the effect of excluding from the rule publicly traded REITs, a large number of special purpose financing vehicles, and many private equity and venture capital funds.

Minimum Asset Size. Some entities, such as small businesses and investment clubs, are so small that they are unlikely to be used for money laundering.[111] Therefore, the Proposed Rule would exclude from its coverage companies with less than $1,000,000 in assets as of the end of the most recent calendar quarter.

Offshore Funds. Because many unregistered investment companies operate "offshore" and offer interests to both U.S. and foreign persons, the rule would extend to funds that (i) are

[111] FinCEN believes that entities with less than $1,000,000 in assets pose significantly lower money laundering risks than larger entities. *See also* section 312(a)(4)(b) of the USA Patriot Act (defining "private banking account" to include accounts of not less than $1,000,000).

organized in the United States; (ii) are organized or sponsored by a U.S. person; or (iii) sell ownership interests to U.S. persons.[112] Treasury proposed the rule having a long jurisdictional reach to prevent circumvention of the rule by money launderers who could easily shift operations to a hedge fund organized offshore in a jurisdiction that did not have adequate laws prohibiting money laundering. The proposed rule reflects Treasury's determination that it is appropriate and reasonable to require issuers that benefit from the financial and legal systems of the United States to establish anti-money laundering programs to prevent, detect, and facilitate the prosecution of international money laundering and terrorist financing.

Exceptions. FinCEN proposed to except from the rule investment companies that are (i) family companies, (ii) employee securities companies, and (iii) employee benefit plans that are not construed to be pools in CFTC Rule 4.5(a)(4).[113] These types of companies are unlikely to be used for money laundering purposes by third parties given their size, structure and purpose. The proposed rule also excepts other types of financial institutions under the BSA to prevent duplicative application of the BSA anti-money laundering rules to the same financial institution.

Notice. The proposed rule would require a company falling within the definition to file a brief notice with FinCEN containing basic information about the company, such as its legal name and address, the name and contact information of its anti-money laundering program compliance officer, the dollar amount of the assets under its management, and the number of investors in the company. The notice will enable Treasury or its designee to identify unregistered investment companies subject to the rule and to monitor their compliance.

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112 The rule would not apply, however, to an unregistered fund that is merely advised by a U.S. person because such a person would be unlikely to be in a position to administer the rule.

113 17 CFR 4.5. CFTC Rule 4.5(a)(4) sets forth the employee benefit plans that are not construed to be pools.

IV. Personal Holding Companies

Section 356 also requires that the report include recommendations on whether the Secretary should promulgate regulations requiring "personal holding companies" to disclose their beneficial owners when opening accounts or initiating transfers at any domestic financial institution.

The USA Patriot Act defines a personal holding company as a business, including a corporation or business or other grantor trust whose assets are predominantly securities, bank certificates of deposit, or other securities or investment instruments (other than those relating to operating subsidiaries of the corporation or trust) and that has 5 or fewer common shareholders or holders of beneficial or other equity interest.[114]

Personal holding companies may be located anywhere in the world and can be defined in several ways. In the United States, the Internal Revenue Code defines a personal holding company[115] and a foreign personal holding company[116] by reference to the amount of passive income it earns and whether it is closely held. Moreover, certain foreign jurisdictions offer asset management vehicles that they describe as personal holding companies, which are often intended for use by high net worth individuals as a means of managing wealth.

Personal holding companies, which are also known as personal investment companies, may be used by individuals as vehicles for managing their personal finances, estate planning, and

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114 In the event that a personal holding company beneficially owned by a non-U.S. person establishes or maintains a "private banking account" (as defined in section 312 of the USA PATRIOT Act) with a U.S. financial institution, the institution would be required by Section 312 to identify, and perform other due diligence with respect to, such beneficial owner and account.

115 26 U.S.C. 542

116 26 U.S.C. 552

other purposes. In addition, entrepreneurs may use personal holding companies to better diversify their investment risk, or manage their personal finances.

The issue of whether and to what extent additional anti-money laundering controls may be needed for a variety of different types of asset management vehicles and products is one that Treasury continues to study, drawing on the knowledge and expertise of others within the Federal regulatory community and within law enforcement. It is important to ensure that a balance is struck between the potential for abuse of asset management vehicles, such as trusts, personal holding companies, and other vehicles, and the limitation and costs resulting from regulatory requirements. Regulatory requirements may have the unintended economic effect of limiting access to such asset management vehicles. At this time, no additional recommendations regarding anti-money laundering controls for personal holding companies are being made.

V. Recommendations

Treasury and the federal functional regulators have greatly expanded the scope and reach of regulations under the BSA since Congress passed the USA Patriot Act approximately one year ago. This report has described regulations, some final, some proposed, that have been promulgated to deter criminals and terrorists from laundering money through the various entities defined as financial institutions under the BSA. Some of these regulations apply to various types of investment companies, both registered and unregistered. This section of the report will briefly summarize the regulations promulgated to date, the regulations that are still under consideration, and the recommendations for regulatory action by the Treasury, the SEC and the Federal Reserve Board.

REGISTERED INVESTMENT COMPANIES:

Mutual Funds:

- Interim Final Regulation requiring the establishment of an anti-money laundering program (issued April 26, 2002). [67 FR 21117]
- Proposed Regulation requiring establishment of customer identification programs (issued July 23, 2002). [67 FR 48318]
- Proposed Regulation requiring implementation of due diligence programs for correspondent and private banking accounts (issued May 30, 2002). [67 FR 37736]
- Final Regulation setting forth procedures for information sharing between federal law enforcement agencies and financial institutions and permitting voluntary information sharing among financial institutions (issued September 26, 2002) [67 FR 48348]
- Treasury recommends requiring mutual funds to file suspicious activity reports.

Closed-End Funds:

- No regulations are recommended for these investment companies. Because these funds' securities operate much like securities issued by a corporation, these funds do not appear to present a money laundering risk sufficient to warrant regulation at this time.
- In an interval fund (a type of closed-end fund with limited repurchase rights), investors do not control either the timing or the amount of a repurchase offer. As a result, it does not appear that these funds present a money laundering risk sufficient to warrant regulation at this time.

Unit Investment Trusts (UITs):

- These funds' securities are available only through broker-dealers or life insurance companies. Registered broker-dealers are subject to both anti-money laundering and (as of January 1, 2003) SAR reporting regulations (issued April 29, 2002 and July 1, 2002). [67 FR 21110; 67 FR 44048] Treasury and the SEC have jointly proposed to require registered broker-dealers to adopt and implement customer identification programs (issued July 23, 2002). [67 FR 48306] Treasury has proposed regulations requiring life insurance companies to implement anti-money laundering compliance programs and to file SARs (issued September 26, 2002 and October 17, 2002) [67 FR 60625; 67 FR 64067]. No new regulations are recommended for these investment companies.

UNREGISTERED INVESTMENT COMPANIES:

- Proposed regulation requiring certain unregistered investment companies to establish anti-money laundering programs (issued September 26, 2002). [67 FR 60617]
- Treasury recommends requiring unregistered investment companies to establish customer identification and verification programs.

PERSONAL HOLDING COMPANIES

- No regulations are recommended for personal holding companies.

DEPARTMENT OF THE TREASURY

OFFICE OF PUBLIC AFFAIRS • 1500 PENNSYLVANIA AVENUE, N.W. • WASHINGTON, D.C. • 20220 • (202) 622-2960

EMBARGOED UNTIL 11:00 A.M.
December 23, 2002

Contact: Office of Financing
202/691-3550

TREASURY OFFERS 4-WEEK BILLS

The Treasury will auction 4-week Treasury bills totaling $16,000 million to refund an estimated $22,000 million of publicly held 4-week Treasury bills maturing December 26, 2002, and to pay down approximately $6,000 million.

Tenders for 4-week Treasury bills to be held on the book-entry records of *TreasuryDirect* will not be accepted.

The Federal Reserve System holds $13,604 million of the Treasury bills maturing on December 26, 2002, in the System Open Market Account (SOMA). This amount may be refunded at the highest discount rate of accepted competitive tenders in this auction up to the balance of the amount not awarded in today's 13-week and 26-week Treasury bill auctions. Amounts awarded to SOMA will be in addition to the offering amount.

Up to $1,000 million in noncompetitive bids from Foreign and International Monetary Authority (FIMA) accounts bidding through the Federal Reserve Bank of New York will be included within the offering amount of the auction. These noncompetitive bids will have a limit of $100 million per account and will be accepted in the order of smallest to largest, up to the aggregate award limit of $1,000 million.

Note: The closing times for receipt of noncompetitive and competitive tenders will be at 11:00 a.m. and 11:30 a.m. eastern standard time, respectively.

The allocation percentage applied to bids awarded at the highest discount rate will be rounded up to the next hundredth of a whole percentage point, e.g., 17.13%.

This offering of Treasury securities is governed by the terms and conditions set forth in the Uniform Offering Circular for the Sale and Issue of Marketable Book-Entry Treasury Bills, Notes, and Bonds (31 CFR Part 356, as amended).

Details about the new security are given in the attached offering highlights.

oOo

Attachment

PO-3723

HIGHLIGHTS OF TREASURY OFFERING
OF 4-WEEK BILLS TO BE ISSUED DECEMBER 26, 2002

December 23, 2002

Offering Amount	$16,000 million
Maximum Award (35% of Offering Amount)	$ 5,600 million
Maximum Recognized Bid at a Single Rate	$ 5,600 million
NLP Reporting Threshold	$ 5,600 million
NLP Exclusion Amount	$11,900 million

Description of Offering:

Term and type of security	28-day bill
CUSIP number	912795 LV 1
Auction date	December 24, 2002
Issue date	December 26, 2002
Maturity date	January 23, 2003
Original issue date	July 25, 2002
Currently outstanding	$45,821 million
Minimum bid amount and multiples	$1,000

Submission of Bids:

Noncompetitive bids: Accepted in full up to $1 million at the highest discount rate of accepted competitive bids.

Foreign and International Monetary Authority (FIMA) bids: Noncompetitive bids submitted through the Federal Reserve Banks as agents for FIMA accounts. Accepted in order of size from smallest to largest with no more than $100 million awarded per account. The total noncompetitive amount awarded to Federal Reserve Banks as agents for FIMA accounts will not exceed $1,000 million. A single bid that would cause the limit to be exceeded will be partially accepted in the amount that brings the aggregate award total to the $1,000 million limit. However, if there are two or more bids of equal amounts that would cause the limit to be exceeded, each will be prorated to avoid exceeding the limit.

Competitive bids:

(1) Must be expressed as a discount rate with three decimals in increments of .005%, e.g., 4.215%.

(2) Net long position (NLP) for each bidder must be reported when the sum of the total bid amount, at all discount rates, and the net long position equals or exceeds the NLP reporting threshold stated above.

(3) Net long position must be determined as of one half-hour prior to the closing time for receipt of competitive tenders.

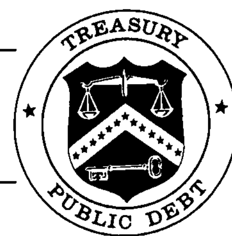
Receipt of Tenders:

Noncompetitive tenders:
Prior to 11:00 a.m. eastern standard time on auction day

Competitive tenders:
Prior to 11:30 a.m. eastern standard time on auction day

Payment Terms: By charge to a funds account at a Federal Reserve Bank on issue date.

PUBLIC DEBT NEWS



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TREASURY SECURITY AUCTION RESULTS
BUREAU OF THE PUBLIC DEBT - WASHINGTON DC

FOR IMMEDIATE RELEASE
December 23, 2002

CONTACT: Office of Financing
202-691-3550

RESULTS OF TREASURY'S AUCTION OF 2-YEAR NOTES

Interest Rate:	1 3/4%	Issue Date:	December 31, 2002
Series:	V-2004	Dated Date:	December 31, 2002
CUSIP No:	912828AR1	Maturity Date:	December 31, 2004

High Yield: 1.820% Price: 99.863

All noncompetitive and successful competitive bidders were awarded securities at the high yield. Tenders at the high yield were allotted 60.06%. All tenders at lower yields were accepted in full.

AMOUNTS TENDERED AND ACCEPTED (in thousands)

Tender Type	Tendered	Accepted
Competitive	$ 50,219,115	$ 26,216,092
Noncompetitive	784,268	784,268
FIMA (noncompetitive)	0	0
SUBTOTAL	51,003,383	27,000,360 1/
Federal Reserve	6,194,733	6,194,733
TOTAL	$ 57,198,116	$ 33,195,093

Median yield 1.790%: 50% of the amount of accepted competitive tenders was tendered at or below that rate. Low yield 1.769%: 5% of the amount of accepted competitive tenders was tendered at or below that rate.

Bid-to-Cover Ratio = 51,003,383 / 27,000,360 = 1.89

1/ Awards to TREASURY DIRECT = $624,654,000

http://www.publicdebt.treas.gov

PO - 3724

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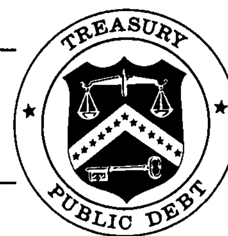

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TREASURY SECURITY AUCTION RESULTS
BUREAU OF THE PUBLIC DEBT - WASHINGTON DC

FOR IMMEDIATE RELEASE
December 23, 2002

CONTACT: Office of Financing
202-691-3550

RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Term: 182-Day Bill
Issue Date: December 26, 2002
Maturity Date: June 26, 2003
CUSIP Number: 912795MT5

High Rate: 1.240% Investment Rate 1/: 1.265% Price: 99.373

All noncompetitive and successful competitive bidders were awarded securities at the high rate. Tenders at the high discount rate were allotted 75.62%. All tenders at lower rates were accepted in full.

AMOUNTS TENDERED AND ACCEPTED (in thousands)

Tender Type	Tendered	Accepted
Competitive	$ 27,383,844	$ 15,180,294
Noncompetitive	819,841	819,841
FIMA (noncompetitive)	0	0
SUBTOTAL	28,203,685	16,000,135 2/
Federal Reserve	5,881,636	5,881,636
TOTAL	$ 34,085,321	$ 21,881,771

Median rate 1.225%: 50% of the amount of accepted competitive tenders was tendered at or below that rate. Low rate 1.190%: 5% of the amount of accepted competitive tenders was tendered at or below that rate.

Bid-to-Cover Ratio = 28,203,685 / 16,000,135 = 1.76

1/ Equivalent coupon-issue yield.
2/ Awards to TREASURY DIRECT = $627,493,000

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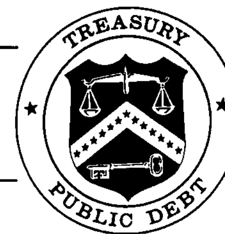

TREASURY SECURITY AUCTION RESULTS
BUREAU OF THE PUBLIC DEBT - WASHINGTON DC

FOR IMMEDIATE RELEASE
December 23, 2002

CONTACT: Office of Financing
202-691-3550

RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Term: 91-Day Bill
Issue Date: December 26, 2002
Maturity Date: March 27, 2003
CUSIP Number: 912795ME8

High Rate: 1.185% Investment Rate 1/: 1.207% Price: 99.700

All noncompetitive and successful competitive bidders were awarded securities at the high rate. Tenders at the high discount rate were allotted 8.10%. All tenders at lower rates were accepted in full.

AMOUNTS TENDERED AND ACCEPTED (in thousands)

Tender Type	Tendered	Accepted
Competitive	$ 29,658,712	$ 12,468,112
Noncompetitive	1,377,092	1,377,092
FIMA (noncompetitive)	155,000	155,000
SUBTOTAL	31,190,804	14,000,204 2/
Federal Reserve	4,908,929	4,908,929
TOTAL	$ 36,099,733	$ 18,909,133

Median rate 1.170%: 50% of the amount of accepted competitive tenders was tendered at or below that rate. Low rate 1.150%: 5% of the amount of accepted competitive tenders was tendered at or below that rate.

Bid-to-Cover Ratio = 31,190,804 / 14,000,204 = 2.23

1/ Equivalent coupon-issue yield.
2/ Awards to TREASURY DIRECT = $1,076,643,000

PO-3726

DEPARTMENT OF THE TREASURY

TREASURY NEWS

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EMBARGOED UNTIL 11:00 A.M.
December 26, 2002

CONTACT: Office of Financing
202/691-3550

TREASURY OFFERS 13-WEEK AND 26-WEEK BILLS

The Treasury will auction 13-week and 26-week Treasury bills totaling $30,000 million to refund an estimated $30,961 million of publicly held 13-week and 26-week Treasury bills maturing January 2, 2003, and to pay down approximately $961 million. Also maturing is an estimated $21,000 million of publicly held 4-week Treasury bills, the disposition of which will be announced December 30, 2002.

The Federal Reserve System holds $13,872 million of the Treasury bills maturing on January 2, 2003, in the System Open Market Account (SOMA). This amount may be refunded at the highest discount rate of accepted competitive tenders either in these auctions or the 4-week Treasury bill auction to be held December 31, 2002. Amounts awarded to SOMA will be in addition to the offering amount.

Up to $1,000 million in noncompetitive bids from Foreign and International Monetary Authority (FIMA) accounts bidding through the Federal Reserve Bank of New York will be included within the offering amount of each auction. These noncompetitive bids will have a limit of $100 million per account and will be accepted in the order of smallest to largest, up to the aggregate award limit of $1,000 million.

TreasuryDirect customers have requested that we reinvest their maturing holdings of approximately $1,067 million into the 13-week bill and $795 million into the 26-week bill.

The allocation percentage applied to bids awarded at the highest discount rate will be rounded up to the next hundredth of a whole percentage point, e.g., 17.13%.

This offering of Treasury securities is governed by the terms and conditions set forth in the Uniform Offering Circular for the Sale and Issue of Marketable Book-Entry Treasury Bills, Notes, and Bonds (31 CFR Part 356, as amended).

Details about each of the new securities are given in the attached offering highlights.

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Attachment

PO-3727

HIGHLIGHTS OF TREASURY OFFERINGS OF BILLS
TO BE ISSUED JANUARY 2, 2003

December 26, 2002

Offering Amount	$14,000 million	$16,000 million
Maximum Award (35% of Offering Amount)	$ 4,900 million	$ 5,600 million
Maximum Recognized Bid at a Single Rate	$ 4,900 million	$ 5,600 million
NLP Reporting Threshold	$ 4,900 million	$ 5,600 million
NLP Exclusion Amount	$ 4,900 million	None

Description of Offering:

Term and type of security	91-day bill	182-day bill
CUSIP number	912795 MF 5	912795 NB 3
Auction date	December 30, 2002	December 30, 2002
Issue date	January 2, 2003	January 2, 2003
Maturity date	April 3, 2003	July 3, 2003
Original issue date	October 3, 2002	January 2, 2003
Currently outstanding	$19,204 million	---
Minimum bid amount and multiples	$1,000	$1,000

The following rules apply to all securities mentioned above:

Submission of Bids:

Noncompetitive bids: Accepted in full up to $1 million at the highest discount rate of accepted competitive bids.

Foreign and International Monetary Authority (FIMA) bids: Noncompetitive bids submitted through the Federal Reserve Banks as agents for FIMA accounts. Accepted in order of size from smallest to largest with no more than $100 million awarded per account. The total noncompetitive amount awarded to Federal Reserve Banks as agents for FIMA accounts will not exceed $1,000 million. A single bid that would cause the limit to be exceeded will be partially accepted in the amount that brings the aggregate award total to the $1,000 million limit. However, if there are two or more bids of equal amounts that would cause the limit to be exceeded, each will be prorated to avoid exceeding the limit.

Competitive bids:

(1) Must be expressed as a discount rate with three decimals in increments of .005%, e.g., 7.100%, 7.105%.
(2) Net long position (NLP) for each bidder must be reported when the sum of the total bid amount, at all discount rates, and the net long position equals or exceeds the NLP reporting threshold stated above.
(3) Net long position must be determined as of one half-hour prior to the closing time for receipt of competitive tenders.

Receipt of Tenders:

Noncompetitive tenders..... Prior to 12:00 noon eastern standard time on auction day
Competitive tenders........ Prior to 1:00 p.m. eastern standard time on auction day

Payment Terms: By charge to a funds account at a Federal Reserve Bank on issue date, or payment of full par amount with tender. *TreasuryDirect* customers can use the Pay Direct feature, which authorizes a charge to their account of record at their financial institution on issue date.

DEPARTMENT OF THE TREASURY

TREASURY NEWS

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EMBARGOED UNTIL 11:00 A.M.
December 30, 2002

Contact: Office of Financing
202/691-3550

TREASURY OFFERS 4-WEEK BILLS

The Treasury will auction 4-week Treasury bills totaling $16,000 million to refund an estimated $21,000 million of publicly held 4-week Treasury bills maturing January 2, 2003, and to pay down approximately $5,000 million.

Tenders for 4-week Treasury bills to be held on the book-entry records of *TreasuryDirect* will not be accepted.

The Federal Reserve System holds $13,872 million of the Treasury bills maturing on January 2, 2003, in the System Open Market Account (SOMA). This amount may be refunded at the highest discount rate of accepted competitive tenders in this auction up to the balance of the amount not awarded in today's 13-week and 26-week Treasury bill auctions. Amounts awarded to SOMA will be in addition to the offering amount.

Up to $1,000 million in noncompetitive bids from Foreign and International Monetary Authority (FIMA) accounts bidding through the Federal Reserve Bank of New York will be included within the offering amount of the auction. These noncompetitive bids will have a limit of $100 million per account and will be accepted in the order of smallest to largest, up to the aggregate award limit of $1,000 million.

Note: The closing times for receipt of noncompetitive and competitive tenders will be at 11:00 a.m. and 11:30 a.m. eastern standard time, respectively.

The allocation percentage applied to bids awarded at the highest discount rate will be rounded up to the next hundredth of a whole percentage point, e.g., 17.13%.

This offering of Treasury securities is governed by the terms and conditions set forth in the Uniform Offering Circular for the Sale and Issue of Marketable Book-Entry Treasury Bills, Notes, and Bonds (31 CFR Part 356, as amended).

Details about the new security are given in the attached offering highlights.

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Attachment

PO-3726

HIGHLIGHTS OF TREASURY OFFERING
OF 4-WEEK BILLS TO BE ISSUED JANUARY 2, 2003

December 30, 2002

Offering Amount........................$16,000 million
Maximum Award (35% of Offering Amount)...$ 5,600 million
Maximum Recognized Bid at a Single Rate..$ 5,600 million
NLP Reporting Threshold..................$ 5,600 million
NLP Exclusion Amount.....................$11,900 million

Description of Offering:
Term and type of security...........28-day bill
CUSIP number........................912795 LW 9
Auction date........................December 31, 2002
Issue date..........................January 2, 2003
Maturity date.......................January 30, 2003
Original issue date.................August 1, 2002
Currently outstanding...............$45,887 million
Minimum bid amount and multiples....$1,000

Submission of Bids:
Noncompetitive bids: Accepted in full up to $1 million at the highest discount rate of accepted competitive bids.
Foreign and International Monetary Authority (FIMA) bids: Noncompetitive bids submitted through the Federal Reserve Banks as agents for FIMA accounts. Accepted in order of size from smallest to largest with no more than $100 million awarded per account. The total noncompetitive amount awarded to Federal Reserve Banks as agents for FIMA accounts will not exceed $1,000 million. A single bid that would cause the limit to be exceeded will be partially accepted in the amount that brings the aggregate award total to the $1,000 million limit. However, if there are two or more bids of equal amounts that would cause the limit to be exceeded, each will be prorated to avoid exceeding the limit.
Competitive bids:
(1) Must be expressed as a discount rate with three decimals in increments of .005%, e.g., 4.215%.
(2) Net long position (NLP) for each bidder must be reported when the sum of the total bid amount, at all discount rates, and the net long position equals or exceeds the NLP reporting threshold stated above.
(3) Net long position must be determined as of one half-hour prior to the closing time for receipt of competitive tenders.

Receipt of Tenders:
Noncompetitive tenders:
Prior to 11:00 a.m. eastern standard time on auction day
Competitive tenders:
Prior to 11:30 a.m. eastern standard time on auction day

Payment Terms: By charge to a funds account at a Federal Reserve Bank on issue date.