Department of the Treasury

PRESS RELEASES

The JS-88 was not used.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

March 3, 2003
JS-73

Remarks of
Treasury Under Secretary for Domestic Finance Peter R. Fisher
To The Institute of International Bankers
Washington, DC

Over the last twenty-five years, traded capital markets have provided the principal means for deepening international capital flows. These flows have contributed to rising standards of living around the world. For some countries, however, these flows have become volatile and disruptive. What can be done to promote the continued growth of international capital flows while reducing the propensity for disruption?

One prerequisite is for individual countries to pursue macro-economic policies that promote sustainable economic growth. Here in the United States, we are doing our part. The President's Growth and Jobs Plan promotes balanced growth of consumption and investment. Eliminating the distorting influence of the double taxation of corporate dividends will increase the efficiency of investment, thereby promoting formation of capital, businesses, and jobs.

To sustain capital flows and reduce their volatility we also need to improve the rules of the road for sovereign lending. My colleague, Treasury Under Secretary John Taylor, has been pressing the agenda on sovereign debt work-outs for two years. Now, with the real leadership of the Mexican Ministry of Finance we are seeing tangible progress.

But to sustain the continued growth of global capital flows we cannot rely upon government action alone. International bankers, in particular, must work to improve the rules of the road for sovereign and private capital-raising so that our traded markets can continue to prosper.

Capital markets are extremely efficient at pricing and allocating resources on the basis of available information. Unfortunately, the important information is too often not available.

When important information is absent, or where great disparities exist in the quality of information available to different market participants, the power of markets is misdirected, the allocation of resources is skewed, and the stage set for future volatility.

Without fundamental improvements in disclosure practices – by you intermediaries and all issuers of debt and equity instruments – I am not optimistic that we will sustain the growth of international capital flows.
As I look back over the last decade, I see a series of capital market disturbances that were at root credit events. Each involved inadequate disclosure of off-balance sheet leverage and insufficient attention to the cash flows needed to sustain that elevated leverage.

In 1994, in the wake of the bond market sell off and Orange County, the hue and cry was about derivatives. Looking back, perhaps it is now easier to recognize the combination of inadequate disclosure and off-balance sheet leverage.

In the Asian crisis of 1997, whole countries were criticized for the purported failure of their economic model. Was it really that? Or were we observing the consequence of heavy off-balance sheet leverage, combined with opaque disclosures, across entire banking systems?

Early in the summer of 1998, the world's financial markets were abuzz with the question: who was the better credit, Russia or Argentina? The conventional wisdom was that possessing missiles made for the better credit risk. Within weeks it turned out that credit risk wasn't about missiles, it was about cash flow.

Anxieties then focused, in 1998, on hedge funds. But it wasn't really about hedge funds themselves. The real issue was inadequate disclosure and excessive off-balance sheet leverage.

Over the last two years, we have all been engrossed by the accounting and corporate leadership scandals. But these episodes were not just about misguided or greedy individuals. In most of these scandals, I also see inadequate disclosure of high degrees of leverage achieved through the use of off-balance sheet devices. Even where off-balance sheet leverage was not involved, murky disclosures appear to have provided the mask for old-fashioned diversion and embezzlement.

Let me be clear: there are lots of legitimate purposes for the use of derivative instruments, structured finance and special purpose vehicles to transfer and pool risk. But hiding an issuer's real, economic leverage from its shareholders, creditors and counterparties is not one of them.

Disclosure failures and the obscuring use of off-balance sheet leverage punctuate each of the major disturbances in our capital markets over the last nine years. Let me suggest that efforts to improve private sector disclosure practices are now over due and that this is a responsibility that you should shoulder – at least, you should if you want international capital flows to continue to grow.

We need to explode the idea that the balance sheet remains a useful concept for measuring a firm's true assets and liabilities. We need to move beyond the false dichotomy between the balance sheet and the off-balance sheet. Why do we continue, collectively, to pretend that we can make reasoned investment decisions about other firms without knowledge of their real, economic leverage?

For our capital markets to prosper, we need disclosures that will depict a measure of all the contractually-obligated liabilities, whether contingent or fixed, future or current. We also need a parallel measure of all the firm's contractually obligated revenues. Tying them together will give the firm's contractually-obligated net present value – a real indicator of economic leverage.

Exposing the real, economic leverage is the only way that shareholders and creditors can judge true performance and distinguish sustainable revenues from financial engineering. We all know that leverage is easy; but that sustained cash flow is not.

For international capital flows to continue to grow, governments need to put in place sensible economic and financial policies that will promote economic growth and financial stability. But bankers need to do their job, too.

If our capital markets are to contribute to the next quarter century of prosperity, market participants like you need to be role models for the disclosures that are necessary for the efficient allocation of capital and credit.

DEPARTMENT OF THE TREASURY

TREASURY NEWS

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

EMBARGOED UNTIL 11:30 A.M.
March 4, 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 $14,000 million of publicly held 4-week Treasury bills maturing March 7, 2002, and to raise new cash of approximately $7,000 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 $12,539 million of the Treasury bills maturing on March 7, 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

JS-74

HIGHLIGHTS OF TREASURY OFFERING
OF 4-WEEK BILLS TO BE ISSUED MARCH 7, 2002

March 4, 2002

Offering Amount ....$21,000 million
Public Offering ....$21,000 million
NLP Exclusion Amount ....$ 8,800 million

Description of Offering:
Term and type of security ....28-day bill
CUSIP number ....912795 JN 2
Auction date ....March 5, 2002
Issue date ....March 7, 2002
Maturity date ....April 4, 2002
Original issue date ....October 4, 2001
Currently outstanding ....$33,667 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
March 04, 2002

CONTACT: Office of Financing
202-691-3550

RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Term:	91-Day Bill
Issue Date:	March 07, 2002
Maturity Date:	June 06, 2002
CUSIP Number:	912795JX0

High Rate: 1.760% Investment Rate 1/: 1.793% Price: 99.555

All noncompetitive and successful competitive bidders were awarded securities at the high rate. Tenders at the high discount rate were allotted 16.95%. All tenders at lower rates were accepted in full.

AMOUNTS TENDERED AND ACCEPTED (in thousands)

Tender Type	Tendered	Accepted
Competitive	$ 25,209,989	$ 12,266,952
Noncompetitive	1,473,117	1,473,117
FIMA (noncompetitive)	260,000	260,000
SUBTOTAL	26,943,106	14,000,069 2/
Federal Reserve	5,149,349	5,149,349
TOTAL	$ 32,092,455	$ 19,149,418

Median rate 1.740%: 50% of the amount of accepted competitive tenders was tendered at or below that rate. Low rate 1.710%: 5% of the amount of accepted competitive tenders was tendered at or below that rate.

Bid-to-Cover Ratio = 26,943,106 / 14,000,069 = 1.92

1/ Equivalent coupon-issue yield.
2/ Awards to TREASURY DIRECT = $1,189,946,000

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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
March 04, 2002

CONTACT: Office of Financing
202-691-3550

RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Term:	182-Day Bill
Issue Date:	March 07, 2002
Maturity Date:	September 05, 2002
CUSIP Number:	912795KZ3

High Rate: 1.890% Investment Rate 1/: 1.934% Price: 99.045

All noncompetitive and successful competitive bidders were awarded securities at the high rate. Tenders at the high discount rate were allotted 87.69%. All tenders at lower rates were accepted in full.

AMOUNTS TENDERED AND ACCEPTED (in thousands)

Tender Type	Tendered	Accepted
Competitive	$ 32,197,827	$ 11,941,086
Noncompetitive	1,034,154	1,034,154
FIMA (noncompetitive)	25,000	25,000
SUBTOTAL	33,256,981	13,000,240 2/
Federal Reserve	4,640,480	4,640,480
TOTAL	$ 37,897,461	$ 17,640,720

Median rate 1.880%: 50% of the amount of accepted competitive tenders was tendered at or below that rate. Low rate 1.840%: 5% of the amount of accepted competitive tenders was tendered at or below that rate.

Bid-to-Cover Ratio = 33,256,981 / 13,000,240 = 2.56

1/ Equivalent coupon-issue yield.
2/ Awards to TREASURY DIRECT = $730,035,000

http://www.publicdebt.treas.gov

JS-76

FROM THE OFFICE OF PUBLIC AFFAIRS

March 3, 2003
JS-77

U.S. Treasury Department Announces New Executive Office for Terrorist Financing and Financial Crimes

The United States Treasury Department today announced the formation of a new Executive Office for Terrorist Financing and Financial Crimes (EOTF/FC) reporting directly to the Deputy Secretary. This office has been charged with coordinating and leading the Treasury Department's multi-faceted efforts to combat terrorist financing and other financial crimes, both within the United States as well as abroad.

"President Bush has reaffirmed that stopping the flow of money to terrorist groups is a top Treasury Department priority, and towards that end I am announcing today the formation of a new office dedicated to that charge," stated Treasury Secretary John Snow.

The Office will work closely with other offices within the Treasury and throughout the U.S. government to identify, block, and dismantle sources of financial support for terror and other criminal activities, including money laundering. In addition, the team will work with international partners to expand the fight against terrorist financing and financial crimes in other nations. The Office will focus on reducing the risk that the domestic and international financial systems are being misused by criminals and terrorists.

To continue Treasury's leadership on these critical issues, the new Office is charged with the following duties: developing and implementing U.S. government strategies to combat terrorist financing domestically and internationally (in concert with Treasury's International Affairs Task Force on Terrorist Financing); developing and implementing the National Money Laundering Strategy, as well as other policies and programs to fight financial crimes; participating in the department's development and implementation of U.S. government policies and regulations in support of the PATRIOT Act, including outreach to the private sector; joining in representation of the United States at focused international bodies dedicated to fighting terrorist financing and financial crimes; and developing U.S. government policies relating to financial crimes.

The office will be led by Juan Zarate, Deputy Assistant Secretary for Terrorist Financing and Financial Crimes. Mr. Zarate will report to the Deputy Secretary of the Treasury. Until a new Deputy Secretary is named to fill the current vacancy, Mr. Zarate will report to David Aufhauser, Treasury General Counsel, who serves as the Chairman of the NSC policy coordinating committee on terrorist financing.

Within the U.S. Treasury, the new Office will provide policy guidance for the Financial Crimes Enforcement Network (FinCEN) bureau as it works with the financial sector, the law enforcement community, and foreign financial intelligence units to foster cooperation against domestic and international financial crimes. Also, the EOTF/FC will provide policy guidance to the Office of Foreign Asset Control (OFAC). OFAC administers U.S. trade and economic sanctions, and targets and blocks financial transactions and assets of terrorists, narcotics traffickers and foreign countries that are known to threaten U.S. national security.

"FinCEN welcomes the establishment of this important office which will serve as a focal point for the Department of the Treasury's vital role in support of the efforts

against terrorist financing, money laundering, and other financial crimes," stated FINCEN Director Jim Sloan.
OFAC Director Rick Newcomb added, "This step by the Treasury Department should enhance and strengthen the role OFAC has traditionally played in targeting those countries, organizations and individuals that threaten U.S. national security, especially through the targeting of terrorists and the financial network that supports their activities."

This new office will work side by side with the International Affairs Task Force on Terrorist Financing (TFTF), led by Director William C. Murden, which continues to work with other countries to implement and improve mechanisms for blocking terrorist assets globally, and thereby deny terrorists access to formal and informal financial systems. The TFTF will continue to track global progress on blocking terrorist assets and coordinate anti-terrorist financing action in international fora such as the IMF and G-7.

The department is also announcing today that until a Deputy Secretary is confirmed, Aufhauser will chair the Treasury Department's existing USA PATRIOT Act Regulation Review Task Force which was established by former Deputy Treasury Secretary Kenneth Dam as part of this department's effort to develop effective regulations which will help us crack down on terrorist financing and money laundering. The task force reviews the regulations we are drafting and have finalized as a result of the Patriot Act to see if they are unnecessarily burdensome on the financial community - or if they are not muscular enough. While a Treasury led effort, the task force reaches out to all the experts in this area, both public and private including appropriate federal regulators from the SEC, OTS, OCC, FDIC, CTFC and the FED, as well as industry groups.

federal financing bank NEWS
WASHINGTON, D.C. 20220

FEDERAL FINANCING BANK

2003 PRESS RELEASE

March 2003

Gary Burner, Manager, Federal Financing Bank (FFB) announced the following activity for the month of February 2003.

FFB holdings of obligations issued, sold or guaranteed by other Federal agencies totaled $35.8 billion on February 28, 2003, posting a decrease of $198.3 million from the level on January 31, 2003. This net change was the result of a decrease in holdings of agency debt of $200.0 million and an increase in holdings of government-guaranteed loans of $1.7 million. The FFB made 29 disbursements and received 12 prepayments during the month of February.

Below are tables presenting FFB February loan activity and FFB holdings as of February 28, 2003.

FEDERAL FINANCING BANK
February 2003 ACTIVITY

Borrower	Date 2003	Amt. Of Advance	Final Maturity Century 2000	Int. Rate	Semi-Annual or Quarterly
GOVERNMENT-GUARANTEED LOANS					
GENERAL SERVICES ADMINISTRATION					
San Francisco OB	2/04	$132,507.93	8/1/2005	2.067%	Semi-Annually
San Francisco Bldg Lease	2/12	$359,607.80	8/1/2005	1.982%	Semi-Annually

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San Francisco OB	2/27	$132,507.94	8/1/2005	1.858%	Semi-Annually
San Francisco OB	2/27	$20,000.00	8/1/2005	1.858%	Semi-Annually
DEPARTMENT OF EDUCATION					
Barber-Scotia College	2/26	$82,379.20	3/1/2030	4.544%	Semi-Annually
Livingstone College	2/28	$150,925.65	7/1/2031	4.529%	Semi-Annually
RURAL UTILITIES SERVICE					
Ponderosa Tele. #517	2/03	$1,565,000.00	1/3/2012	3.312%	Quarterly
United Elec. #858	2/03	$1,513,000.00	12/31/2036	4.781%	Quarterly
Farmers Mutual Elec. Co. #898	2/04	$183,000.00	12/31/2036	4.777%	Quarterly
Freeborn-Mower Coop. #736	2/04	$200,000.00	6/30/2003	1.196%	Quarterly
Southside Electric #786	2/04	$1,400,000.00	12/31/2035	4.760%	Quarterly
Washington Electric #655	2/04	$200,000.00	1/2/2035	4.744%	Quarterly
Jackson Energy #794	2/05	$2,000,000.00	6/30/2003	1.170%	Quarterly
KEM Electric #537	2/05	$465,000.00	1/3/2034	4.690%	Quarterly
Hart Elec. #885	2/07	$3,000,000.00	12/31/2036	4.754%	Quarterly
Licking Valley Elec. #854	2/07	$2,000,000.00	6/30/2003	1.177%	Quarterly
Sangre De Cristo Elec. #732	2/10	$500,000.00	3/31/2010	3.461%	Quarterly
Darien Telephone Co. #719	2/12	$543,000.00	6/30/2003	1.179%	Quarterly
Tri-County Electric #876	2/12	$1,300,000.00	12/31/2036	4.788%	Quarterly
Block Island Power #652	2/13	$225,000.00	12/31/2024	4.392%	Quarterly
Vernon Electric Coop. #200	2/13	$2,764,101.00	12/31/2036	4.775%	Quarterly
Central Florida Elec. #521	2/27	$3,500,000.00	1/3/2033	4.555%	Quarterly
East Kentucky Power #753	2/27	$3,200,000.00	12/31/2030	4.499%	Quarterly
Farmer's Telephone #459	2/27	$53,322.00	6/30/2017	3.748%	Quarterly
Tri-County Elec. Coop. #855	2/27	$7,500,000.00	12/31/2031	4.530%	Quarterly
Valley Rural Elec. Coop. #884	2/27	$2,000,000.00	12/31/2036	4.645%	Quarterly
Douglas Electric #725	2/28	$100,000.00	12/31/2035	4.612%	Quarterly
Northstar Technology #811	2/28	$1,000,000.00	6/30/2003	1.204%	Quarterly
Tri-State E.M.C. #730	2/28	$1,000,000.00	3/31/2010	2.620%	Quarterly

FEDERAL FINANCING BANK HOLDINGS

(in millions of dollars)

Agency Debt	February 28, 2003	January 31, 2003	Monthly Net Change 2/1/03- 2/28/03	Fiscal Year Net Change 10/1/02- 2/28/03

U.S. Postal Service	7,273.40	7,473.40	(200.00)	(3,840.60)
Subtotal*	7,273.40	7,473.40	(200.00)	(3,840.60)
Agency Assets:				
FmHA-RDIF	950.00	950.00	0.00	0.00
FmHA-RHIF	2,530.00	2,530.00	0.00	(375.00)
Rural Utilities Service-CBO	4,270.20	4,270.20	0.00	0.00
Subtotal*	7,750.20	7,750.20	0.00	(375.00)
Government-Guaranteed Lending:				
DOD-Foreign Military Sales	1,823.10	1,856.80	(33.70)	(99.40)
DoEd-HBCU+	74.20	74.00	0.20	5.60
DHUD-Community Dev. Block Grant	3.90	3.90	0.00	(1.20)
DHUD-Public Housing Notes	1,133.20	1,133.20	0.00	(74.10)
General Services Administration+	2,176.40	2,175.70	0.60	(29.20)
DOI-Virgin Islands	10.10	10.10	0.00	(1.30)
DON-Ship Lease Financing	705.30	705.30	0.00	(75.40)
Rural Utilities Service	14,750.30	14,714.10	36.20	692.10
SBA-State/Local Development Cos.	90.70	92.40	(1.70)	(11.70)
DOT-Section 511	3.20	3.20	0.00	0.00
Subtotal*	20,770.50	20,768.80	1.70	405.30
Grand total*	**35,794.10**	**35,992.40**	**(198.30)**	**(3,810.20)**

Last Updated on 3/17/03

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

March 3, 2003
JS-79

Treasury Department Names Gregory Zerzan as Deputy Assistant Secretary for Financial Institutions Policy

The Treasury Department today announced that Gregory P. J. Zerzan has been appointed as Deputy Assistant Secretary for Financial Institutions Policy. He begins his new post March 3, 2003.

In this position, Mr. Zerzan is responsible for legislative and policy matters related to the financial services sector – including commercial banks, investment banks, insurance companies, credit unions and savings and loans. He manages Treasury policy regarding Government Sponsored Enterprises and the agencies that regulate and insure these entities. He also oversees the Treasury's Terrorism Risk Insurance Program.

Mr. Zerzan was most recently the Senior Counsel for Legislation for the House Financial Services Committee, where he worked since 2000 on legislation that included financial services modernization, commodity futures modernization and corporate accountability. He had worked on the former House Banking Committee and was part of the staff that implemented the transfer of securities and insurance jurisdiction to the newly formed Financial Services Committee.

Previously, Mr. Zerzan served as Counsel and Chief Counsel for the House Agriculture Committee from 1997 until 2000. He worked from 1996 to 1997 as an Associate at the Portland, OR, law firm of Kell, Alterman & Runstein, LLP.

Mr. Zerzan earned an undergraduate degree in Political Science at Willamette University in 1993 and a law degree at Willamette University College of Law in 1996.

FROM THE OFFICE OF PUBLIC AFFAIRS

March 4, 2003
JS-80

Treasury Under Secretary John B. Taylor
Testimony before the
Senate Committee on Foreign Relations

Chairman Lugar, Senator Biden, Members of the Committee, thank you for the opportunity to testify today on the Millennium Challenge Account (MCA). My statement will focus on the economic rationale behind the MCA and how it fits well with the Administration's approach to development.

Today there are more than one billion people living on less than $1 a day and nearly three billion living on less than $2 a day. In addition to the tragedy of those living in extreme poverty are those whose lives are claimed by ailments virtually unseen in the U.S. Last year alone 3 million people died for lack of immunization, 1 million died from malaria, 3 million died from water-related diseases, and 2 million died from exposure to stove smoke inside their own homes. In addition, HIV/AIDS has ravaged the populations of developing nations, killing 3 million people in 2002 alone.
The United States is helping in many ways to combat these problems. The MCA is part of the Administration's overall development strategy, as Administrator Natsios and Under Secretary Larson describe in their testimony. The MCA is designed specifically to catalyze the policy reforms that are the foundation of economic growth and poverty reduction.

Development Assistance and Productivity Growth

Sustainable poverty reduction can only be achieved via economic growth, which is primarily determined by productivity growth. Productivity is the amount of goods and services that a worker produces per unit of time with the skills and tools available. If you want to reduce the number of countries with low per capita incomes, then you have no choice but to increase productivity in those countries. And the higher the rate of productivity growth, the faster poverty will decline. Simply put, the ticket out of poverty is higher productivity jobs.

Productivity depends on two things: capital per worker and the level of technology. If there are no impediments to the flow and accumulation of capital and technology, then countries that are behind in productivity should have a higher productivity growth rate. They should catch up, and we have seen many countries catching up over the years – such as South Korea, Chile, and Botswana.

However, many of the poorest nations still have had low and stagnant productivity and income, and they are not catching up. More and more evidence has been accumulating that this is due to significant impediments to investment and the adoption of technology.

These impediments can be grouped into three areas. First, poor governance — the lack of rule of law or enforceable contracts and the prevalence of corruption — creates disincentives to invest, start up new firms, and expand existing firms with high-productivity jobs. This has a negative impact on capital formation and entrepreneurial activity. Second, weak health and education systems impede the development of human capital. Workers without adequate education do not have the skills to take on high-productivity jobs or to increase the productivity of the jobs they do have. Third, too many restrictions on economic transactions prevent people from trading goods and services or adopting new technologies. Poor economic policies, state monopolies, excessive regulation, and the lack of openness to trade are all examples of restrictions that reduce the incentives for innovation and investment that are needed to boost productivity.

The Administration's approach to assisting developing nations to overcome these impediments and thereby increase their productivity growth is to increase aid, reward better performance, and measure results. All three must be simultaneously implemented; two of three alone would not succeed. As the MCA clearly represents a significant increase in aid levels, I want to focus on how the MCA will reward better performance and measure results.

Rewarding Better Performance

President Bush's vision of the MCA recognizes the importance of rewarding pro-growth policies. He categorizes these policies as ruling justly, investing in people and encouraging economic freedom. The MCA provides an incentive for countries to adopt good policies that will benefit them in three distinct ways:

i. These policies, in and of themselves, will increase growth;
ii. These policies will create an environment conducive to foreign and domestic investment; and
iii. Development assistance will be more effective in good policy environments.

Following President Bush's leadership, the Administration sought to develop a set of indicators that will be used to measure a country's commitment to pro-growth policies. An interagency group with representatives from Treasury, State, USAID, OMB, Commerce, CEA and NSC worked intensively for several months evaluating a wide range of possible indicators. As part of this process, we met with representatives from other donor countries, developing countries, non-governmental organizations (NGOs), universities, think tanks, the private sector, and other interested parties to gather their ideas.

As a first step we needed to decide which set of countries would be eligible to compete for MCA funds. Our proposal is to expand the number of countries eligible as funding ramps up. In FY'04, countries eligible to borrow from the International Development Association (IDA), and which have per capita incomes below $1,435 (the historical IDA cutoff), will be considered. This is currently 74 countries. In FY'05, all countries with incomes below $1,435 will be considered, which adds another 13 countries.
In FY'06, all countries with incomes up to $2,975 — the current World Bank cutoff for lower middle income countries — will be eligible to compete as a separate pool. This group currently consists of 29 countries. It is important to note that countries prohibited from receiving assistance by current statutory restrictions will not be eligible.

Eligible countries will qualify for funding based on their policy performance in the categories of ruling justly, investing in people and encouraging economic freedom. In an attempt to objectively quantify performance in these three categories, we considered a variety of potential indicators. Ultimately, we selected 16 based on their relationship to growth and poverty reduction, the number of countries they cover, their transparency and availability, and their relative soundness and objectivity. These indicators are not set in stone and may change in the future if problems with them emerge or better indicators become available. To qualify as a better performer, a country will have to be above the median on half of the indicators in each of the three policy areas.

Governing Justly: There is a growing literature on the importance of strong political institutions and good economic governance to successful development.

1) Civil Liberties: Freedom House evaluates freedom of expression, association and organizational rights, rule of law and human rights, and personal autonomy and economic rights.

2) Political Rights: Freedom House also evaluates the prevalence of free and fair elections of officials with real power; the ability of citizens to form political parties that may compete fairly in elections; freedom from domination by the military, foreign powers, totalitarian parties, religious hierarchies and economic oligarchies; and the political rights of minority groups.

3) Voice and Accountability: The World Bank Institute has designed a set of indices that aggregates existing quantitative assessments of governance from a broad range of sources. One of these indices attempts to measure a country's ability to protect civil liberties, the extent to which citizens of a country are able to participate in the selection of governments, and the independence of the media.

The policies incorporated in the previous three indicators should be seen as ends in their own right apart from their impact on growth. Additionally, freedom of expression and of the media allow civil society to effectively monitor the government and reduce corruption and more subtle rent-seeking behavior. Free and fair elections make governments accountable to the entire country rather than to a narrow power base, thus making them more responsive to development needs.

The remaining three indicators are produced by the World Bank Institute. These indices are formed by aggregating surveys from 15-20 different sources, similar to Voice and Accountability:

4) Government Effectiveness: Good governance includes the provision of quality public services, civil servants who are competent and independent from political pressures, and credible governments that make good on their commitment to produce and implement sound policies and deliver public goods.

5) Rule of Law: This index attempts to measure the extent to which people have confidence in and abide by rules of society, the incidence of violent and non-violent crime, the effectiveness and predictability of the judiciary, and the enforceability of contracts.

6) Control of Corruption: With respect to this indicator, President Bush made it clear that MCA funds should only go to the most transparent and least corrupt countries. To meet the President's concerns, we have determined that those countries which fall below the median on this indicator will be considered ineligible for MCA funds, absent material change in their circumstances.

Investing in People: In terms of measuring a country's commitment to educating its citizenry and providing basic health care, we were particularly concerned that a country's income level not preclude it from qualifying, yet we also wanted to provide an incentive for countries to focus on key policies that contribute to growth. Our proposal, therefore, includes two budgetary input measures, which governments can control and rapidly change. However, more money does not always lead to better results. Consequently, we have included two output measures that more accurately reflect improvement in the policy environment over time and are key to sustainable development.

1) Public expenditure on health as a percent of GDP: These data are being provided directly by the recipient government.

2) Immunization rate for DPT and measles: The UN's World Health Organization publicly compiles and annually releases data on immunization rates for nearly all member countries. Immunization rates can be associated with growth because labor productivity increases when workers are not out sick or caring for ill family members.

3) Total public expenditure on primary education as a percent of GDP: These data are being provided directly by the recipient government.

4) Primary Completion Rate: The World Bank and UNESCO compile data that

measure whether children are attaining minimum education levels. A higher level of education increases labor productivity.

Encouraging Economic Freedom: The MCA will measure a country's level of economic freedom based on its performance in implementing prudent macroeconomic and microeconomic policies, as well as creating the conditions necessary to attract investors.

1) Country Credit Rating: Institutional Investor magazine produces a semi-annual survey of bankers' and fund managers' perceptions of a country's risk of default. Our belief is that such a survey is an important indicator of the views of the private sector. In addition, an improved credit rating usually leads to a lower cost of capital and greater domestic and foreign direct investment.

2) Inflation: High inflation distorts relative prices and discourages long-term investments. Also, as the poor hold a higher percentage of their wealth in cash, they are disproportionately hurt by the erosion of their purchasing power. Of the 16 indicators, this is the only one where performance is not judged relative to the median. Instead, a country must have inflation of less than 20% in order to pass the indicator.

3) Budget Deficit/GDP: As a measure of fiscal policy, we use a country's overall budget deficit averaged over a three-year period. The data for this measure will be provided directly by the recipient government, cross-checked with other sources, and made publicly available.
Among other impacts on growth, a high budget deficit crowds out private sector investment and can lead to inflation.

4) Days to start a business: The Private Sector Advisory Service of the World Bank Group works with local lawyers and other professionals to examine specific regulations that impact business investment. One of their studies measures how many days it takes to open a new business. Bureaucratic barriers to business formation that go beyond protecting society not only hinder entrepreneurship but may exist to preserve the economic rents of political cronies.

5) Trade Policy: The Heritage Foundation's Index of Economic Freedom measures a country's openness to international trade based on average tariff rates and non-tariff barriers to trade. Open economies — those with low to moderate trade barriers and exchange controls — tend to grow faster than more closed economies.

6) Regulatory Quality Rating: The World Bank Institute (see section above on Governing Justly) measures the burden on business arising from, among others, licensing requirements, labor regulations, and bureaucratic corruption. Excessive regulations and their arbitrary application deter investment and raise the cost of doing business, thereby hindering job creation and reducing growth.

While these indicators meet all of our criteria, there may still be gaps or lags in the data, or trends not reflected in the data, which may be material for assessing performance. To correct for these possibilities, the MCA Board of Directors will look behind the numbers to make a final recommendation to the President on qualifying countries.

Measuring Results

Aid effectiveness requires not only better performance but also a focus on measuring results. This is a core component of the Administration's development strategy and is one that we have pushed in the Multilateral Development Banks (MDBs). For example, the U.S. made part of its financial commitment to the IDA-13 replenishment in the form of an incentive contribution that will reward the World Bank for increasing the use of various diagnostic tools (such as reviewing the policies of developing countries in the areas of financial accountability, procurement, public expenditure management, and poverty analysis) as well as making progress towards a set of development indicators (in health, education, and private sector development). The agreement also called for the initiation of a performance measurement system which will develop ultimately into a common set of outcome indicators that can be compared across countries.

The MCA furthers this focus on measuring results by making accountability for results an integral part of every activity for which MCA funds are used. Americans are by nature a generous people but they want to see results from their funds that are devoted to development, and their support for providing foreign assistance will only increase if those results are demonstrated in a convincing and straightforward manner. By measuring concrete results, we can focus our efforts on what really matters: helping poor people around the world escape from poverty and lead better lives. The approach helps us cut through bureaucratic layers, ignore non-essentials, and concentrate on development problems that must be solved. It is a way to maximize the benefits of our funds.

MCA contracts will state in quantitative terms the expected outcomes of individual activities and overall country assistance. We will require a clear strategy for gathering baseline data and measuring progress towards stated results and assessing the reasons for success and failure. We will also require projects to be structured in a way that steps up or cuts back funding contingent on achieving results. In addition, evaluation of results will allow the MCA to incorporate lessons learned into ongoing and future operations. In keeping with the MCA's commitment to transparency, all monitoring and evaluation reports, as well as the terms of each contract, will be made public in the U.S. and in the host country. Furthermore, we will continue to monitor country commitment to MCA selection criteria.

In addition to sector specific monitoring, we will also be concerned with the broader policy environment. The Millennium Challenge Corporation will monitor overall budget data to determine whether recipient governments are using MCA resources in a complementary manner with their own domestic and other development resources.

Coordination of assistance with other donors will be vital to the success of the MCA. Each recipient country will be responsible for managing coordination among the MCA and other donors to maximize impact and avoid duplication of efforts. The effort to align MCA country contracts and MDB assistance with each country's Poverty Reduction Strategy Paper (PRSP) or other development strategy will also help coordinate development assistance.

Conclusion

For many years, we have all heard about the importance of aid effectiveness. The MCA represents this country's greatest opportunity to transform rhetoric into an operational action plan. The MCA has the ability to challenge countries to demonstrate performance, to achieve results, and most importantly to assist their people in having a better opportunity to pursue a better life for themselves and their families. I urge your favorable consideration of the "Millennium Challenge Act of 2003."

FROM THE OFFICE OF PUBLIC AFFAIRS

March 4, 2003
JS-81

**United States Treasury Secretary John W. Snow
Statement to the House Ways and Means Committee**

Chairman Thomas, ranking member Rangel, and distinguished members of the House Ways and Means Committee, it is my privilege to appear before you today to discuss the President's plan for jobs and growth. Let me begin my testimony by thanking Chairman Thomas for introducing the President's Jobs and Growth proposal. I believe that if passed as introduced by the Chairman, the President's plan will create and secure jobs, accelerate and sustain our recovery, increase workers' standards of living and increase the economic performance of our nation for many years to come.

This plan is needed because too many people who want jobs can't find them, and too many people who have jobs are concerned about their job security. Let me explain.

In the near-term, this plan puts money in consumers' pockets right away, which will stimulate demand. The 10% tax rate bracket will expand immediately; helping low-income earners keep more of their pay. The punitive marriage penalty will end once and for all, and the child credit will increase by $400 to $1,000 per child this year. The plan will accelerate the additional income tax relief approved in 2001, to accelerate the benefits to the American people.

Under the President's proposal this year, a typical family of four with two earners making a combined $39,000 will receive a total of $1,100 in tax relief, compared to 2002 – not just this year, but in every year thereafter.

The tax rate cuts will spur business investment in the near term. Much investment and new employment comes from small businesses, most of which are S corporations, sole proprietorships, and partnerships. These businesses are taxed at individual tax rates, so marginal rate reductions help create new jobs and equipment.

Rate reductions combined with the proposed increase in new equipment expensing for small businesses will give our economy a big boost, and quickly. According to this Administration's analysis, our economy will add about 1.4 million new jobs under this plan by the end of next year – that's the best kind of help to a lot of families, who really need it.

As I stated earlier, the President's plan also contains the elements for a healthier, higher-performing economy over the longer-term. A key element of the plan for both fairness and effectiveness is the complete elimination of the double-taxation of dividends. Anything you tax more of, you will get less of – including business investment. Today, corporate profits are taxed at 35 percent range, and then these profits, which represent the return on business capital, are taxed again when paid to shareholders, so that total tax on this money can be as high as 60%.

Taxing anything twice is unfair. It is nothing short of double jeopardy for those who invest in America, and we pay for it with American jobs.

This is a double tax on investment. When you tax investment, you get less of it.

That policy is directly opposed to economic growth. Investment is basic to the American economy. We need to encourage business owners to invest for growth. Why instead would we punish those who want to invest in America?

Again, this double taxation is unfair, counter-productive and damaging to our economy. Double taxation makes it doubly difficult for companies to hire new workers, for hardworking taxpayers to save for their retirement, and for the economy to grow and create jobs. For every dollar a business sends to Washington in taxes, it is one less dollar it can spend to hire a new employee, develop a new product or invest in the future. For every dollar an individual taxpayer sends to Washington in the form of a dividend tax, it's one less dollar to invest in a business or save for the future.

Because the President's proposal lowers the cost of capital by reducing the double taxation of capital, it encourages investment and a higher long-term growth rate. Lower capital taxes mean more capital, which means higher productivity, which means faster growth and higher wages for everyone.

Also, ending the double taxation of dividends benefits people who will never receive a penny of dividends, because they will live in a more prosperous economy.

This package is good economics. The President's plan makes the economy more efficient, which raises productivity, which raises real wage rates, which raises the standard of living, which in turn provides more choice, opportunity, security and confidence for the American people.

In addition, dividend tax relief will stimulate the economy by increasing disposable incomes and by raising stock market share prices, inducing a "wealth effect." We are now a nation of shareholders: over half of families own stock shares, many of which pay dividends.

Let me further illustrate the argument. Let's say a family owns 200 shares of a $50 stock with a 3% yield. That means they receive $300 in dividends from those shares each year, but they only keep $200 of that because of the dividend tax. Without that tax, they keep another $100, which they can spend as they please. That means higher consumer spending.

But there is potentially a much larger benefit from higher equity prices and the wealth effect. If our hypothetical company has 200 million shares outstanding, the effect of eliminating the double taxation of dividends is to increase the shareholders' after-tax earnings by up to $100 million. That is, $100 million of dividends that would have gone to shareholder taxes are now kept by the shareholders. These additional earnings are capitalized into the price of the company's shares, assuming a certain discount rate and earnings multiple, so they might add, say, $1 billion to the market cap of the company. This encourages "wealth effect" spending by the owners, which we saw in great abundance in the last decade, and it lowers the cost of capital for the company.

The President's goal is to do something now that would pay off today and long into America's future – not here today, gone tomorrow. President Bush's jobs and growth plan will not only help American's achieve their economic dreams, creating a more abundant future with more good and secure jobs and rising real wages.

I urge this committee to pass it quickly. 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

FOR IMMEDIATE RELEASE
March 04, 2003

CONTACT: Office of Financing
202-691-3550

RESULTS OF TREASURY'S AUCTION OF 4-WEEK BILLS

Term:	28-Day Bill
Issue Date:	March 06, 2003
Maturity Date:	April 03, 2003
CUSIP Number:	912795MF5

High Rate: 1.190% Investment Rate 1/: 1.217% Price: 99.907

All noncompetitive and successful competitive bidders were awarded securities at the high rate. Tenders at the high discount rate were allotted 83.65%. All tenders at lower rates were accepted in full.

AMOUNTS TENDERED AND ACCEPTED (in thousands)

Tender Type	Tendered	Accepted
Competitive	$ 48,670,894	$ 24,947,044
Noncompetitive	53,582	53,582
FIMA (noncompetitive)	0	0
SUBTOTAL	48,724,476	25,000,626
Federal Reserve	1,860,694	1,860,694
TOTAL	$ 50,585,170	$ 26,861,320

Median rate 1.190%: 50% of the amount of accepted competitive tenders was tendered at or below that rate. Low rate 1.160%: 5% of the amount of accepted competitive tenders was tendered at or below that rate.

Bid-to-Cover Ratio = 48,724,476 / 25,000,626 = 1.95

1/ Equivalent coupon-issue yield.

JS-82

FROM THE OFFICE OF PUBLIC AFFAIRS

March 4, 2003
JS-83

Statement by Treasury Department Spokesman Regarding Currency Policy

"We do not intend to comment on daily fluctuations in currency markets. Secretary Snow made the Administration's position on the dollar very clear at his confirmation hearing. He said that we have a consistent policy of favoring a strong dollar, and sound, pro-growth economic policies and a commitment to free and open markets are the foundation for a strong dollar. The Secretary's position hasn't changed." – Tony Fratto, Treasury Department spokesman

FROM THE OFFICE OF PUBLIC AFFAIRS

March 5, 2003
JS-84

Secretary Snow and Treasurer Marin Provide Signatures for U.S. Paper Currency

Treasury Secretary John W. Snow and U.S. Treasurer Rosario Marin today provided their signatures to the Bureau of Engraving and Printing (BEP) for use on Series 2003 U.S. paper currency.

"Having my signature on the currency of this nation is a great honor," said Secretary Snow. "The swift enactment of the President's Jobs and Growth plan will ensure that more of these notes stay in the pockets of the American family."

The signatures of Secretary Snow and Treasurer Marin will be transferred by the BEP's engravers to steel plates, which will be used to print all new U.S. paper currency. Since the introduction of the smaller-size notes in 1929, the signatures of 24 Treasury Secretaries and 15 Treasurers – including Secretary Snow and Treasurer Marin – have appeared on U.S. paper currency.

The BEP expects to begin production of $1 Series 2003 Snow-Marin notes by April 2003 once the engraved plates are completed. The paper currency is expected to be sent to the Federal Reserve by July 2003 for distribution as needed.

Each business day, the BEP produces roughly 38 million notes with a face value of approximately $696 million. An estimated $641 billion U.S. paper currency is currently in circulation worldwide.

FROM THE OFFICE OF PUBLIC AFFAIRS

March 5, 2003
JS-85

Testimony of Wayne A. Abernathy
Assistant Secretary for Financial Institutions
U.S. Department of the Treasury
Before the
Subcommittee on Financial Institutions and Consumer Credit
of the Committee on Financial Services
U.S. House of Representatives
INTEREST ON BUSINESS CHECKING ACCOUNTS
AND RESERVE BALANCES

Chairman Bachus, Representative Sanders, and Members of the Subcommittee, I appreciate this opportunity to present the Treasury Department's views on legislation repealing the prohibition on the payment of interest on business checking accounts, and permitting the payment of interest on reserve balances that depository institutions maintain at the Federal Reserve Banks. The Treasury Department supports permitting banks and thrifts to pay interest on business checking accounts. We are also sympathetic to the arguments in favor of permitting the Federal Reserve to pay interest on reserve balances and support the goals of the legislation; however, inasmuch as the potential budget impact of the provision is not included in the President's Budget, we are not prepared to endorse the proposal at this time.

Paying Interest on Demand Deposits

The Treasury Department has consistently supported provisions repealing the prohibition on paying interest on demand deposits. In each of the last two Congresses, the House of Representatives passed legislation that included this repeal. We hope that the House does so again and that the Senate moves forward soon with similar legislation.

The prohibition is a relic of the Great Depression. Many policymakers in the 1930s worried about the solvency of the nation's banks and the harmful effects of widespread bank failures on the overall economy. One manifestation of that worry was the belief that limiting competition among banks would reduce bank failures, even if that resulted in fewer options and higher costs for consumers of financial services. Therefore, among other competition-limiting measures, Congress prohibited the payment of interest on demand deposits and established ceilings on the interest rates that depository institutions could pay their customers on other types of deposits.

Experience has shown that limiting consumer choice is a sub-optimal strategy for bank regulation. The market has a way of asserting itself. In recent decades, competition to banks from money market mutual funds (not subject to rate caps) and the development of negotiable order of withdrawal (NOW) accounts by New England thrifts worked to undermine the "Regulation Q" deposit interest rate ceilings. At the beginning of the 1980s, Congress allowed banks to offer money market deposit accounts (MMDAs), free of interest rate controls, to compete with non-bank money market mutual funds. It also permitted interest to be paid on household checking deposits, approving NOW accounts nationwide.

Repeal of the prohibition on paying interest on demand deposits would eliminate a needless government control, consistent with the earlier elimination of Regulation Q rate ceilings on other deposits. The result will be greater economic efficiency. Banks could reduce the resources that they spend on procedures to get around these market restrictions, such as practices that provide implicit interest on compensating balance accounts or mechanisms that sweep demand deposits into money market investments. Community banks with fewer means to compensate for the lack of interest payments would be better able to compete with large banks and non-bank financial services providers in attracting business depositors. Repeal would benefit the nation's small businesses by allowing them to earn a positive return on their transaction balances. Larger businesses today have been able to offset the lack of interest on checking accounts by using sweep accounts to earn interest or by obtaining price concessions on other bank products.

We favor the direct repeal of the prohibition on paying interest on demand deposits, such as that contained in the bill authored by Representative Toomey (H.R. 859) that would be effective one year after enactment. Rather than directly repealing the prohibition, the bill introduced by Representative Kelly (H.R. 758) would authorize an increase from 6 to 24 in the allowable transactions per month between demand deposits and interest bearing money market deposit accounts, an indirect way for businesses to earn interest on their checking account funds. We think that this would be appropriate as a transitional arrangement until full repeal of the prohibition on demand deposit interest becomes effective. Combining these two proposals, as the House of Representatives did in the last Congress, would help ensure that banks are immediately able to offer the equivalent of interest bearing checking accounts to their business customers before the repeal of the prohibition becomes effective. In any event, the Treasury Department continues to prefer a relatively quick repeal of the prohibition on paying interest on demand deposits.

Permitting the Federal Reserve to Pay Interest on Reserve Balances

H.R. 758 also would allow the Federal Reserve Banks to pay interest on the reserve balances that they hold of depository institutions. The Federal Reserve Act requires depository institutions to maintain reserves against certain of their deposit liabilities. The first $6 million of an institution's transaction accounts are currently exempt from reserve requirements. Transaction balances between that level and $42.1 million are subject to a 3 percent reserve requirement. The Federal Reserve prescribes a 10 percent requirement on balances above that amount, within a statutorily prescribed range of 8 to 14 percent. Institutions typically meet these reserve requirements through vault cash and a portion of their reserve balances at a Federal Reserve Bank, known as required reserve balances. Depository institutions may voluntarily hold reserve balances above the amount necessary to meet reserve requirements, which are called excess reserves. They may also enter into agreements with the Federal Reserve to hold certain balances that would cover transactions cleared through their accounts, called contractual clearing balances. Contractual clearing balances do not count toward meeting reserve requirements.

Required reserve balances and excess reserves held at the Federal Reserve do not earn interest. They are therefore sometimes referred to as sterile reserves. Contractual clearing balances earn implicit interest through the offset of fees for Federal Reserve services. In January 2003, depository institution reserve requirements averaged $41 billion. Depository institutions met these requirements with $32.7 billion in vault cash and $8.3 billion in required reserve balances at Federal Reserve Banks. They also held $1.7 billion in excess reserves and $10.5 billion in contractual clearing balances.

Although they have risen in the last couple of years due largely to declining interest rates, required reserve balances at Federal Reserve Banks have declined by more than three-fourths since the end of the 1980s (from $34.4 billion in December 1989 to $8.3 billion in January 2003). Three factors may be primarily responsible for the long-term decline: (1) regulatory actions taken by the Federal Reserve in the early 1990s reducing reserve requirements, (2) banks' growing use of new products and technology, such as retail sweep accounts, to minimize required reserves, and (3) growth in the use of vault cash through the first half of the 1990s to meet reserve requirements, as increased ATM usage continued to increase the need for such cash. The proportion of reserve requirements met by vault cash rose from 44 percent in December 1989 to 80 percent in January 2003.

Governor Kohn has presented the concerns that current limitations may affect the ability to conduct monetary policy. While these problems are not imminent, we share the concerns about the implications of these restrictions over time.

In addition to potential benefits for the operation of monetary policy, permitting the payment of interest on reserve balances at the Federal Reserve Banks would promote economic efficiency. Uncompensated reserves act as a tax upon banks, while serving no public policy interest. To avoid this tax, banks have engaged in otherwise uneconomic activity to avoid holding these non-interest bearing required reserve balances. In recent years, the declining cost of technology has allowed banks to establish new types of sweep arrangements for retail customer accounts with the express purpose of minimizing reserve requirements. This sweeping is often invisible to the customer as a practical matter, but it does impose an unrecompensed business cost on banks. These costs harm the competitiveness of banks – not only with foreign institutions but with other financial services providers. If banks earned interest on these reserve balances, they would be less likely to expand the use of sweeps and might unwind some existing sweep programs.

The Office of Management and Budget (OMB) and Congressional Budget Office (CBO) have in the past estimated that paying interest on required reserve balances would have a budget cost, since it would reduce Federal Reserve System earnings transferred to the Treasury. Neither the OMB nor CBO have recently updated their estimates of the cost of this proposal.

H.R. 758 provides an "offset" to the budget cost by transferring a part of the Federal Reserve's surplus to the Treasury. It is true that in the past, budget accounting rules have at times permitted the transfer of Federal Reserve surplus funds to the Treasury to count as receipts that would offset the cost of other programs. Yet, over time, transfers of the surplus do not result in budget savings. In transferring a portion of its surplus to the Treasury, the Federal Reserve would reduce its portfolio of interest-earning assets. This would in turn decrease the Federal Reserve's future earnings and remittances to the Treasury. Budgetary receipts in the near term would increase only at the expense of foregone longer-term receipts.

Conclusion

We welcome action by Congress to repeal prohibitions on paying interest on business checking accounts at depository institutions. Repeal would eliminate unnecessary restrictions on these institutions' ability to serve their commercial customers, and it would level the playing field between them and other financial services providers that can compensate businesses for deposits without similar legal restrictions. Repeal would especially benefit the nation's small businesses.

The ability to pay interest on reserve balances maintained at the Federal Reserve Banks may improve the effectiveness of the tools that the Federal Reserve has to implement monetary policy. Financial system efficiency would likely improve as fewer resources would be devoted to minimizing reserve balances. As a general matter, we are sympathetic to these arguments and support the goals of the legislation. However, inasmuch as the potential budgetary costs associated with this proposal are not provided for in the President's Budget, the Administration is not prepared to endorse the proposal at this time.

Thank you for the opportunity to appear before the Subcommittee. I am happy to respond to any questions.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

March 5, 2003
JS-86

Testimony of Barbara Angus, International Tax Counsel
United States Department of the Treasury
on Pending Income Tax Agreements

Mr. Chairman and distinguished Members of the Committee, I appreciate the opportunity to appear today at this hearing to recommend, on behalf of the Administration, favorable action on three income tax agreements that are pending before this Committee. We appreciate the Committee's interest in these agreements as demonstrated by the scheduling of this hearing.

This Administration is dedicated to eliminating unnecessary barriers to cross-border trade and investment. The primary means for eliminating tax barriers to trade and investment are bilateral tax treaties. Tax treaties eliminate barriers by providing greater certainty to taxpayers regarding their potential liability to tax in the foreign jurisdiction; allocating taxing rights between the two jurisdictions so that the taxpayer is not subject to double taxation; by reducing the risk of excessive taxation that may arise because of high gross-basis withholding taxes; and by ensuring that taxpayers will not be subject to discriminatory taxation in the foreign jurisdiction. The international network of over 2000 bilateral tax treaties has established a stable framework that allows international trade and investment to flourish. The success of this framework is evidenced by the fact that the millions of cross-border transactions that take place around the world each year give rise to relatively few disputes regarding the allocation of tax revenues between governments.

The Administration believes that these three agreements, which update important treaty relationships with the United Kingdom, Australia and Mexico, would provide significant benefits to the United States and to our treaty partners, as well as our respective business communities. We request the Committee and the Senate to take prompt and favorable action on all three agreements.

Purposes and Benefits of Tax Treaties

Tax treaties provide benefits to both taxpayers and governments by setting out clear ground rules that will govern tax matters relating to trade and investment between the two countries. A tax treaty is intended to mesh the tax systems of the two countries in such a way that there is little potential for dispute regarding the amount of tax that should be paid to each country. The goal is to ensure that taxpayers do not end up caught in the middle between two governments, each of which would like to tax the same income. Once a treaty relationship is in place and working as it should, governments need expend little additional resources negotiating to resolve individual cases because the general principles for taxation of cross-border transactions and activities will have been agreed in the treaty.

One of the primary functions of tax treaties is to provide certainty to taxpayers with respect to the "threshold" question – that is, whether the taxpayer's cross-border activities will subject it to taxation by two or more countries. Treaties answer this question by establishing the minimum level of economic activity that a resident of one country must engage in within the other country before the latter country may tax any resulting business profits. In general terms, tax treaties provide that if the branch operations have sufficient substance and continuity, the country where the activities occur will have primary (but not exclusive) jurisdiction to tax. In other cases, where the operations are relatively minor, the home country retains the sole jurisdiction to tax its residents. In the absence of a tax treaty, a U.S. company operating a branch or division or providing services in another country might be subject to income tax in both the United States and the other country on the income generated by such operations. Although the United States generally provides a credit against U.S. tax liability for foreign taxes paid, there remains potential for resulting double taxation that could make an otherwise attractive investment opportunity unprofitable, depriving both countries of the benefits of increased cross-border investment.

Tax treaties protect taxpayers from potential double taxation through the allocation of taxing rights between the two countries. This allocation takes several forms. First, the treaty has a mechanism for determining the residence of a taxpayer that otherwise would be a resident of both countries. Second, with respect to each category of income, the treaty assigns the "primary" right to tax to one country, usually (but not always) the country in which the income arises (the "source" country), and the "residual" right to tax to the other country, usually (but not always) the country of residence of the taxpayer. Third, the treaty provides rules for determining which country will be treated as the source country for each category of income. Finally, the treaty establishes both limitations on the amount of tax that the source country can impose on each category of income and the obligation of the residence country to eliminate double taxation that otherwise would arise from the exercise of concurrent taxing jurisdiction by the two countries.

As a complement to these substantive rules regarding allocation of taxing rights, treaties provide a mechanism for dealing with disputes or questions of application that arise after the treaty enters into force. In such cases, designated tax authorities of the two governments – known as the Acompetent authorities@ in tax treaty parlance – are to consult and reach an agreement under which the taxpayer's income is allocated between the two taxing jurisdictions on a consistent basis, thereby preventing the double taxation that might otherwise result. The U.S. competent authority under our tax treaties is the Secretary of the Treasury. That function has been delegated to the Director, International (LMSB) of the Internal Revenue Service.

In addition to reducing potential double taxation, treaties also reduce "excessive" taxation by reducing withholding taxes that are imposed at source. Under U.S. domestic law, payments to non-U.S. persons of dividends and royalties as well as certain payments of interest are subject to withholding tax equal to 30 percent of the gross amount paid. Most of our trading partners impose similar levels of withholding tax on these types of income. This tax is imposed on a gross, rather than net, amount. Because the withholding tax does not take into account expenses incurred in generating the income, the taxpayer frequently will be subject to an effective rate of tax that is significantly higher than the tax rate that would be applicable to net income in either the source or residence country. The taxpayer may be viewed, therefore, as having suffered "excessive" taxation.

Tax treaties alleviate this burden by providing maximum levels of withholding tax that the treaty partners may impose on these types of income. In general, U.S. tax treaty policy is to reduce the rate of withholding tax on interest and royalties to zero, so that such payments are taxed exclusively in the country of residence and not in the country of source. In contrast, U.S. tax treaties have allowed some source-country taxation of dividends, with many U.S. treaties providing for a maximum source-country withholding tax of 5 percent on dividends paid to direct corporate investors and a maximum source-country withholding tax of 15 percent on dividends paid to all other shareholders. Over the years, U.S. treaty negotiators have considered proposals to treat intercompany dividends in the same manner as interest and royalties and therefore to provide for exclusive residence-country taxation of intercompany dividends in some cases. The three treaties before the Committee are the first U.S. tax treaties to do so.

Our tax treaties also include provisions intended to ensure that cross-border investors do not suffer discrimination in the application of the tax laws of the other country. While this is similar to a basic investor protection provided in several types of agreements, the non-discrimination provisions of tax treaties are more effective because they are specifically tailored to tax concerns. They provide guidance about what "national treatment" means in the tax context by specifically prohibiting types of discriminatory measures that once were common in some tax systems. At the same time, they clarify the manner in which discrimination is to be tested in the tax context. Particular rules are needed here, for example, to reflect the fact that foreign persons that are subject to tax in the host country only on certain income may not be in the same position as domestic taxpayers that may be subject to tax in such country on all their income.

Treaties also include provisions dealing with more specialized situations. Some of these provisions are becoming increasingly important as the number of individuals engaged in cross-border activities increases. For example, provisions coordinating the pension rules of the tax systems of the two countries are needed to ensure that individuals who are expecting in their retirement to be subject to a certain manner and level of taxation do not find their pensions eaten into by unexpected taxation by another country. Other quite specific rules address the treatment of employee stock options, Social Security benefits, and alimony and child support in the cross-border context. While these subjects may not involve a lot of revenue from the perspective of the two governments, rules providing clear and appropriate treatment can be very important to each of the individual taxpayers who are affected.

Other treaty provisions deal with the administration of the treaty and, to a certain extent, the domestic tax law of the two countries. One of the most important of these is the provision addressing the exchange of information between the tax authorities. Under tax treaties, the competent authority of one country may provide to the other competent authority such information as may be necessary for the proper administration of that country's tax laws, subject to strict protections on the confidentiality of taxpayer information. Because access to information from other countries is critically important to the full and fair enforcement of the U.S. tax laws, information exchange is a priority for the United States in its tax treaty program. If a country has bank secrecy rules that would prevent or seriously inhibit the appropriate exchange of information under a tax treaty, we will not conclude a treaty with that country. In fact, information exchange is a matter we raise with the other country before commencement of formal negotiations because it is one of a very few matters that we consider non-negotiable.

Treaty Program and Negotiation Priorities

The United States has a network of 56 bilateral income tax treaties, the oldest of which currently in force now dates from 1950. This network includes all 29 of our fellow members of the OECD and covers the vast majority of foreign trade and investment of U.S. companies.

The Treasury Department is working to renegotiate our older tax treaties to ensure that they reflect current U.S. tax treaty policy. The treaties before you are evidence of how even good treaty relationships can be made better. At the same time, we are actively working to establish new treaty relationships that will fill gaps in our treaty network.

In establishing priorities, our primary objective is the conclusion of treaties or protocols that will provide the greatest benefits to the United States and to U.S. taxpayers. We communicate regularly with the U.S. business community, seeking input regarding the areas in which treaty network expansion and improvement efforts should be focused and information regarding practical problems they face with respect to the application of particular treaties and the application of the tax regimes of particular countries.

The U.S. commitment to including comprehensive provisions designed to prevent "treaty-shopping" in all of our tax treaties is one of the keys to improving our overall treaty network. Our tax treaties are intended to provide benefits to residents of the United States and residents of the particular treaty partner on a reciprocal basis. The reductions in source-country taxes agreed to in a particular treaty mean that U.S. persons pay less tax to that country on income from their investments there and residents of that country pay less U.S. tax on income from their investments in the United States. Those reductions and benefits are not intended to flow to residents of a third country. If third-country residents can exploit one of our treaties to secure reductions in U.S. tax, the benefits would flow only in one direction. Such use of treaties is not consistent with the balance of the deal negotiated. Moreover, preventing this exploitation of our treaties is critical to ensuring that the third country will sit down at the table with us to negotiate benefits and reductions in tax on a reciprocal basis, so that we can secure for U.S. persons the benefits of reductions in source-country tax on their investments in that country.

Treaty-shopping can take a number of forms, but it generally involves a resident of a third country that either has no treaty with the United States or has a treaty that offers relatively less benefit. The third-country resident establishes an entity in a treaty partner that has a relatively more favorable treaty with the United States in order to hold title to the resident's investments in the United States, which could range from portfolio stock investments to substantial operating subsidiaries. By interposing the new entity so that the U.S. investment appears to be made through the treaty partner, the third country resident is able to withdraw the returns from the U.S. investment subject to the favorable rates of tax provided in the tax treaty, rather than the higher rates that would be imposed on such returns if the person had held the U.S. investments directly.

If treaty-shopping is allowed to occur, then there is less incentive for the third country with which the United States has no treaty (or has a treaty that does not reflect our preferred positions on reductions in source-country withholding taxes) to negotiate a tax treaty with the United States. The third country could maintain inappropriate barriers to investment and trade from the United States and yet its companies could obtain the benefits of lower U.S. tax by organizing their investment and trade in the United States so that they flow through a country with a favorable tax treaty with the United States.

For these reasons, all recent U.S. tax treaties contain comprehensive "limitation on benefits" provisions that limit the benefits of the treaty to bona fide residents of the treaty partner. These provisions are not uniform, as each country has particular characteristics that affect both its attractiveness as a country through which to treaty shop and the mechanisms through which treaty shopping may be attempted. Consequently, the specific limitation on benefits provision in each treaty must to some extent be tailored to fit the facts and circumstances of the treaty partner's internal laws and practices. Moreover, the provisions need to strike a balance that prevents the inappropriate exploitation of treaty benefits while ensuring that the treaty benefits flow smoothly to the legitimate and desirable economic activity for which the benefits were intended.

Despite the protections of the limitation on benefits provisions, there may be countries with which we choose not to have a tax treaty because of the possibility of abuse. With other countries there may not be the type of cross-border tax issues that are best resolved by treaty. For example, we generally do not conclude tax treaties with jurisdictions that do not impose significant income taxes, because there is little possibility of double taxation of income in such a case. In such cases, an agreement focused on the exchange of tax information can be very valuable in furthering the goal of reducing U.S. tax evasion.

The situation is more complex when a country adopts a special preferential regime for certain parts of the economy that is different from the rules generally applicable to the country's residents. In those cases, the residents benefiting from the preferential regime do not face potential double taxation and so should not be entitled to reductions in U.S. withholding taxes, while a treaty relationship might be useful and appropriate in order to avoid double taxation in the case of the residents who do not receive the benefit of the preferential regime. Accordingly, in some cases we have treaty relationships that carve out certain residents and activities from the benefits of the treaty. In other cases, we have determined that economic relations with the relevant country were such that the potential gains from a treaty were not sufficient to outweigh the risk of abuse, and have therefore decided against entering into a tax treaty relationship (or have terminated an existing relationship).

Prospective treaty partners must indicate that they understand their obligations under the treaty, including those with respect to information exchange, and must demonstrate that they are able to comply with those obligations. Sometimes a potential treaty partner is unable to do so. In other cases we may feel that a treaty is inappropriate because the potential treaty partner may be unwilling to address in the treaty real tax problems identified by U.S. businesses operating there. Lesser developed and newly emerging economies, for which capital and trade flows with the United States are often disproportionate or virtually one-way, may not be willing to reduce withholding taxes to a level acceptable to the United States because of concerns about the short-term effects on tax revenues.

The primary constraint on the size of our tax treaty network, however, may be the complexity of the negotiations themselves. The various functions performed by tax treaties, and particularly the goal of meshing two different tax systems, make the negotiation process exacting and time-consuming. While the starting point for all U.S. tax treaty negotiations is the U.S. Model Tax Convention, it is never the ending point.

A country's tax policy, as reflected in its domestic tax legislation as well as its tax treaty positions, reflects the sovereign choices made by that country. Numerous features of the treaty partner's unique tax legislation and its interaction with U.S. domestic tax rules must be considered in negotiating an appropriate treaty. Examples include whether the country eliminates double taxation through an exemption or a credit system, the country's treatment of partnerships and other transparent entities, and how the country taxes contributions to pension funds, the funds themselves, and distributions from the funds. A treaty negotiation must take into account all of these and many other aspects of the treaty partner's tax system in order to arrive at an acceptable treaty from the perspective of the United States. Accordingly, a simple side by side comparison of two treaties, or of a proposed treaty against a model treaty, will not enable meaningful conclusions to be drawn as to whether a proposed treaty reflects an appropriate balance. Moreover, there may be differences that are of little substantive importance, reflecting language issues, cultural obstacles or other impediments to the use of particular U.S. or other model text.

Each treaty is the result of a negotiated bargain between two countries that often have conflicting objectives. Each country has certain positions that it considers non-negotiable. The United States, which insists on effective anti treaty-shopping and exchange of information provisions, and which must accommodate its uniquely complex tax laws, probably has more non-negotiable positions than most countries. For example, every U.S. treaty must contain the A saving clause@, which permits the United States to tax its citizens and residents as if the treaty had not come into effect, and allow the United States to apply its rules applicable to former citizens and long-term residents. Other U.S. tax law provisions that may complicate negotiations are the branch profits tax and the branch level interest tax, rules regarding contingent interest, real estate mortgage investment conduits, real estate investment trusts and regulated investment companies, and the Foreign Investors in Real Property Tax Act rules.

Obtaining the agreement of our treaty partners on provisions of importance to the United States sometimes requires other concessions on our part. Similarly, other countries sometimes must make concessions to obtain our agreement on matters that are critical to them. In most cases, the process of give-and-take produces a document that is the best treaty that is possible with that other country. In others, we may reach a point where it is clear that it will not be possible to reach an acceptable agreement. In those cases, we simply stop negotiating with the understanding that negotiations might restart if circumstances change. Accordingly, each treaty that we present here represents not only the best deal that we believe we can achieve with the particular country at this time, but also constitutes an agreement that we believe is in the best interests of the United States.

Discussion of Treaties and Protocols

I would now like to discuss the importance and purposes of each agreement that has been transmitted for your consideration. We have submitted Technical Explanations of each agreement that contain detailed discussions of the provisions of each treaty and protocol. These Technical Explanations serve as an official

Treasury Department guide to each agreement. Before discussing the individual treaties, however, I would like to discuss a development common to all three agreements.

Elimination of Source Country Tax on Certain Intercompany Dividends

As discussed above, U.S. tax treaty policy for many years has been to eliminate (or when that is not possible, to substantially reduce) source-country withholding taxes on interest and royalties. By contrast, the United States regularly reduces by treaty the withholding tax on intercompany dividends but has never agreed in a treaty to eliminate source-country withholding taxes on intercompany dividends. These three agreements each include provisions eliminating source-country withholding taxes on intercompany dividends if certain conditions are satisfied. Treasury believes that this is an appropriate development in light of our overall treaty policy of reducing tax barriers to cross-border investment and in the context of these three treaty relationships.

Bilateral reductions in source-country withholding taxes have two offsetting effects on U.S. tax revenues in the short term. Reductions in the U.S. withholding taxes imposed on foreign persons with investments in the United States represent a short-term static reduction in U.S. tax revenues. On the other hand, reductions in foreign withholding taxes imposed on U.S. persons with foreign investments represent a short-term static increase in tax revenues for the United States because the U.S. persons that pay less in foreign withholding taxes therefore claim less in foreign tax credits to offset their U.S. tax liability. When U.S. companies receive more in payments from their foreign subsidiaries than U.S. subsidiaries make in payments to their foreign parents, the reduction in foreign tax credit claims will offset the reduction in withholding tax collections. This should hold true with respect to dividends, as U.S. companies receive significantly more direct dividends from abroad than foreign companies receive from the United States.

Reductions in foreign withholding taxes borne by U.S. taxpayers result in a direct benefit to the U.S. fisc to the extent that the U.S. taxpayer otherwise would have been able to use the foreign tax credits associated with such withholding taxes to offset its U.S. tax liability. Reductions in foreign withholding taxes result in a direct benefit to the U.S. taxpayer to the extent that the taxpayer could not have used the foreign tax credits to offset its U.S. tax liability because of applicable limitations of domestic law. In cases where the U.S. taxpayer has excess foreign tax credits, a reduction in foreign withholding taxes represents a dollar-for-dollar reduction in its overall tax burden. The reduction in foreign withholding taxes thus represents a reduction in costs that may increase competitiveness in connection with international business opportunities.

For example, if a U.S. company is considering an investment in a foreign country, it of course must consider the after-tax cost of that investment. If the potential investment is the purchase of an existing business in a foreign country, the U.S. company likely will compete against bidders from other countries. If the U.S. company is in an excess foreign tax credit position, any withholding tax paid to the host country will decrease the U.S company's expected return on the foreign investment. If another bidder is not subject to the host country withholding tax (perhaps because of its home country's treaty relationship with the host country), it may be willing to pay a higher price for the target.

Similarly, a foreign company that is in an excess foreign tax credit position in its home country might be discouraged from investing in the United States because of the five percent withholding tax that the United States is permitted to impose on direct investment dividends under most of its tax treaties. The same is true of a company that is based in a country that relieves double taxation by exempting direct investment dividends from taxation. In either case, the imposition of a five percent U.S. withholding tax reduces the return on the investment in the United States dollar-for-dollar. Eliminating the withholding tax by treaty therefore may encourage inbound investment. Increased investment in the United States means more jobs, greater productivity and higher wage rates.

The historical U.S. position of not eliminating by treaty withholding taxes on direct investment dividends was consistent with general treaty practice throughout the world. When most major trading partners imposed such a tax, then the tax would not create the competitive advantages and disadvantages described above, since every company would be subject to it. In addition, many of our treaties were negotiated at a time when corporate tax rates in Europe tended to be higher than those in the United States, making it less likely for foreign companies to be in an excess foreign tax credit position. As a result, a five percent U.S. withholding tax on direct investment may not have been seen as a significant cost of doing business here. However, more and more countries are eliminating their withholding taxes on intercompany dividends. In this regard, it should be noted that the Parent-Subsidiary Directive adopted by the European Union in 1990 eliminated all withholding taxes on dividends paid by a subsidiary in one EU member country to a parent in another of the fifteen (soon to be 25) members of the European Union. Moreover, corporate tax rates have been falling around the world. In this climate, it was appropriate for the United States to consider agreeing by treaty to eliminate source-country withholding taxes on certain intercompany dividends.

We believe that it is in the interest of the United States to take a flexible approach, agreeing to eliminate the withholding tax on intercompany dividends in appropriate cases. This would not be a blanket change in policy, and the Treasury Department does not recommend a change to the U.S. negotiating position in this respect, because it may not be appropriate to agree to such reductions in every treaty with every country. Therefore, we would approach each case individually.

Some key parameters apply across the board. We do not believe that it is appropriate to eliminate source-country taxation of intercompany dividends by treaty unless the treaty contains anti-treaty-shopping rules that meet the highest standards and the information exchange provision of the treaty is sufficient to allow us to confirm that the requirements for entitlement to this benefit are satisfied. Strict protections against treaty shopping are particularly important when the elimination of withholding taxes on intercompany dividends is included in relatively few U.S. treaties.

In addition to these conditions, we must be satisfied with the overall balance of the treaty. This assessment will be relatively simple in cases where the other country imposes a withholding tax on dividends comparable to the U.S. withholding tax and the dividend flows are roughly equal (or favor the United States). In other cases, eliminating withholding taxes on intercompany dividends nevertheless may be appropriate if the United States benefits from concessions made by the other country with respect to other provisions of the treaty. As with many treaty elements, it is a matter of balance. Finally, there may be cases where the elimination of withholding taxes by treaty is desirable from the U.S. perspective in order to lock in a treaty partner whose domestic law regarding withholding taxes may be in flux and to establish certainty and stability with respect to the tax treatment of investments in a particular country. We do not believe that we should attempt now to set all the parameters for when elimination of source-country withholding taxes on intercompany dividends is appropriate and when it is not. The optimal treatment of source-country withholding taxes on intercompany dividends must be considered in the context of each treaty relationship.

United Kingdom

The proposed Convention with the United Kingdom was signed in London on July 24, 2001, and was amended by a Protocol, signed in Washington on July 19, 2002. The Convention is accompanied by an exchange of diplomatic notes, also dated July 24, 2001. The Convention, Protocol and notes replace the existing Convention, which was signed in London in 1975 and modified by subsequent notes and protocols. The proposed Convention generally follows the pattern of other recent U.S. treaties and the U.S. Model treaty.

A significant impetus for the re-negotiation of the U.S.-U.K. tax treaty was the impact on the operation of the treaty of changes made by the United Kingdom to its domestic laws regarding the treatment of dividends. The dividend article of the current treaty (along with corresponding provisions of the article regarding foreign tax credits) contains unusual rules intended to extend to U.S. shareholders the benefit of the United Kingdom's imputation system for the taxation of dividends, while dividing the cost of that benefit between the United States and the United Kingdom. Changes in the United Kingdom's domestic system for taxing dividends mean that the provisions no longer work as intended.

The start of negotiations also provided an opportunity to bring the treaty into greater conformity with U.S. tax treaty policy. The current treaty does not include an effective anti-treaty-shopping provision, and it grants a waiver of the insurance excise tax without the anti-abuse protection that has become standard in other U.S. tax treaties. There were substantial problems under the information exchange provisions of the current treaty because the United Kingdom could obtain information for the United States only if it too needed the information for its own domestic tax purposes. Moreover, because the treaty was negotiated in the late 1970's, it did not include any of the provisions that are included in modern treaties to reflect the changes in U.S. domestic law made over the last 20 years.

The maximum withholding tax rates on investment income in the proposed Convention are the same or lower than those in the existing treaty. Although the Convention continues the rule under which the country of source may tax direct investment dividends and portfolio dividends at a maximum rate of 5 and 15 percent, respectively, the proposed Convention provides for a withholding rate of zero percent on dividends from certain 80-percent-owned corporate subsidiaries and those derived by pension plans. The proposed Convention was the first income tax treaty signed by the United States that contains this elimination of source-country tax for intercompany dividends.

Dividends paid by non-taxable conduit entities, such as U.S. regulated investment companies and real estate investment trusts, and any comparable investment vehicles in the United Kingdom, are subject to special rules to prevent the use of these entities to obtain withholding rate reductions that would not otherwise be available.

The proposed Convention, like the existing treaty and the U.S. Model, provides for the elimination of source-country tax on interest and royalties. Excess inclusions with respect to residual interests in U.S. real estate mortgage investment conduits may be taxed under U.S. domestic rules, without regard to the rest of the provisions relating to interest, and contingent interest may be taxed by the source country at a maximum rate of 15 percent rate.

The proposed Convention confirms that the United States generally will not impose the excise tax on insurance policies issued by foreign insurers if the premiums on such policies are derived by a U.K. enterprise. This rule is a continuation of the waiver of the excise tax that applies under the existing Convention. However, the proposed Convention has been improved through the addition of an anti-abuse rule that will prevent companies in third countries that do not benefit from a waiver of the insurance excise tax from using a U.K. insurance company as a conduit to avoid imposition of the tax.

The proposed Convention provides for exclusive residence-country taxation of profits from the operation in international traffic of ships or aircraft, including profits from the rental of ships and aircraft on a full basis, or on a bareboat basis if the rental income is incidental to profits from the operation of ships or aircraft in international traffic. All income from the use, maintenance or rental of containers used in international traffic is likewise exempt from source-country taxation under the proposed Convention.

The proposed Convention carries over from the existing treaty special rules regarding offshore exploration and exploitation activities. These rules were included at the request of the United Kingdom. The proposed Convention reflects technical changes to avoid some unintended consequences of the old rules and provides a slightly higher threshold for taxation of employees working in the offshore oil sector.

The proposed Convention contains rules to coordinate the two countries' regimes for the tax treatment of pensions and pension contributions. These rules are more comprehensive than those in recent U.S. treaties and the existing Convention. Under the proposed Convention, the United States and the United Kingdom each will treat pension plans established in the other State the same way comparable domestic plans are treated. A similar rule applies to earnings and accretions of pension plans and to employer contributions to pension plans. In addition, the proposed Convention provides for the exclusive residence-based taxation of Social Security payments, which is different from the U.S. Model but consistent with the existing Convention.

The proposed Convention also deals with income earned by entertainers and sportsmen, corporate directors, government employees and students in a manner consistent with the rules of the U.S. Model. The Convention continues a host-country exemption for income earned by teachers that is found in the existing treaty, although not in the U.S. Model.

The proposed Convention contains comprehensive rules in its "Limitation on Benefits" article, designed to deny "treaty-shoppers" the benefits of the Convention. This article is essentially the same as the limitation on benefits articles contained in recent U.S. treaties.

At the request of the United Kingdom, the proposed Convention includes an additional limit on the availability of certain treaty benefits obtained in connection with "conduit arrangements." The conduit arrangement test may apply to deny treaty benefits in certain tax avoidance cases involving the payment of insurance premiums, dividends, interest, royalties, or other income. The conduit arrangement test is not contained in the U.S. Model. The test is designed primarily to allow the United Kingdom to address treaty shopping transactions that would not be caught by the limitation on benefits article of the proposed Convention. U.K. domestic law does not provide sufficient protection against such abusive transactions, but U.S. domestic law does. The tax authorities of the two countries have agreed on an interpretation of the term "conduit arrangement" that is consistent with existing tax avoidance doctrines and measures under U.S. law.

The proposed Convention provides relief from double taxation in a manner consistent with the U.S. Model and eliminates the provision of the existing treaty that obligates the United States to provide a foreign tax credit for "phantom" dividend withholding taxes. The proposed Convention also contains a re-sourcing rule to ensure that a U.S. resident can obtain a U.S. foreign tax credit for U.K. taxes paid when the Convention assigns to the United Kingdom primary taxing rights over an item of gross income. A comparable rule applies for purposes of the U.K. foreign tax credit. Although the U.S. Model does not contain a re-sourcing rule, the existing Convention contains a similar rule.

Like the existing treaty, the proposed Convention provides a credit for the U.K. Petroleum Revenue Tax, limited to the amount of the tax attributable to sources within the United Kingdom. The credit allowed by the proposed Convention is somewhat broader than that allowed under the existing Convention to account for intervening changes in U.S. domestic law.

The proposed Convention provides for non-discriminatory treatment (i.e., national treatment) by one country to residents and nationals of the other. Also included in the proposed treaty are rules necessary for administering the treaty, including rules for the resolution of disputes under the Convention. The information exchange provisions generally follow the U.S. Model and make clear that the United Kingdom will provide U.S. tax officials such information as is relevant to carry out the provisions of the Convention and the domestic tax laws of the United States. Inclusion of this U.S. Model provision was made possible by a recent change in U.K. law.

Australia

The proposed Protocol to the Income Tax Convention with Australia was signed in Canberra on September 27, 2001. It was negotiated to bring the current Convention, concluded in 1982, up to date and into closer conformity with current

U.S. tax treaty practice, while also incorporating some provisions found in the Australian Model income tax convention.

The most important aspects of the proposed Protocol deal with the taxation of cross-border dividend, royalty and interest payments. The current treaty provides for levels of source-country taxation that are consistent with Australian treaty practice but substantially higher than the preferred U.S. position. We were able to negotiate substantial reductions with respect to all three categories of payments.

Whereas the existing Convention allows for taxation at source of 15 percent on all dividends, the proposed Protocol provides for a maximum source-country withholding tax rate of 5 percent on direct dividends that meet a 10 percent ownership threshold. The proposed Protocol also provides for the elimination of the source-country withholding taxes with respect to dividends from certain 80 percent owned corporate subsidiaries. Portfolio dividends will continue to be subject to a 15 percent rate of withholding. Australia imposes a withholding tax on dividends paid out of earnings that have not been subject to full corporate tax ("unfranked dividends"), which will be eliminated under the proposed Protocol.

Dividends paid by U.S. regulated investment companies and real estate investment trusts are subject to special rules to prevent the use of these entities to obtain withholding rate reductions that would not otherwise be available. The provision was adapted to recognize the special investment structure of Australian unit trusts and their participation in the U.S. REIT industry.

The proposed Protocol provides for the elimination of source-country withholding taxes on interest payments in two key cases. Interest derived by a financial institution that is unrelated to the payor and interest paid to governmental entities are exempt from withholding tax at source. All other types of interest (including interest received by financial institutions in back-to-back loans or their economic equivalent) continue to be subject to source-country withholding tax at the 10 percent maximum rate prescribed in the existing Convention.

The proposed Protocol also reduces the maximum level of withholding tax on royalty payments from the 10 percent limit prescribed in the existing Convention to 5 percent. The existing Convention treats rental payments for the use of or the right to use any industrial, commercial or scientific equipment as royalties that may be taxed by the source country at a maximum rate of 10 percent. The proposed Protocol eliminates the source-country withholding tax on such income by treating this category of income as business profits. These changes in the treatment of royalties represent a major concession by Australia, which has never agreed in a treaty to lower its withholding tax on royalties below 10 percent.

The proposed Protocol brings the existing Convention's treatment of income from the operation of ships, aircraft and containers in international traffic closer to that of the U.S. Model. The proposed Protocol provides for exclusive residence-country taxation of profits from the rental of ships and aircraft on a bareboat basis when the rental activity is incidental to the operation in international traffic of ships or aircraft by the lessor. All income from the use, maintenance or rental of containers used in international traffic is likewise exempt from source-country taxation under the proposed Protocol.

The proposed Protocol clarifies that Australia's tax on capital gains will be a covered tax for purposes of the existing Convention. This closes a gap in the existing Convention and increases the likelihood that U.S. taxpayers subject to capital gains tax in Australia will be able to claim a foreign tax credit with respect to that tax thereby avoiding potential double taxation. The proposed Protocol generally preserves the existing Convention's tax treatment of capital gains, while incorporating some aspects of Australia's domestic law regarding expatriation. The proposed Protocol also provides rules that coordinate both countries' tax systems with respect to these expatriation rules.

The proposed Protocol contains an updated version of a comprehensive "Limitation on Benefits" article, designed to deny "treaty-shoppers" the benefits of the

Convention. This article is essentially the same as the limitation on benefits article contained in recent U.S. treaties.

The current Convention preserves the U.S. right to tax former citizens whose loss of citizenship had as one of its principal purposes the avoidance of tax. The proposed Protocol expands this right to include former long-term residents whose loss of such status had, as one of its principal purposes, the avoidance of tax. Therefore, the United States may fully apply the provisions of section 877 of the Internal Revenue Code.

Mexico

The proposed Protocol to the Income Tax Convention with Mexico was signed in Mexico City on November 26, 2002. It was negotiated to bring the existing Convention, concluded in 1992, into closer conformity with current U.S. tax treaty policy.

The major feature of the proposed Protocol is the treatment of intercompany dividends. As in the agreements with the United Kingdom and Australia, the proposed Protocol eliminates source-country withholding taxes on certain types of cross-border direct dividends. Under the existing Convention, dividends may be taxed by the country of source at a maximum rate of 5 percent on direct dividends (where the recipient of the dividends owns at least 10 percent of the company paying the dividends) and 10 percent with respect to all other dividends. The proposed Protocol eliminates withholding taxes with respect to dividends from certain 80-percent owned corporate subsidiaries. The other rules will remain in place with respect to those dividends that do not qualify for the elimination of the source-country withholding tax. Dividends paid to qualified pension funds also will be exempt from withholding tax at source.

While Mexico does not currently impose a withholding tax on dividends, it has enacted such a tax and then repealed it since the existing treaty was negotiated in the early 1990's. As a result, locking in the elimination of source-country withholding taxes on intercompany dividends will provide greater certainty to U.S. taxpayers regarding the long-term tax environments for their investments in Mexico.

Dividends paid by U.S. regulated investment companies and real estate investment trusts are subject to special rules to prevent the use of these entities to obtain withholding rate reductions that would not otherwise be available.

The current treaty preserves the U.S. right to tax former citizens whose loss of citizenship had as one of its principal purposes the avoidance of tax. The proposed Protocol expands this right to include former long-term residents whose loss of such status had, as one of its principal purposes, the avoidance of tax. Therefore, the United States may fully apply the provisions of section 877 of the Internal Revenue Code.

The proposed Protocol incorporates a modernized provision regarding the source of income that will be more effective in eliminating double taxation. Under the new provision, income that may be taxed by one of the parties to the Convention will generally be treated as arising in that country. Thus, the other country generally will exempt that income or provide a credit for the taxes paid with respect to such income.

Treaties under Negotiation

We continue to maintain an active calendar of tax treaty negotiations. We are in active negotiations with Japan, the Netherlands, Iceland, Hungary, Barbados, France, Bangladesh, Canada, and Korea. We have also signed an agreement with Sri Lanka which we expect will be ready for transmittal to the Senate soon. In accordance with the treaty program priorities noted earlier, we continue to seek appropriate opportunities for tax treaty discussions and negotiations with several countries in Latin America and in the developing world generally.

Conclusion

Let me conclude by again thanking the Committee for its continuing interest in the tax treaty program, and the Members and staff for devoting the time and attention to the review of the agreements that are pending before you. We also appreciate the assistance and cooperation of the staffs of this Committee and of the Joint Committee on Taxation in the tax treaty process.

We urge the Committee to take prompt and favorable action on the three agreements before you today. Such action will strengthen and expand our economic relations with countries that have been significant economic and political partners for many years and will help to further reduce barriers to cross-border trade and investment.

- Mexico
- Australia
- United Kingdom

DEPARTMENT OF THE TREASURY
TECHNICAL EXPLANATION OF THE PROTOCOL BETWEEN
THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE
GOVERNMENT OF THE UNITED MEXICAN STATES
SIGNED AT MEXICO CITY ON NOVEMBER 26, 2002, AMENDING THE CONVENTION
BETWEEN THE UNITED STATES OF AMERICA AND MEXICO WITH RESPECT TO
TAXES ON INCOME SIGNED AT WASHINGTON ON SEPTEMBER 18, 1992, ALONG
WITH A PROTOCOL, AND AN ADDITIONAL PROTOCOL THAT MODIFIES THE
CONVENTION SIGNED AT MEXICO CITY ON SEPTEMBER 8, 1994.

This is a technical explanation of the Protocol between the United States and Mexico, signed on November 26, 2002, (the "Protocol") amending the Convention between the United States of America and the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed on September 18, 1992, along with a protocol, and an additional protocol that modifies the Convention, signed on September 8, 1994.

Negotiations took into account the U.S. Treasury Department's current tax treaty policy and the U.S. Treasury Department's Model Income Tax Convention, published on September 20, 1996 (the "U.S. Model"). Negotiations also took into account the Model Tax Convention on Income and Capital , published by the Organization for Economic Cooperation and Development, as updated in April 2000 (the "OECD Model"), and recent tax treaties concluded by both countries.

The Technical Explanation is an official guide to the Protocol. It reflects the policies behind particular Protocol provisions, as well as understandings reached with respect to the application and interpretation of the Protocol. References in the Technical Explanation to "he" or "his" should be read to mean "he or she" or "his or her."

Article I

Article I of the Protocol replaces the existing Article 1 (General Scope) of the Convention with a new Article which reflects current U.S. tax treaty policy. Article 1 as amended extends to former long-term residents the tax treaty regime applicable to former U.S. citizens who renounce their citizenship for tax avoidance reasons (section 877 of the U.S. Internal Revenue Code (the "Code")), and provides rules that clarify the relationship between the Convention and other agreements between the Contracting States with respect to taxation measures.

Article 1 (General Scope)

Paragraph 1

Paragraph 1 of Article 1 provides that the Convention applies to residents of the United States or Mexico, except where the terms of the Convention provide otherwise. This paragraph has simply been restated and not amended. Under Article 4 (Residence), a person is generally treated as a resident of a Contracting State if that person is, under the laws of that State, liable to tax therein by reason of his domicile, residence or other similar criteria. However, if a person is considered a resident of both Contracting States, Article 4 provides rules for determining a single State of residence (or no State of residence). This determination governs for all purposes of the Convention.

Certain provisions are applicable to persons who may not be residents of either Contracting State. For example, Article 20 (Government Service) may apply to an employee of a Contracting State who is resident in neither State. Under Article 27 (Exchange of Information), information may be exchanged with respect to residents of third states.

Paragraph 2

Paragraph 2 states the generally accepted relationship both between the Convention and domestic law and between the Convention and other agreements between the Contracting States (*i.e.*, that no provision in the Convention may restrict any exclusion, exemption, deduction, credit or other allowance accorded by the tax laws of the Contracting States, or by any other agreement between the Contracting States). This paragraph has simply been restated and not amended. The relationship between the non-discrimination provisions of the Convention and other agreements is addressed not in paragraph 2 but in paragraph 3.

Under paragraph 2, for example, if a deduction would be allowed under the Code in computing the U.S. taxable income of a resident of Mexico, the deduction also is allowed to that person in computing taxable income under the Convention. Paragraph 2 also means that the Convention may not increase the tax burden on a resident of a Contracting State beyond the burden determined under domestic law. Thus, a right to tax given by the Convention cannot be exercised unless that right also exists under internal law.

It follows that, under the principle of paragraph 2, a taxpayer's U.S. tax liability need not be determined under the Convention if the Code would produce a more favorable result. A taxpayer may not, however, choose among the provisions of the Code and the Convention in an inconsistent manner in order to minimize tax. For example, assume that a resident of Mexico has three separate businesses in the United States. One is a profitable permanent establishment and the other two are trades or businesses that would earn taxable income under the Code but that do not meet the permanent establishment threshold tests of the Convention. One is profitable and the other incurs a loss. Under the Convention, the income of the permanent establishment is taxable in the United States, and both the profit and loss of the other two businesses are ignored. Under the Code, all three would be subject to tax, but the loss would offset the profits of the two profitable ventures. The taxpayer may not invoke the Convention to exclude the profit of the profitable trade or business and invoke the Code to claim the loss of the losing trade or business against the profit of the permanent establishment. *See* Rev. Rul. 84-17, 1984-1 C.B. 308. If, however, the taxpayer invokes the Code for the taxation of all three ventures, the taxpayer would not be precluded from invoking the Convention, for example, with respect to any dividend income the taxpayer may receive from the United States that is not effectively connected with any of the taxpayer's business activities in the United States.

Similarly, nothing in the Convention can be used to deny any benefit granted by any other agreement between the United States and Mexico. For example, if certain benefits are provided for military personnel or military contractors under a Status of Forces Agreement between the United States and Mexico, those benefits will be available to residents of the Contracting States regardless of any provisions to the contrary (or silence) in the Convention.

Paragraph 3

Paragraph 3 specifically relates to non-discrimination obligations of the Contracting States under other agreements. The provisions of paragraph 3 are an exception to the rule provided in subparagraph (b) of paragraph 2 of this article under which the Convention shall not restrict in any manner any benefit now or hereafter accorded by any other agreement between the Contracting States.

Subparagraph (a) of paragraph 3 provides that, notwithstanding any other agreement to which the Contracting States may be parties, a dispute concerning the interpretation or application of the Convention, including a dispute concerning whether a taxation measure is within the scope of the Convention, shall be considered only by the competent authorities of the Contracting States, and the procedures under Article 26 (Mutual Agreement Procedure) of the Convention exclusively shall apply to the dispute. Thus, dispute-resolution procedures that may be incorporated into trade, investment, or other agreements between the Contracting States shall not apply in determining the scope of the Convention.

Subparagraph (b) of paragraph 3 provides that no other agreement to which the United States and Mexico are parties shall apply with respect to a taxation measure unless the competent authorities agree that the measure is not within the scope of the non-discrimination provisions of Article 25 (Non-Discrimination) of the Convention. Accordingly, if the non-discrimination provisions of this Convention apply to a taxation measure, no national treatment or most-favored-nation ("MFN") obligations undertaken by the Contracting States in any other agreement shall apply to that taxation measure.

Although the language in paragraph 3 is somewhat broader than that of the equivalent provision in the U.S. Model, the effect of the two provisions is similar. Under the U.S. Model, the only national treatment or MFN provision that may apply to a taxation measure that is within the scope of the Convention are those that apply under the GATT with respect to trade in goods. In contrast, the provision in the Convention does not specifically affirm the applicability of GATT to taxation measures that are also within the scope of Article 25. However, Article 25 of the Convention is concerned with treatment of nationals and residents of the other Contracting State, not with the treatment of trade in goods. Therefore, it is unlikely that any taxation measure that would violate the national treatment or MFN provisions of the GATT would be found to be within the scope of Article 25. If the competent authorities agree that the relevant taxation measure is not within the scope of Article 25, then the national treatment and MFN provisions of the GATT would apply with respect to that taxation measure, just as they would under the provision in the U.S. Model.

Paragraph 3 defines a "measure" broadly. It would include, for example, a law, regulation, rule, procedure, decision, administrative action, or any other form of governmental action or guidance.

Paragraph 4

Paragraph 4 contains the traditional saving clause found in U.S. tax treaties. The Contracting States reserve their rights, except as provided in paragraph 5, to tax their residents and citizens as provided in their internal laws, notwithstanding any provisions of the Convention to the contrary. For example, if a resident of Mexico performs professional services in the United States and the income from the services is not attributable to a permanent establishment in the United States, Article 7 (Business Profits) would by its terms prevent the United States from taxing the income. If, however, the resident of Mexico is also a citizen of the United States, the saving clause permits the United States to include the remuneration in the worldwide income of the citizen and subject it to tax under the normal Code rules (*i.e.*, without regard to Code section 894(a)). However, subparagraph 5(a) of this Article preserves the benefits of special foreign tax credit rules applicable to the U.S. taxation of certain U.S. income of its citizens resident in Mexico. See paragraph 4 of Article 24 (Relief from Double Taxation).

For purposes of the saving clause, "residence" is determined under Article 4 (Residence). Thus, an individual who is a U.S. resident under the Internal Revenue Code but who is deemed to be a resident of Mexico under the tie-breaker rules of Article 4 would be subject to U.S. tax only to the extent permitted by the Convention. For example, if an individual who is not a U.S. citizen is a resident of the United States under the Code, and is also a resident of Mexico under its law, and that individual has a permanent home available to him in Mexico and not in the United States, he would be treated as a resident of Mexico under Article 4 and for purposes of the saving clause. The United States would not be permitted to apply its statutory rules to that person if they are inconsistent with the treaty.

However, the person would be treated as a U.S. resident for U.S. tax purposes other than determining the individual's U.S. tax liability. For example, in determining under Code section 957 whether a foreign corporation is a controlled foreign corporation, shares in that corporation held by the individual would be considered to be held by a U.S. resident. As a result, other U.S. citizens or residents might be deemed to be United States shareholders of a controlled foreign corporation subject to current inclusion of Subpart F income recognized by the corporation. See Treas. Reg. section 301.7701(b)-7(a)(3). The application of the saving clause to former citizens and long-term residents is not addressed in paragraph 4, but in paragraphs 6, 7, and 8.

Paragraph 5

Some provisions are intended to provide benefits to citizens and residents even if such benefits do not exist under internal law. Paragraph 5 sets forth certain exceptions to the saving clause that preserve these benefits for citizens and residents of the Contracting States.

Subparagraph (a) lists certain provisions of the Convention that are applicable to all citizens and residents of a Contracting State, despite the general saving clause rule of paragraph 4:

(1) Paragraph 2 of Article 9 (Associated Enterprises) grants the right to a correlative adjustment with respect to income tax due on profits reallocated under Article 9.
(2) Subparagraph 1(b) and paragraph 3 of Article 19 (Pensions, Annuities, Alimony, and Child Support) provide exemptions from source or residence State taxation for certain pension distributions, social security payments and child support.
(3) Article 22 (Exempt Organizations) provides for reciprocal recognition of tax-exempt, charitable organizations resident in a Contracting State and qualifying for benefits of the Convention under paragraph 1(e) or 2 of Article 17 (Limitation on Benefits).
(4) Article 24 (Relief from Double Taxation) confirms the benefit of a credit to citizens and residents of one Contracting State for income taxes paid to the other, even if such a credit may not be available under the Code.
(5) Article 25 (Non-Discrimination) requires one Contracting State to grant national treatment to nationals of the other Contracting State in certain circumstances. Excepting this Article from the saving clause requires, for example, that the United States give such benefits to a national of Mexico even if that person is a citizen of the United States.
(6) Article 26 (Mutual Agreement Procedure) may confer benefits on residents or nationals of the Contracting States. For example, the statute of limitations may be waived for refunds and the competent authorities are permitted to use a definition of a term that differs from the internal law definition.

As with the foreign tax credit, these benefits are intended to be granted by a Contracting State to its citizens and residents.

Subparagraph (b) of paragraph 5 provides a different set of exceptions to the saving clause. The benefits referred to are all intended to be granted to temporary residents of a Contracting State (for example, in the case of the United States, holders of non- immigrant visas), but not to citizens or to persons who have acquired permanent residence in that State. If beneficiaries of these provisions travel from one of the Contracting States to the other, and remain in the other long enough to become residents under its internal law, but do not acquire permanent residence status (*i.e.*, in the U.S. context, they do not become "green card" holders) and are not citizens of that State, the host State will continue to grant these benefits even if they conflict with statutory rules. The benefits preserved by this paragraph are the host country exemptions for the following items: government service salaries and pensions under Article 20 (Government Service); certain income of visiting students or business apprentices under Article 21 (Students); and the income of diplomatic agents and consular officers under Article 28 (Diplomatic Agents and Consular Officers).

Paragraph 6

Under subparagraph (a) of paragraph 6, each Contracting State reserves for a period of ten years its right to tax former citizens and long-term residents whose loss of citizenship or long-term resident status had as one of its principal purposes the avoidance of tax. Thus, the saving clause in paragraph 4 applies to such persons for a period of ten years.

In the case of the United States, section 877 of the Code applies to former citizens and long-term residents of the United States whose loss of citizenship or long-term resident status had as one of its principal purposes the avoidance of tax. Under section 877, the United States generally treats an individual as having a principal purpose to avoid tax if either of the following criteria exceed established thresholds: (a) the average annual net income tax of such individual for the period of 5 taxable years ending before the date of the loss of status, or (b) the net worth of such individual as of the date of the loss of status. The thresholds are adjusted annually for inflation. Section 877(c) provides certain exceptions to these presumptions of tax avoidance. Paragraphs 7 and 8 provide similar factors that will be considered in favor of the taxpayer for purposes of determining whether one of the principal purposes of a change in status of a former citizen or long-term resident is the avoidance of tax.

Subparagraph (b) of paragraph 6 defines the term "long-term resident" of a Contracting State as an individual (other than a citizen of that State) who is a lawful permanent resident of that State in at least 8 of the 15 taxable years ending with the taxable year in which the individual ceased to be a long-term resident. In determining whether this threshold is met, the Convention provides that an individual will not be treated as a lawful permanent resident for any year in which the individual is: (1) treated as a resident of the other Contracting State, or as a resident of any country other than the first-mentioned State under the provisions of any other tax treaty of that Contracting State, and (2) the individual does not waive the benefits of such treaty applicable to residents of the other country. This test is consistent with U.S. law.

Paragraph 7

In the case of an individual who is a former citizen of a Contracting State, a number of factors may be considered by that Contracting State in determining whether or not one of the principal purposes of that individual's loss of citizenship ("expatriation") was the avoidance of tax. Paragraph 7 sets forth the following factors which will be considered in favor of the taxpayer for purposes of determining whether a former citizen had a tax avoidance purpose for expatriating: (1) the individual is, at the time of his expatriation, a resident fully liable to tax in the other Contracting State, or becomes a resident fully liable to tax within a reasonable period after his expatriation; and (2) the individual meets one of the following four additional requirements: (a) the individual was a citizen of both Contracting States at birth and has remained a citizen of the other Contracting State; (b) at the time of expatriation (or within a reasonable period thereafter), the individual was or became a citizen of the other Contracting State, and that other Contracting State is the individual's country of birth, the country of birth of that individual's spouse, or the country of birth of either of that individual's parents; (c) in the 10 years prior to expatriation, the individual was present in the Contracting State from which he expatriated for no more than 30 days in each taxable year or year of assessment; or (d) the individual expatriated before he reached the age of 18 ½ years. This provision is consistent with U.S. law.

Paragraph 8

In the case of an individual who is a former long-term resident of a Contracting State, a number of factors may be considered by that Contracting State in determining whether or not one of the principal purposes of that individual's loss of long-term resident status ("expatriation") was the avoidance of tax. Paragraph 8 sets forth the following factors which will be considered favorably for purposes of determining whether a former long-term resident had a tax avoidance purpose for expatriating: (1) at the time of the individual's expatriation (or within a reasonable time thereafter) the individual is or becomes a resident fully liable to tax in the other Contracting State and that other Contracting State is the individual's country of birth, the country of birth of that individual's spouse, or the country of birth of either of that individual's parents; (2) in the 10 years prior to expatriation, the individual was present in the Contracting State from which he expatriated for no more than 30 days in each taxable year or year of assessment; or (3) the individual expatriated before he reached the age of 18 ½ years. This provision is consistent with U.S. law.

Article II

Paragraph a) of Article II of the Protocol replaces Article 10 (Dividends) of the Convention. Article 10 provides rules for the taxation of dividends paid by a company that is a resident of one Contracting State to a beneficial owner that is a resident of the other Contracting State. The Article provides for full residence country taxation of such dividends and a limited source-State right to tax. Finally, the Article prohibits a State from imposing taxes on a company resident in the other Contracting State, other than a branch profits tax, on undistributed earnings.

Paragraph 1

The right of a shareholder's country of residence to tax dividends arising in the source country is preserved by paragraph 1, which permits a Contracting State to tax its residents on dividends paid to them by a company that is a resident of the other Contracting State. This paragraph has simply been restated and not amended.

Paragraph 2

The State of source also may tax dividends beneficially owned by a resident of the other State, subject to the limitations of paragraphs 2 and 3. Paragraph 2 generally limits the withholding tax in the State of source on the dividend paid by a company resident in that State to 10 percent of the gross amount of the dividend. If, however, the beneficial owner of the dividend is a company resident in the other State and directly owns shares representing at least 10 percent of the voting power of the company paying the dividend, then the withholding tax in the State of source is limited to 5 percent of the gross amount of the dividend. Shares are considered voting shares if they provide the power to elect, appoint or replace any person vested with the powers ordinarily exercised by the board of directors of a U.S. corporation.

The benefits of paragraph 2 may be granted at the time of payment by means of reduced withholding at source. It also is consistent with the paragraph for tax to be withheld at the time of payment at full statutory rates, and the treaty benefit to be granted by means of a subsequent refund so long as such procedures are applied in a reasonable manner.

Paragraph 2 does not affect the taxation of the profits out of which the dividends are paid. The taxation by a Contracting State of the income of its resident companies is governed by the internal law of the Contracting State, subject to the provisions of paragraph 5 of Article 25 (Non-Discrimination).

The term "beneficial owner" is not defined in the Convention, and is, therefore, defined as under the internal law of the country imposing tax (*i.e.*, the source country). The beneficial owner of the dividend for purposes of Article 10 is the person to which the dividend income is attributable for tax purposes under the laws of the source State. Thus, if a dividend paid by a corporation that is a resident of one of the States (as determined under Article 4 (Residence)) is received by a nominee or agent that is a resident of the other State on behalf of a person that is not a resident of that other State, the dividend is not entitled to the benefits of this Article. However, a dividend received by a nominee on behalf of a resident of that other State would be entitled to benefits. These limitations are confirmed by paragraph 12 of the OECD Commentaries to Article 10. See also paragraph 24 of the Commentary to Article 1 of the OECD Model.

Companies holding shares through fiscally transparent entities such as partnerships are considered for purposes of this paragraph to hold their proportionate interest in the shares held by the intermediate entity. As a result, companies holding shares through such entities may be able to claim the benefits of subparagraph (a) under certain circumstances. The lower rate applies when the company's proportionate share of the shares held by the intermediate entity meets the 10 percent threshold. Whether this ownership threshold is satisfied may be difficult to determine and often will require an analysis of the partnership or trust agreement.

Paragraph 3

Paragraph 3 provides exclusive residence-country taxation (*i.e.* a zero rate of withholding tax) with respect to certain dividends distributed by a company resident in one Contracting State to a resident in the other Contracting State. As described further below, the zero rate of withholding tax is available with respect to certain intercompany dividends and with respect to dividends received by tax-exempt pension funds.

Subparagraph (a) of paragraph 3 reduces the withholding tax rate to zero on dividends beneficially owned by a company that has owned directly 80 percent or more of the voting power of the company paying the dividend for the 12-month period ending on the date the dividend is declared.

Eligibility for the zero rate of withholding tax provided by subparagraph (a) is subject to an additional restriction which states that companies qualifying for treaty benefits by virtue of the active trade or business, ownership-base erosion or subsidiaries of a publicly traded NAFTA company tests must have acquired shares representing 80 percent or more of the voting stock of the company paying the dividends prior to October 1, 1998. This restriction supplements those imposed under Article 17 (Limitation on Benefits), and is necessary because of the increased pressure on the Limitation on Benefits tests resulting from the fact that the Convention is one of the first U.S. tax treaties to provide for a zero rate of withholding tax on intercompany dividends. The test is intended to prevent companies from re-organizing in order to become eligible for the zero rate of withholding tax in circumstances where the Limitation on Benefits provision does not provide sufficient protection against treaty-shopping.

For example, assume that ThirdCo is a company resident in a third state. ThirdCo owns directly 100% of the issued and outstanding voting stock of USCo, a U.S. company, and of MEXCo, a Mexican company. MEXCo is a substantial company that manufactures widgets; USCo distributes those widgets in the United States. If ThirdCo contributes to MEXCo all the stock of USCo, dividends paid by USCo to MEXCo would qualify for treaty benefits under the active trade or business test of subparagraph (c) of paragraph 1 of Article 17. However, allowing ThirdCo to qualify for the zero rate of withholding tax, which is not available to it under the third state's tax treaty with the United States (if any), would encourage treaty-shopping.

In order to prevent this type of treaty-shopping, the Convention imposes an additional holding requirement on companies that qualify for benefits only under paragraphs 1(c) (the active trade or business test), 1(d)(iii) (the subsidiaries of a publicly traded NAFTA company test) or 1(f) (the ownership-base erosion test) of Article 17. For those companies, the zero rate of withholding tax is available only with respect to dividends received from companies that the recipient company owned, directly or indirectly, prior to October 1, 1998.

Accordingly, in the example above, MEXCo will not qualify for the zero rate of withholding tax on dividends unless it owned USCo before October 1, 1998. If it did own USCo before October 1, 1998, then it will continue to qualify for the zero rate of withholding tax on dividends so long as it qualifies for benefits under at least one of the tests of Article 17. So, for example, if ThirdCo decided to get out of the widget business and sold its stock in MEXCo to FWCo, a company that is resident in a country with which the United States does not have a tax treaty, MEXCo would continue to qualify for the zero rate of withholding tax on dividends so long as it continued to meet the requirements of the active trade or business test of Article 17(1)(c) or, possibly, the competent authority discretionary test of Article 17(2).

The results would be different under the "ownership-base erosion" test of Article 17(1)(f). For example, assume MEXCo is a passive holding company owned by Mexican individuals, which was established in 1996 to hold the shares of USCo. MEXCo qualifies for benefits only under the ownership-base erosion test of Article 17(1)(f). If the Mexican individuals sold their stock in MEXCo to FWCo, MEXCo would lose all the benefits accorded to residents of Mexico under the Convention (including the zero rate of withholding tax on dividends) because the company would not longer qualify for benefits under Article 17 (unless, of course, the U.S. competent authority were to grant benefits under Article 17(2)).

Other methods of qualifying under Limitation on Benefits do not raise the same concerns. Accordingly, a resident of a Contracting State that satisfies Limitation on Benefits by virtue of being a publicly-traded company or a subsidiary of a publicly-traded company does not have to meet the October 1, 1998 holding requirement. Thus, a Mexican resident company that meets the listing and trading requirements of Article 17(1)(d)(i) or (ii) will be entitled to the zero withholding rate on dividends no matter when it acquired the shares of the U.S. company (subject to the 12-month holding period requirement of Article 10(3)(a)).

Under Article 10(3)(a)(iii), a company that is a resident of a Contracting State may also qualify for the zero rate of withholding tax on dividends if it satisfies the derivative benefits test of Article 17(1)(g), even if it acquired the U.S. company after September 30, 1998 (subject to the 12-month holding requirement). As of the date of signing of the Protocol no company can qualify for the zero rate under the derivative benefits test because neither the U.S.-Canada nor the Mexico-Canada tax treaty provides for a zero rate of withholding taxes on dividends.

If a company does not qualify for the zero rate of withholding tax under any of the foregoing tests, it may request a determination from the relevant competent authority pursuant to paragraph 2 of Article 17. Benefits may be granted with respect to an item of income if the competent authority of the Contracting State in which the income arises determines that the establishment, acquisition or maintenance of such resident and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under the Convention. As noted below, paragraph 8 of Article 10 anticipates that the competent authorities may develop a commonly-agreed application of Article 17(2) as it relates to the zero rate of withholding tax.

Subparagraph (b) of paragraph 3 allows the zero rate of withholding tax for dividends beneficially owned by a trust, company, or other organization constituted and operated exclusively to provide benefits under a pension, retirement, or other employee benefit plan. In order to qualify for the zero rate of withholding tax, the trust, company or other organization must be generally exempt from tax in the Contracting State of which it is a resident, and the dividends must not be derived from the carrying on of a business, directly or indirectly, by such trust, company or organization. This exemption is parallel to an existing exemption from the withholding tax on interest available to pension funds under Article 11(4)(c).

Paragraph 4

Paragraph 4 modifies in particular cases the maximum rates of withholding tax at source provided in paragraphs 2 and 3.

Subparagraph (a) provides that dividends paid by a RIC or a REIT are not eligible for the 5 percent maximum rate of withholding tax in subparagraph (a) of paragraph 2 or the zero rate of withholding tax of subparagraph (a) of paragraph 3. As described below, the zero rate provided by subparagraph (b) of paragraph 3 (with respect to dividends paid to a pension plan) will be available with respect to dividends paid by RICs and REITs in certain circumstances.

Subparagraph (b) of paragraph 4 provides that the 10 percent maximum rate of withholding tax in subparagraph (b) of paragraph (2), and the zero rate of withholding tax of subparagraph (b) of paragraph 3 with respect to pension funds, shall apply for dividends paid by a RIC.

Subparagraph (c) provides that the 10 percent withholding rate in subparagraph (b) of paragraph (2), and the zero rate of subparagraph (b) of paragraph 3 with respect to pensions, shall apply for dividends paid by a REIT, provided certain conditions are met. Pursuant to subparagraph (c)(i) of paragraph 4, a pension plan will qualify for the zero rate of withholding tax with respect to dividends paid by REITs, provided that the pension plan holds an interest of not more than 10 percent in the REIT. Other investors will qualify for the 10 percent rate of withholding tax if one of three conditions is met. First, the dividend may qualify for the 10 percent rate of withholding tax if the person beneficially entitled to the dividend is an individual holding an interest of not more than 10 percent in the REIT. Second, the dividend may qualify for the 10 percent rate of withholding tax if it is paid with respect to a class of stock that is publicly traded and the person beneficially entitled to the dividend is a person holding an interest of not more than 5 percent of any class of the REIT's stock. Third, the dividend may qualify for the 10 percent rate of withholding tax if the person beneficially entitled to the dividend holds an interest in the REIT of not more than 10 percent and the REIT is "diversified" (*i.e.*, the gross value of no single interest in real property held by the REIT exceeds 10 percent of the gross value of the REIT's total interest in real property). For purposes of this diversification test, foreclosure property is not considered an interest in real property, and a REIT holding a partnership interest is treated as owning its proportionate share of any interest in real property held by the partnership.

The restrictions set forth above are intended to prevent the use of RICs and REITs to gain inappropriate source-country tax benefits for certain shareholders resident in Mexico. For example, a company resident in Mexico that wishes to hold a diversified portfolio of U.S. corporate shares could hold the portfolio directly and pay a U.S. withholding tax of 10 percent on all of the dividends that it receives. Alternatively, it could hold the same diversified portfolio by purchasing 10 percent or more of the interests in a RIC. If the RIC is a pure conduit, there may be no U.S. tax cost to interposing the RIC in the chain of ownership. Absent the special rule in paragraph 4, such use of the RIC could transform portfolio dividends, taxable in the United States under the Convention at 10 percent, into direct investment dividends taxable at zero or 5 percent.

Similarly, a resident of Mexico directly holding U.S. real property would pay U.S. tax either at a 30 percent rate on the gross income or at graduated rates on the net income. As in the preceding example, by placing the real property in a REIT, the investor could transform real estate income into dividend income, taxable at the rates provided in Article 10, significantly reducing the U.S. tax that otherwise would be imposed. Paragraph 4 prevents this result and thereby avoids a disparity between the taxation of direct real estate investments and real estate investments made through REIT conduits. In the cases covered by the exceptions, the holding in the REIT is not considered the equivalent of a direct holding in the underlying real property.

Paragraph 5

Paragraph 5 excludes from the general source country limitations under paragraph 2 and 3 dividends paid with respect to holdings that form part of the business property of a permanent establishment or fixed base situated in the source country. This paragraph has simply been restated and not amended. Such dividends will be taxed on a net basis using the rates and rules of taxation generally applicable to residents of the State in which the permanent establishment is located, as modified by the Convention. An example of dividends paid with respect to the business property of a permanent establishment would be dividends derived by a dealer in stock or securities from stock or securities that the dealer held for sale to customers. In such a case, Article 7 (Business Profits) applies with respect to business profits from a permanent establishment and Article 14 (Independent Personal Services) applies to income from the performance of personal services in an independent capacity from a fixed base.

The provisions of this paragraph shall apply to dividends attributable to a permanent establishment or fixed base even in the case of a permanent establishment or fixed base that once existed in the State but that no longer exists. See the Technical Explanation of paragraph 2 of Article 7 and of Article 14.

Paragraph 6

Paragraph 6 provides a broad and flexible definition of the term "dividends." This paragraph has simply been restated and not amended. The definition is intended to cover all arrangements that yield a return on an equity investment in a corporation as determined under the tax law of the state of source, as well as arrangements that might be developed in the future.

The term dividends includes income from shares, or other corporate rights that are not treated as debt under the law of the source State, that participate in the profits of the company. The term also includes income that is subjected to the same tax treatment as income from shares by the law of the State of source. Thus, a constructive dividend that results from a non-arm's length transaction between a corporation and a related party is a dividend.

In the case of the United States, the term dividend includes amounts treated as a dividend under U.S. law upon the sale or redemption of shares or upon a transfer of shares in a reorganization. See, *e.g.*, Rev. Rul. 92-85, 1992-2 C.B. 69 (sale of foreign subsidiary's stock to U.S. sister company is a deemed dividend to extent of subsidiary's and sister's earnings and profits). Further, a distribution from a U.S. publicly traded limited partnership, which is taxed as a corporation under U.S. law, is a dividend for purposes of Article 10. However, a distribution by a limited liability company is not characterized by the United States as a dividend and, therefore, is not a dividend for purposes of Article 10, provided the limited liability company is not taxable as a corporation under U.S. law.

Finally, a payment denominated as interest that is made by a thinly capitalized corporation may be treated as a dividend to the extent that the debt is recharacterized as equity under the laws of the source State. Paragraph 9 of the Convention's first protocol clarifies this by providing that each Contracting State may apply its statutory rules for distinguishing debt and equity or for preventing thin capitalization in defining dividends for purposes of this article. In the case of the United States, these rules include Code section 163(j).

Paragraph 7

A State's right to tax dividends paid by a company that is a resident of the other State is restricted by paragraph 7 to cases in which the dividends are paid to a resident of that State or are attributable to a permanent establishment in that State. Thus, a State may not impose a "secondary" withholding tax on dividends paid by a nonresident company out of earnings and profits from that State. In the case of the United States, paragraph 7, therefore, overrides the ability to impose taxes under sections 871 and 882(a) on dividends paid by foreign corporations that have a U.S. source under section 861(a)(2)(B).

Paragraph 8

Paragraph 8 provides that the competent authorities of the Contracting States shall consult each other with a view to develop a commonly agreed upon application of clause iv) of subparagraph (a) of paragraph 3 of this Article which provides that if a company does not qualify for the zero withholding rate under any of the tests provided for in paragraph 3, it may request a determination that the benefits of the zero rate of withholding tax shall be granted by the relevant competent authority pursuant to paragraph 2 of Article 17. To the extent a common application is agreed upon, the competent authorities shall publish regulations or other public guidance.

Relation to Other Articles

Notwithstanding the foregoing limitations on source country taxation of dividends, the saving clause of paragraph 4 of Article 1 (General Scope) permits the United States to tax dividends received by its residents and citizens, subject to the special foreign tax credit rules of paragraph 6 of Article 24 (Relief from Double Taxation), as if the Convention had not come into effect.

The benefits of this Article are also subject to the provisions of Article 17 (Limitation on Benefits). Thus, if a resident of Mexico is the beneficial owner of dividends paid by a U.S. company, the shareholder must qualify for treaty benefits under at least one of the tests of Article 17 in order to receive the benefits of this Article.

Paragraph b) of Article II of the Protocol replaces paragraph 8 of the Convention's existing protocol. The new paragraph provides that if the United States agrees in a tax treaty to a dividend exemption under conditions more beneficial than those in paragraph 3, the Contracting States shall, at Mexico's request, consult each other with a view to concluding another protocol to incorporate a similar provision into paragraph 3 of Article 10 (Dividends).

Paragraph c) of Article II of the Protocol is a technical correction to ensure that the provisions of the Convention's existing protocol paragraph 9 (relating to the application of statutory thin capitalization rules) will continue to refer to the definition of "dividends," which in the new Article 10 is found in paragraph 6.

Article III

Article III of the Protocol amends Article 11A (Branch Tax) of the Convention by inserting an additional paragraph 3. Paragraphs 1 and 2 of Article 11A permit a Contracting State to impose branch taxes on the dividend equivalent amount and excess interest of a company resident in the other Contracting State which derives business profits attributable to a permanent establishment located in the first-mentioned State or which derives income subject to tax on a net basis in the first-mentioned State under Article 6 (Income from Immovable (Real Property)) or Article 13 (Capital Gains).

Paragraph 3 of Article 11A provides that the branch profits tax will not be imposed if certain requirements are met. In general, these requirements provide rules for a branch that parallel the rules for when a dividend paid by a subsidiary will be subject to exclusive residence-country taxation. Accordingly, the branch profits tax may not be imposed in the case of a company which, before October 1, 1998, was engaged in activities constituting a permanent establishment (whether or not the permanent establishment was actually profitable during that period) or to income or gains that are of a type that would be subject to the provisions of Article 6 or paragraphs 1 or 4 of Article 13. In addition, the branch profits tax does not apply to a company which is a qualified person by reason of clauses (i) or (ii) of subparagraph (d) of paragraph 1 of Article 17 (Limitation on Benefits) (*i.e.*, a publicly-traded company), nor does it apply to a company that is entitled to benefits with respect to dividends under subparagraph (g) of paragraph 1 of Article 17. Finally, the branch profits tax does not apply to a company entitled to benefits under paragraph 2 of Article 17 with respect to the dividend equivalent amount.

Thus, for example, if a Mexican company would be subject to the branch profits tax with respect to profits attributable to a U.S. branch and not reinvested in that branch, paragraph 3 may apply to eliminate the branch profits tax if that branch was established in the United States before October 1, 1998 and the other requirements of the Convention (e.g., Limitation on Benefits) are met. If, by contrast, a Mexican company that did not have a branch in the United States before October 1, 1998, takes over after October 1, 1998, the activities of a branch belonging to a third party, then the branch profits tax would apply, unless the Mexican company is a qualified person under clauses (i) and (ii) of subparagraph (d) of paragraph 1 of Article 17, or is entitled to benefits under subparagraph (g) of paragraph 1, or paragraph 2 of that Article.

Moreover, the transfer of assets from a branch that meets the requirements for an exemption under paragraph 3 into a subsidiary that meets the requirements of paragraph 3 of Article 10 should not change the result. Accordingly, in that case, it is expected that the U.S. competent authority will exercise its discretion to treatthe new parent-subsidiary to qualify for the zero rate of withholding tax, so long as the Mexican parent meets the 80-percent ownership requirement of paragraph 3(a) of Article 10 with respect to the subsidiary.

Article IV

Article IV of the Protocol amends paragraph 4 of Article 13 (Capital Gains) of the Convention.

Paragraph 4 allows the Contracting State of which a company is resident to tax certain gains from the sale of shares of that company if the gain is derived by a resident of the other Contracting State. This rule is the same as in the existing Convention. In the existing Convention, this paragraph contains a second sentence that provides that the State of residence of the taxpayer will treat the gain that may be taxed by the other Contracting State as arising in that Contracting State to the extent necessary to avoid double taxation. This sentence has been removed because it is no longer necessary in light of the change to paragraph 3 of Article 24 (Relief from Double Taxation) described below.

Article V

Article V of the Protocol replaces paragraph 3 of Article 24 (Relief From Double Taxation) of the Convention, the existing rule that re-sources income taxed in accordance with the Convention to relieve double taxation.

Specifically, paragraph 3 as revised states that the State of residence of the taxpayer will treat an item of gross income (as defined under its law) that may be taxed by the other State in accordance with the Convention as arising in that other State. In the case of the United States, this means that, if the Convention allows Mexico to tax an item of gross income (as defined under U.S. law) derived by a resident of the United States, the United States will treat that item of gross income as gross income from sources within Mexico for U.S. foreign tax credit purposes. In that case, however, section 904(g)(10) may apply for purposes of determining the U.S. foreign tax credit with respect to income subject to this re-sourcing rule. Section 904(g)(10) generally applies the foreign tax credit limitation separately to re-sourced income. Furthermore, the paragraph 3 re-sourcing rule applies to gross income, not net income. Accordingly, U.S. expense allocation and apportionment rules, see, *e.g.*, Treas.Reg. section 1.861-9, continue to apply to income re-sourced under paragraph 3.

Article VI

This Article contains the rules for bringing the Protocol into force and giving effect to its provisions.

Paragraph (a)

Paragraph (a) provides for the ratification of the Convention by both Contracting States according to their constitutional and statutory requirements. Each State must notify the other as soon as its requirements for ratification have been complied with. The Convention will enter into force on the date of the later of such notifications.

In the United States, the process leading to ratification and entry into force is as follows: Once a treaty has been signed by authorized representatives of the two Contracting States, the Department of State sends the treaty to the President who formally transmits it to the Senate for its advice and consent to ratification, which requires approval by two-thirds of the Senators present and voting. Prior to this vote, however, it generally has been the practice for the Senate Committee on Foreign Relations to hold hearings on the treaty and make a recommendation regarding its approval to the full Senate. Both Government and private sector witnesses may testify at these hearings. After receiving the Senate's advice and consent to ratification, the treaty is returned to the President for his signature on the ratification document. The President's signature on the document completes the process in the United States.

Paragraph (b)

The date on which a treaty enters into force is not necessarily the date on which its provisions take effect. Paragraph (b) contains rules that determine when the provisions of the treaty will have effect. Under subparagraph (i), the Protocol will have effect with respect to dividends paid or credited on or after the first day of the second month following the date on which the Protocol enters into force. For example, if instruments of ratification are exchanged on April 25 of a given year, the withholding rates specified in paragraph 2 and 3 of Article 10 (Dividends) as provided in Article II would be applicable to any dividends paid or credited on or after June 1 of that year. This rule allows the benefits of the withholding reductions to be put into effect as soon as possible, without waiting until the following year. The delay of one to two months is required to allow sufficient time for withholding agents to be informed about the change in withholding rates. If for some reason a withholding agent withholds at a higher rate than that provided by the Convention (perhaps because it was not able to re-program its computers before the payment is made), a beneficial owner of the income that is a resident of Mexico may make a claim for refund pursuant to section 1464 of the Code.

For all other taxes, paragraph (b) specifies that the Protocol will have effect for any taxable year or assessment period beginning on or after January 1 of the year following entry into force.

Article VII

This article provides that the Protocol shall remain in force as long as the Convention remains in force.

DEPARTMENT OF THE TREASURY
TECHNICAL EXPLANATION OF THE PROTOCOL BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF AUSTRALIA SIGNED AT CANBERRA ON SEPTEMBER 27, 2001, AMENDING THE CONVENTION BETWEEN THE UNITED STATES OF AMERICA AND AUSTRALIA WITH RESPECT TO TAXES ON INCOME SIGNED AT SYDNEY ON AUGUST 6, 1982

Introduction

This is a technical explanation of the Protocol between the United States and Australia, signed on September 27, 2001, (the "Protocol") amending the Convention between the United States of America and Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed on August 6, 1982 (the "Convention").

Negotiations took into account the U.S. Treasury Department's current tax treaty policy, the Treasury Department's Model Income Tax Convention (the "U.S. Model"), published on September 20, 1996, and the Australian Model Tax Convention. Negotiations also took into account the Model Tax Convention on Income and on Capital, published by the Organization for Economic Cooperation and Development, as updated in April 2000 (the "OECD Model"), and recent tax treaties concluded by both countries.

The Technical Explanation is an official guide to the Protocol. It reflects the policies behind particular Protocol provisions, as well as understandings reached with respect to the application and interpretation of the Protocol. References in the Technical Explanation to "he" or "his" should be read to mean "he or she" or "his or her."

Article 1

Article 1 of the Protocol modifies paragraph (3) of Article 1 of the Convention which permits the United States to continue to tax as U.S. citizens former citizens whose loss of citizenship had as one of its principal motives the avoidance of tax. To make the Convention consistent with U.S. law, the Protocol extends this treatment to former long term residents whose loss of such status had as one of its principal purposes the avoidance of tax.

Section 877 of the Internal Revenue Code of 1986 (the "Code") applies to former citizens and long-term residents of the United States whose loss of citizenship or long-term resident status had as one of its principal purposes the avoidance of tax. Under section 877, the United States generally treats an individual as having a principal purpose to avoid tax if either of the following criteria exceed established thresholds: (a) the average annual net income tax of such individual for the period of 5 taxable years ending before the date of the loss of status, or (b) the net worth of such individual as of the date of the loss of status. The thresholds are adjusted annually for inflation. Section 877(c) provides certain exceptions to these presumptions of tax avoidance. The United States defines "long-term resident" as an individual (other than a U.S. citizen) who is a lawful permanent resident of the United States in at least 8 of the prior 15 taxable years. An individual is not treated as a lawful permanent resident for any taxable year if such individual is treated as a resident of a foreign country under the provisions of a tax treaty between the United States and the foreign country and the individual does not waive the benefits of such treaty applicable to residents of the foreign country.

Article 2

Article 2 of the Protocol amends paragraph (1) of Article 2 (Taxes Covered) of the Convention. Article 2 of the Convention specifies the U.S. and Australian taxes to which the Convention applies.

In respect of the United States, the taxes to which the Convention applies currently are the Federal income taxes imposed by the Code, but excluding the accumulated earnings tax and the personal holding company tax. Article 2 of the Protocol amends sub-paragraph (1)(a) of Article 2 (Taxes Covered) of the Convention to provide that all U.S. income taxes are covered taxes for purposes of the Convention. Thus, the accumulated earnings tax and the personal holding company tax are covered taxes because they are income taxes and they are not otherwise excluded from coverage. Under the Code, these taxes will not apply to most foreign corporations because of either a statutory exclusion or the corporation's failure to meet a statutory requirement. The Protocol does not change the Convention's exclusion of social security taxes and excise taxes, such as those imposed on private foundations and foreign insurers, from the taxes covered by the Convention.

In respect of Australia, the tax to which the Convention currently applies is the Australian income tax, including the additional tax upon the undistributed amount of the distributable income of a private company (which has been repealed). Article 2 of the Protocol provides that the covered taxes are (i) the Australian income tax, including tax on capital gains, and (ii) the resource rent tax in respect of offshore projects relating to exploration for or exploitation of petroleum resources ("RRT"), imposed under the federal law of Australia. The specific reference to the Australian capital gains tax makes clear that U.S. taxpayers receive a foreign tax credit for Australian capital gains taxes paid. With respect to the RRT, the Protocol's modifications to the covered Australian taxes mean that the provisions of the Convention, including Article 5 (Permanent Establishment), Article 7 (Business Profits) and Article 27 (Miscellaneous), generally will apply to the RRT. However, the effect of the Protocol's modification to Article 22 (Relief from Double Taxation) is that even though the RRT is a covered tax, the United States is not required by the Convention to grant a U.S. foreign tax credit for RRT paid to Australia. Whether the RRT is creditable therefore is determined under U.S. domestic law.

Article 3

Article 3 of the Protocol amends Article 4 (Residence) of the Convention. Article 4 of the Convention sets forth rules for determining whether a person is a resident of a Contracting State for purposes of the Convention. As a general matter only residents of the Contracting States may claim the benefits of the Convention. The treaty definition of residence is to be used only for purposes of the Convention. The fact that a person is determined to be a resident of a

Contracting State under Article 4 of the Convention does not necessarily entitle that person to the benefits of the Convention. In addition to being a resident, a person also must qualify for benefits under Article 23 (Limitation on Benefits) of the Convention (as amended by the Protocol) in order to receive benefits conferred on residents of a Contracting State.

Sub-paragraph (1)(b) of Article 4 (Residence) of the Convention provides that a person is a resident of the United States for treaty purposes if the person is (i) a United States corporation or (ii) subject to certain exceptions, any other person resident in the United States for United States tax purposes. Paragraph (a) of Article 3 of the Protocol clarifies the treatment of a United States citizen. A United States citizen is treated as a resident of the United States unless the United States citizen is a resident of a State other than Australia for purposes of a double tax agreement between that third State and Australia.

This rule means that a U.S. citizen who is a resident of a country other than the United States or Australia cannot choose the benefits of the Convention over those provided by the tax treaty between Australia and his country of residence. For example, a U.S. citizen who is a resident of the United Kingdom and entitled to full benefits under the U.K.-Australian tax treaty could claim only the benefits of that convention, even if the Convention would provide greater benefits. If a U.S. citizen's country of residence does not have a tax treaty with Australia (or if the U.S. citizen does not qualify as a "resident" of the third State for purposes of the tax treaty between that State and Australia or is otherwise denied benefits of the treaty), then he will be treated as a resident of the United States. If such a person is a resident of both the United States and Australia, whether or not he is to be treated as a resident of the United States for purposes of the Convention is determined by the tie-breaker rules of paragraph (2) of Article 4 of the Convention.

The fact that a U.S. citizen may not be treated as a U.S. resident under the Convention does not alter the application of the saving clause of paragraph (3) of Article 1 (Personal Scope) of the Convention to that citizen. For example, a U.S. citizen who, under this rule, is not considered to be a resident of the United States still is taxable on his worldwide income under the generally applicable rules of the Code.

Article 4

Article 4 of the Protocol adds a new paragraph (9) to Article 7 (Business Profits) of the Convention. Article 7 of the Convention generally provides that business profits of an enterprise of one Contracting State may not be taxed by the other Contracting State unless the enterprise carries on business in that other Contracting State through a permanent establishment (as defined in Article 5 (Permanent Establishment)) situated there. When that condition is met, the State in which the permanent establishment is situated may tax the enterprise on the income that is attributable to the permanent establishment.

The Protocol does not change the basic rules of Article 7 (Business Profits) of the Convention. Rather, new paragraph (9) simply clarifies the treatment of fiscally transparent entities (including trusts) and beneficial owners thereof under Article 7 of the Convention. Australia requested this clarification because, under Australian law, the trustees of a trust, as the legal owner of the trust property, might be regarded as the only person having a permanent establishment (rather than the beneficiaries of the trust, who have a beneficial entitlement to the income but no legal ownership). Thus, absent this clarification, any permanent establishment resulting from that trade or business might be considered to be that of the trustees, rather than that of the beneficiaries.

New paragraph (9) provides that if a fiscally transparent entity (or trustee) has a permanent establishment in a Contracting State and a resident of the other Contracting State is beneficially entitled to a share of the business profits from the business that is carried on by the fiscally transparent entity (or trustee) through that permanent establishment, then the beneficial owner is treated as carrying on a business through a permanent establishment in that Contracting State, and its share of business profits therefrom are attributed to the permanent establishment. Thus, if a trust with a U.S. beneficiary carries on a business in Australia through its trustee, and that trustee's actions rise to the level of a permanent establishment, then the U.S. beneficiary will be treated as having a permanent establishment in Australia and the profits of the trust associated with that permanent establishment will be treated as business profits under Article 7. Since paragraph (9) is added solely to address the Australian law relating to trusts, the absence of similar language in other U.S. tax treaties should not be read as implying that a resident may avoid permanent establishment treatment and business profits by investing through a fiscally transparent entity.

Article 5

Article 5 of the Protocol revises Article 8 (Shipping and Air Transport) of the Convention which governs the taxation of profits from the operation of ships and aircraft in international traffic. Paragraph (1) of Article 8 of the Convention provides that profits derived by a resident of one of the Contracting States from the operation in international traffic of ships or aircraft are taxable only in that Contracting State. In addition to income derived directly from the operation of ships and aircraft in international traffic, this rule also includes certain items of rental income that are closely related to those activities.

Under sub-paragraph (a) of paragraph (1) of Article 8 of the Convention, income of a resident of one of the Contracting States from the rental of ships or aircraft on a full basis (*i.e.*, with crew) operated in international traffic by the lessee is income from the operation of ships and aircraft in international traffic if the resident either operates ships or aircraft in international traffic or regularly leases ships or aircraft on a full basis. Such income is exempt from tax in the other Contracting State. The Protocol does not modify this rule.

Sub-paragraph (b) of paragraph (1) of Article 8 of the Convention currently applies to profits from the lease of ships or aircraft on a bare boat basis (*i.e.*, without crew), or of containers and related equipment, provided that the lease is merely incidental to the operation in international traffic of ships or aircraft by the lessor and the leased ships or aircraft are operated in international traffic, or the containers and related equipment are used in international traffic by the lessee. The Protocol revises this rule to delete the requirement that the leased ships or aircraft actually be operated in international traffic. Thus, paragraph (1) now encompasses income from the lease of ships or aircraft on a bare boat basis when the income is incidental to the operation of ships or aircraft in international traffic by the lessor. Such income is exempt from tax in the other Contracting State. The Protocol makes coverage of bare boat leasing in Article 8 of the Convention generally consistent with Article 8 of the OECD Model, although narrower than in Article 8 of the U.S. Model, which covers income from bare boat leasing without regard to whether it is incidental to the operation of ships or aircraft by the lessor.

The Protocol also deletes the references to containers and related equipment in sub-paragraph (1)(b) of Article 8. Containers (including trailers, barges, and related equipment for the transport of containers) used in international traffic are addressed in new paragraph (2) of Article 8 of the Convention, which tracks the U.S. Model. Under this paragraph, profits of an enterprise of a Contracting State from the use, maintenance or rental of containers (including equipment for their transport) that are used for the transport of goods in international traffic are exempt from tax in the other Contracting State. This result obtains under paragraph (2) regardless of whether the recipient of the income is engaged in the operation of ships or aircraft in international traffic. By contrast, Article 8 of the OECD Model covers only income from the use, maintenance or rental of containers that is incidental to other income from international traffic.

Article 8 of the Convention provides that the rules of the Article apply to income derived though participation in a pool service, in a joint transport operating organization or in an international operating agency. New paragraph (3) of Article 8 of the Convention, as revised by the Protocol, provides that the rules of Article 8 include profits from participation in a pool service or other profit sharing arrangement. This language follows the Australian model tax treaty. It refers to various arrangements for international cooperation by carriers in shipping and air transport. For example, airlines from two countries may agree to share the transport of passengers between the two countries. They each will fly the same number of flights per week and share the revenues from that route equally, regardless of the number of passengers that each airline actually transports. New paragraph (3) makes clear that with respect to each carrier the Article excepts all the income earned by that carrier with respect to the pool service or other profit sharing arrangement, and not just the income derived directly by that carrier.

The Protocol clarifies the rule in Article 8 of the Convention dealing with carriage within a Contracting State as part of international traffic of ships or aircraft. Paragraph (3) of Article 8 of the Convention, prior to amendment by the Protocol, excludes from the definition of operation in international traffic of ships or aircraft profits derived from the carriage of passengers, livestock, mail, goods or merchandise shipped in a Contracting State for discharge at another place in that State. This language has led to questions regarding the treatment of a domestic leg of an international trip. Accordingly, the Protocol clarifies the Article to provide that the carriage of passengers, livestock, mail, goods or merchandise taken on board in a Contracting State for discharge in that State is not operation in international traffic of ships or aircraft and may be taxed in that State. Thus, consistent with the Commentary to Article 8 of the OECD Model, income earned by an enterprise from the inland transport of property or passengers within either Contracting State falls within Article 8 if the transport is undertaken as part of the international transport of property or passengers by the enterprise. Accordingly, if a U.S. shipping company contracts to carry property from Australia to a U.S. city and, as part of that contract, it transports the property by truck from its point of origin to an airport in Australia (or it contracts with a

DEPARTMENT OF THE TREASURY
TECHNICAL EXPLANATION OF THE CONVENTION BETWEEN
THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND
THE GOVERNMENT OF THE UNITED KINGDOM OF
GREAT BRITAIN AND NORTHERN IRELAND
FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL
EVASION WITH RESPECT TO TAXES ON INCOME AND ON CAPITAL GAINS

This is a technical explanation of the Convention between the United States and the United Kingdom of Great Britain and Northern Ireland, signed on July 24, 2001 (the "Convention"), as amended by the Protocol between the United States and the United Kingdom of Great Britain and Northern Ireland, signed on July 22, 2002 (the "Protocol"). References are made to the Convention between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, signed on December 31, 1975, as amended by Protocols signed on August 26, 1976, March 31, 1977, and March 15, 1979 (the "prior Convention"). The Convention replaces the prior Convention.

In connection with the negotiation of the Convention, the delegations of the United States and the United Kingdom developed and agreed upon an exchange of diplomatic notes (the "notes"). The notes constitute an agreement between the two governments that shall enter into force at the same time as the entry into force of the Convention. These understandings and interpretations are intended to give guidance both to the taxpayers and to the tax authorities of the Contracting States in interpreting the Convention. The notes are discussed below in connection with relevant provisions of the Convention.

Negotiations took into account the U.S. Treasury Department's current tax treaty policy and the Treasury Department's Model Income Tax Convention, published on September 20, 1996 (the "U.S. Model"). Negotiations also took into account the Model Tax Convention on Income and on Capital, published by the Organization for Economic Cooperation and Development, as updated in April 2000 (the "OECD Model"), and recent tax treaties concluded by both countries.

The notes provide that the United States and the United Kingdom will consult together at regular intervals regarding the terms, operation and application of the Convention to ensure that it continues to serve the purposes of avoiding double taxation and preventing fiscal evasion. The first such consultation will take place no later than December 31st of the fifth year following the date on which the Convention enters into force in accordance with the provisions of Article 29 (Entry into Force). Further consultations shall take place thereafter at intervals of no more than five years. The notes also provide that the United States and the United Kingdom will conclude further protocols to amend the Convention, if appropriate.

The Technical Explanation is an official guide to the Convention. It reflects the policies behind particular Convention provisions, as well as understandings reached with respect to the application and interpretation of the Convention. References in the Technical Explanation to "he" or "his" should be read to mean "he or she" or "his or her."

Article 1 (General Scope)

Paragraph 1

Paragraph 1 of Article 1 provides that the Convention applies to residents of the United States or the United Kingdom, except where the terms of the Convention provide otherwise. Under Article 4 (Residence), a person is generally treated as a resident of a Contracting State if that person is, under the laws of that State, liable to tax therein by reason of his domicile, residence or other similar criteria. However, if a person is considered a resident of both Contracting States, Article 4 provides rules for determining a single State of residence (or no State of residence). This determination governs for all purposes of the Convention.

Certain provisions are applicable to persons who may not be residents of either Contracting State. For example, Article 19 (Government Service) may apply to an employee of a Contracting State who is resident in neither State. Under Article 27 (Exchange of Information and Administrative Assistance), information may be exchanged with respect to residents of third states.

Paragraph 2

Paragraph 2 states the generally accepted relationship both between the Convention and domestic law and between the Convention and other agreements between the Contracting States (*i.e.*, that no provision in the Convention may restrict any benefit accorded by the tax laws of the Contracting States, or by any other agreement between the Contracting States). The relationship between the non-discrimination provisions of the Convention and other agreements is addressed not in paragraph 2 but in paragraph 3.

Under paragraph 2, for example, if a deduction would be allowed under the U.S. Internal Revenue Code (the "Code") in computing the U.S. taxable income of a resident of the United Kingdom, the deduction also is allowed to that person in computing taxable income under the Convention. Paragraph 2 also means that the Convention may not increase the tax burden on a resident of a Contracting State beyond the burden determined under domestic law. Thus, a right to tax given by the Convention cannot be exercised unless that right also exists under internal law.

It follows that, under the principle of paragraph 2, a taxpayer's U.S. tax liability need not be determined under the Convention if the Code would produce a more favorable result. A taxpayer may not, however, choose among the provisions of the Code and the Convention in an inconsistent manner in order to minimize tax. For example, assume that a resident of the United Kingdom has three separate businesses in the United States. One is a profitable permanent establishment and the other two are trades or businesses that would earn taxable income under the Code but that do not meet the permanent establishment threshold tests of the Convention. One is profitable and the other incurs a loss. Under the Convention, the income of the permanent establishment is taxable in the United States, and both the profit and loss of the other two businesses are ignored. Under the Code, all three would be subject to tax, but the loss would offset the profits of the two profitable ventures. The taxpayer may not invoke the Convention to exclude the profit of the profitable trade or business and invoke the Code to claim the loss of the losing trade or business against the profit of the permanent establishment. *See* Rev. Rul. 84-17, 1984-1 C.B. 308. If, however, the taxpayer invokes the Code for the taxation of all three ventures, the taxpayer would not be precluded from invoking the Convention, for example, with respect to any dividend income the taxpayer may receive from the United States that is not effectively connected with any of the taxpayer's business activities in the United States.

Similarly, nothing in the Convention can be used to deny any benefit granted by any other agreement between the United States and the United Kingdom. For example, if certain benefits are provided for military personnel or military contractors under a Status of Forces Agreement between the United States and the United Kingdom, those benefits will be available to residents of the Contracting States regardless of any provisions to the contrary (or silence) in the Convention.

Paragraph 3

Paragraph 3 specifically relates to non-discrimination obligations of the Contracting States under other agreements. The provisions of paragraph 3 are an exception to the rule provided in subparagraph (b) of paragraph 2 of this article under which the Convention shall not restrict in any manner any benefit now or hereafter accorded by any other agreement between the Contracting States.

Clause (i) of subparagraph (a) of paragraph 3 provides that, notwithstanding any other agreement to which the Contracting States may be parties, a dispute concerning the interpretation or application of the Convention, including a dispute concerning whether a taxation measure is within the scope of the Convention, shall be considered only by the competent authorities of the Contracting States, and the procedures under Article 26 (Mutual Agreement Procedure) of the Convention exclusively shall apply to the dispute. Thus, dispute-resolution procedures that may be incorporated into trade, investment, or other agreements between the Contracting States shall not apply in determining the scope of the Convention.

Clause (ii) of subparagraph (a) of paragraph 3 provides that the dispute resolution procedures set forth in Article II and Article XVII of the General Agreement on Trade in Services shall not apply to any taxation measure unless the competent authorities agree that such measure is not within the scope of the non-discrimination provisions of Article 25 (Non-Discrimination) of the Convention. Accordingly, no national treatment or most-favored-nation ("MFN") obligations undertaken by the Contracting States pursuant to the GATS shall apply to a taxation measure, unless the competent authorities otherwise agree.

The Convention does not include an additional limitation on the application of other agreements that is included in the U.S. Model. The U.S. Model provision states that national-treatment or MFN obligations undertaken by the Contracting States under agreements other than the Convention (with the exception of the General Agreement on Tariffs and Trade, as applicable to trade in goods) may not apply to a taxation measure, unless the competent authorities otherwise agree. Instead of limiting the effect of other agreements, the Contracting States analyzed existing agreements that might provide such rights. As reflected in the notes, the Contracting States believe that the only agreements in force as between the two Contracting States that may impose such national treatment or MFN obligations are: the General Agreement on Trade in Services; the General Agreement on Tariffs and Trade; the Convention to Regulate the Commerce between the Territories of the United States and of his Britannick Majesty, signed in London on July 3, 1815; and the Treaty of Amity, Commerce, and Navigation, between his Britannic Majesty and the United States of America, signed at London, November 19, 1794. The interaction between the Convention and the General Agreement on Trade in Services is discussed above. The specific language of the other three agreements makes it unlikely that they would ever apply with respect to an income tax provision. However, if there were overlap between Article 25 (Non-Discrimination) and any of these agreements, benefits would be available under both agreements. In the event of such overlap, to the extent benefits are available under one of the above three agreements, and such benefits are not available under Article 25 of the Convention, a resident of a Contracting State is entitled to the benefits provided under the overlapping agreement. Conversely, if benefits available under the Convention are not available under the overlapping agreement, a resident of a Contracting State is entitled to the benefits provided by Article 25.

The notes clarify that if it is determined that some other agreement in force at the time of the signing of the Convention includes such obligations with respect to taxation measures, the Contracting States will consult with a view to ensuring the proper interaction of the Convention and such other agreement. Such consultation may result in an amendment to the Convention if necessary. Unless and until such an amendment is made, any other such agreement would apply concurrently with the Convention.

Subparagraph (b) of paragraph 3 defines a "measure" broadly. It would include, for example, a law, regulation, rule, procedure, decision, administrative action, or any other form of governmental action or guidance.

Paragraph 4

Paragraph 4 contains the traditional saving clause found in U.S. tax treaties. The Contracting States reserve their rights, except as provided in paragraph 5, to tax their residents and citizens as provided in their internal laws, notwithstanding any provisions of the Convention to the contrary. For example, if a resident of the United Kingdom performs professional services in the United States and the income from the services is not attributable to a permanent establishment in the United States, Article 7 (Business Profits) would by its terms prevent the United States from taxing the income. If, however, the resident of the United Kingdom is also a citizen of the United States, the saving clause permits the United States to include the remuneration in the worldwide income of the citizen and subject it to tax under the normal Code rules (*i.e.*, without regard to Code section 894(a)). However, subparagraph 5(a) of this Article preserves the benefits of special foreign tax credit rules applicable to the U.S. taxation of certain U.S. income of its citizens resident in the United Kingdom. See paragraph 6 of Article 24 (Relief from Double Taxation).

For purposes of the saving clause, "residence" is determined under Article 4 (Residence). Thus, an individual who is a U.S. resident under the Internal Revenue Code but who is deemed to be a resident of the United Kingdom under the tie-breaker rules of Article 4 would be subject to U.S. tax only to the extent permitted by the Convention. For example, if an individual who is not a U.S. citizen is a resident of the United States under the Code, and is also a resident of the United Kingdom under its law, and that individual has a permanent home available to him in the United Kingdom and not in the United States, he would be treated as a resident of the United Kingdom under Article 4 and for purposes of the saving clause. The United States would not be permitted to apply its statutory rules to that person if they are inconsistent with the treaty.

However, the person would be treated as a U.S. resident for U.S. tax purposes other than determining the individual's U.S. tax liability. For example, in determining under Code section 957 whether a foreign corporation is a controlled foreign corporation, shares in that corporation held by the individual would be considered to be held by a U.S. resident. As a result, other U.S. citizens or residents might be deemed to be United States shareholders of a controlled foreign corporation subject to current inclusion of Subpart F income recognized by the corporation. See Treas. Reg. section 301.7701(b)-7(a)(3). The application of the saving clause to former citizens and long-term residents is addressed not in paragraph 4 but in paragraph 6.

Paragraph 5

Some provisions are intended to provide benefits to citizens and residents even if such benefits do not exist under internal law. Paragraph 5 sets forth certain exceptions to the saving clause that preserve these benefits for citizens and residents of the Contracting States.

Subparagraph (a) lists certain provisions of the Convention that are applicable to all citizens and residents of a Contracting State, despite the general saving clause rule of paragraph 4:

(1) Paragraph 2 of Article 9 (Associated Enterprises) grants the right to a correlative adjustment with respect to income tax due on profits reallocated under Article 9.

(2) Subparagraph 1(b) and paragraphs 3 and 5 of Article 17 (Pensions, Social Security, Annuities, Alimony, and Child Support) provide exemptions from source or residence State taxation for certain pension distributions, social security payments and child support.

(3) Paragraph 1 of Article 18 (Pension Scheme) provides an exemption for certain investment income of pension schemes located in the other State, while paragraph 5 provides benefits for certain contributions by or on behalf of a U.S. citizen to certain pension schemes established in the United Kingdom.

(4) Article 24 (Relief from Double Taxation) confirms the benefit of a credit to citizens and residents of one Contracting State for income taxes paid to the other, even if such a credit may not be available under the Code.

(5) Article 25 (Non-Discrimination) requires one Contracting State to grant national treatment to nationals of the other Contracting State in certain circumstances. Excepting this Article from the saving clause requires, for example, that the United States give such

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

March 5, 2003
JS-87

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 $78,719 million as of the end of that week, compared to $78,681 million as of the end of the prior week.

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

	February 21, 2003			February 28, 2003		
TOTAL		78,681			78,719	
1. Foreign Currency Reserves [1]	Euro	Yen	TOTAL	Euro	Yen	TOTAL
a. Securities	7,076	13,243	20,319	7,082	13,306	20,387
Of which, issuer headquartered in the U.S.			0			0
b. Total deposits with:						
b.i. Other central banks and BIS	11,566	2,659	14,225	11,564	2,671	14,235
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]			21,708			21,687
3. Special Drawing Rights (SDRs) [2]			11,386			11,368
4. Gold Stock [3]			11,043			11,043
5. Other Reserve Assets			0			0

II. Predetermined Short-Term Drains on Foreign Currency Assets

	February 21, 2003			February 28, 2003		
	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

	February 21, 2003			February 28, 2003		
	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.

FROM THE OFFICE OF PUBLIC AFFAIRS

March 6, 2003
JS-89

Treasury Under Secretary John B. Taylor
Testimony before the
House Committee on International Relations

Chairman Hyde, Representative Lantos, Members of the Committee, thank you for the opportunity to testify today on the Millennium Challenge Account (MCA). My statement will focus on the economic rationale behind the MCA and how it fits well with the Administration's approach to development.

Today there are more than one billion people living on less than $1 a day and nearly three billion living on less than $2 a day. In addition to the tragedy of those living in extreme poverty are those whose lives are claimed by ailments virtually unseen in the U.S. Last year alone 3 million people died for lack of immunization, 1 million died from malaria, 3 million died from water-related diseases, and 2 million died from exposure to stove smoke inside their own homes. In addition, HIV/AIDS has ravaged the populations of developing nations, killing 3 million people in 2002 alone.

The United States is helping in many ways to combat these problems. The MCA is part of the Administration's overall development strategy, as Administrator Natsios and Under Secretary Larson describe in their testimony. The MCA is designed specifically to catalyze the policy reforms that are the foundation of economic growth and poverty reduction.

Development Assistance and Productivity Growth

Sustainable poverty reduction can only be achieved via economic growth, which is primarily determined by productivity growth. Productivity is the amount of goods and services that a worker produces per unit of time with the skills and tools available. If you want to reduce the number of countries with low per capita incomes, then you have no choice but to increase productivity in those countries. And the higher the rate of productivity growth, the faster poverty will decline. Simply put, the ticket out of poverty is higher productivity jobs.

Productivity depends on two things: capital per worker and the level of technology. If there are no impediments to the flow and accumulation of capital and technology, then countries that are behind in productivity should have a higher productivity growth rate.

They should catch up, and we have seen many countries catching up over the years – such as South Korea, Chile, and Botswana. However, many of the poorest nations still have had low and stagnant productivity and income, and they are not catching up. More and more evidence has been accumulating that this is due to significant impediments to investment and the adoption of technology.

These impediments can be grouped into three areas. First, poor governance — the lack of rule of law or enforceable contracts and the prevalence of corruption — creates disincentives to invest, start up new firms, and expand existing firms with high-productivity jobs. This has a negative impact on capital formation and entrepreneurial activity. Second, weak health and education systems impede the development of human capital. Workers without adequate education do not have the skills to take on high-productivity jobs or to increase the productivity of the jobs they do have.

Third, too many restrictions on economic transactions prevent people from trading goods and services or adopting new technologies. Poor economic policies, state monopolies, excessive regulation, and the lack of openness to trade are all examples of restrictions that reduce the incentives for innovation and investment that are needed to boost productivity.

The Administration's approach to assisting developing nations to overcome these impediments and thereby increase their productivity growth is to increase aid, reward better performance, and measure results. All three must be simultaneously implemented; two of three alone would not succeed. As the MCA clearly represents a significant increase in aid levels, I want to focus on how the MCA will reward better performance and measure results.

Rewarding Better Performance

President Bush's vision of the MCA recognizes the importance of rewarding pro-growth policies. He categorizes these policies as ruling justly, investing in people and encouraging economic freedom. The MCA provides an incentive for countries to adopt good policies that will benefit them in three distinct ways:

i. These policies, in and of themselves, will increase growth;
ii. These policies will create an environment conducive to foreign and domestic investment; and
iii. Development assistance will be more effective in good policy environments.

Following President Bush's leadership, the Administration sought to develop a set of indicators that will be used to measure a country's commitment to pro-growth policies. An interagency group with representatives from Treasury, State, USAID, OMB, Commerce, CEA and NSC worked intensively for several months evaluating a wide range of possible indicators. As part of this process, we met with representatives from other donor countries, developing countries, non-governmental organizations (NGOs), universities, think tanks, the private sector, and other interested parties to gather their ideas.

As a first step we needed to decide which set of countries would be eligible to compete for MCA funds. Our proposal is to expand the number of countries eligible as funding ramps up. In FY'04, countries eligible to borrow from the International Development Association (IDA), and which have per capita incomes below $1,435 (the historical IDA cutoff), will be considered. This is currently 74 countries. In FY'05, all countries with incomes below $1,435 will be considered, which adds another 13 countries. In FY'06, all countries with incomes up to $2,975 — the current World Bank cutoff for lower middle income countries — will be eligible to compete as a separate pool. This group currently consists of 29 countries. It is important to note that countries prohibited from receiving assistance by current statutory restrictions will not be eligible.

Eligible countries will qualify for funding based on their policy performance in the categories of ruling justly, investing in people and encouraging economic freedom. In an attempt to objectively quantify performance in these three categories, we considered a variety of potential indicators. Ultimately, we selected 16 based on their relationship to growth and poverty reduction, the number of countries they cover, their transparency and availability, and their relative soundness and objectivity. These indicators are not set in stone and may change in the future if problems with them emerge or better indicators become available. To qualify as a better performer, a country will have to be above the median on half of the indicators in each of the three policy areas.

Governing Justly: There is a growing literature on the importance of strong political institutions and good economic governance to successful development.

1) Civil Liberties: Freedom House evaluates freedom of expression, association and

organizational rights, rule of law and human rights, and personal autonomy and economic rights.

2) Political Rights: Freedom House also evaluates the prevalence of free and fair elections of officials with real power; the ability of citizens to form political parties that may compete fairly in elections; freedom from domination by the military, foreign powers, totalitarian parties, religious hierarchies and economic oligarchies; and the political rights of minority groups.

3) Voice and Accountability: The World Bank Institute has designed a set of indices that aggregates existing quantitative assessments of governance from a broad range of sources. One of these indices attempts to measure a country's ability to protect civil liberties, the extent to which citizens of a country are able to participate in the selection of governments, and the independence of the media.

The policies incorporated in the previous three indicators should be seen as ends in their own right apart from their impact on growth. Additionally, freedom of expression and of the media allow civil society to effectively monitor the government and reduce corruption and more subtle rent-seeking behavior. Free and fair elections make governments accountable to the entire country rather than to a narrow power base, thus making them more responsive to development needs.

The remaining three indicators are produced by the World Bank Institute. These indices are formed by aggregating surveys from 15-20 different sources, similar to Voice and Accountability:

4) Government Effectiveness: Good governance includes the provision of quality public services, civil servants who are competent and independent from political pressures, and credible governments that make good on their commitment to produce and implement sound policies and deliver public goods.

5) Rule of Law: This index attempts to measure the extent to which people have confidence in and abide by rules of society, the incidence of violent and non-violent crime, the effectiveness and predictability of the judiciary, and the enforceability of contracts.

6) Control of Corruption: With respect to this indicator, President Bush made it clear that MCA funds should only go to the most transparent and least corrupt countries. To meet the President's concerns, we have determined that those countries which fall below the median on this indicator will be considered ineligible for MCA funds, absent material change in their circumstances.

Investing in People: In terms of measuring a country's commitment to educating its citizenry and providing basic health care, we were particularly concerned that a country's income level not preclude it from qualifying, yet we also wanted to provide an incentive for countries to focus on key policies that contribute to growth. Our proposal, therefore, includes two budgetary input measures, which governments can control and rapidly change. However, more money does not always lead to better results. Consequently, we have included two output measures that more accurately reflect improvement in the policy environment over time and are key to sustainable development.

1) Public expenditure on health as a percent of GDP: These data are being provided directly by the recipient government.

2) Immunization rate for DPT and measles: The UN's World Health Organization publicly compiles and annually releases data on immunization rates for nearly all member countries. Immunization rates can be associated with growth because labor productivity increases when workers are not out sick or caring for ill family members.

3) Total public expenditure on primary education as a percent of GDP: These data

are being provided directly by the recipient government.

4) Primary Completion Rate: The World Bank and UNESCO compile data that measure whether children are attaining minimum education levels. A higher level of education increases labor productivity.

Encouraging Economic Freedom: The MCA will measure a country's level of economic freedom based on its performance in implementing prudent macroeconomic and microeconomic policies, as well as creating the conditions necessary to attract investors.

1) Country Credit Rating: Institutional Investor magazine produces a semi-annual survey of bankers' and fund managers' perceptions of a country's risk of default. Our belief is that such a survey is an important indicator of the views of the private sector. In addition, an improved credit rating usually leads to a lower cost of capital and greater domestic and foreign direct investment.

2) Inflation: High inflation distorts relative prices and discourages long-term investments. Also, as the poor hold a higher percentage of their wealth in cash, they are disproportionately hurt by the erosion of their purchasing power. Of the 16 indicators, this is the only one where performance is not judged relative to the median. Instead, a country must have inflation of less than 20% in order to pass the indicator.

3) Budget Deficit/GDP: As a measure of fiscal policy, we use a country's overall budget deficit averaged over a three-year period. The data for this measure will be provided directly by the recipient government, cross-checked with other sources, and made publicly available.
Among other impacts on growth, a high budget deficit crowds out private sector investment and can lead to inflation.

4) Days to start a business: The Private Sector Advisory Service of the World Bank Group works with local lawyers and other professionals to examine specific regulations that impact business investment. One of their studies measures how many days it takes to open a new business. Bureaucratic barriers to business formation that go beyond protecting society not only hinder entrepreneurship but may exist to preserve the economic rents of political cronies.

5) Trade Policy: The Heritage Foundation's Index of Economic Freedom measures a country's openness to international trade based on average tariff rates and non-tariff barriers to trade. Open economies — those with low to moderate trade barriers and exchange controls — tend to grow faster than more closed economies.

6) Regulatory Quality Rating: The World Bank Institute (see section above on Governing Justly) measures the burden on business arising from, among others, licensing requirements, labor regulations, and bureaucratic corruption. Excessive regulations and their arbitrary application deter investment and raise the cost of doing business, thereby hindering job creation and reducing growth.

While these indicators meet all of our criteria, there may still be gaps or lags in the data, or trends not reflected in the data, which may be material for assessing performance. To correct for these possibilities, the MCA Board of Directors will look behind the numbers to make a final recommendation to the President on qualifying countries.

Measuring Results

Aid effectiveness requires not only better performance but also a focus on measuring results. This is a core component of the Administration's development strategy and is one that we have pushed in the Multilateral Development Banks (MDBs). For example, the U.S. made part of its financial commitment to the IDA-13 replenishment in the form of an incentive contribution that will reward the World Bank for increasing the use of various diagnostic tools (such as reviewing the policies of developing countries in the areas of financial accountability, procurement, public expenditure management, and poverty analysis) as well as making progress towards a set of development indicators (in health, education, and private sector development). The agreement also called for the initiation of a performance measurement system which will develop ultimately into a common set of outcome indicators that can be compared across countries.

The MCA furthers this focus on measuring results by making accountability for results an integral part of every activity for which MCA funds are used. Americans are by nature a generous people but they want to see results from their funds that are devoted to development, and their support for providing foreign assistance will only increase if those results are demonstrated in a convincing and straightforward manner. By measuring concrete results, we can focus our efforts on what really matters: helping poor people around the world escape from poverty and lead better lives.
The approach helps us cut through bureaucratic layers, ignore non-essentials, and concentrate on development problems that must be solved. It is a way to maximize the benefits of our funds.

MCA contracts will state in quantitative terms the expected outcomes of individual activities and overall country assistance. We will require a clear strategy for gathering baseline data and measuring progress towards stated results and assessing the reasons for success and failure. We will also require projects to be structured in a way that steps up or cuts back funding contingent on achieving results. In addition, evaluation of results will allow the MCA to incorporate lessons learned into ongoing and future operations. In keeping with the MCA's commitment to transparency, all monitoring and evaluation reports, as well as the terms of each contract, will be made public in the U.S. and in the host country. Furthermore, we will continue to monitor country commitment to MCA selection criteria.

In addition to sector specific monitoring, we will also be concerned with the broader policy environment. The Millennium Challenge Corporation will monitor overall budget data to determine whether recipient governments are using MCA resources in a complementary manner with their own domestic and other development resources.

Coordination of assistance with other donors will be vital to the success of the MCA. Each recipient country will be responsible for managing coordination among the MCA and other donors to maximize impact and avoid duplication of efforts. The effort to align MCA country contracts and MDB assistance with each country's Poverty Reduction Strategy Paper (PRSP) or other development strategy will also help coordinate development assistance.

Conclusion

For many years, we have all heard about the importance of aid effectiveness. The MCA represents this country's greatest opportunity to transform rhetoric into an operational action plan. The MCA has the ability to challenge countries to demonstrate performance, to achieve results, and most importantly to assist their people in having a better opportunity to pursue a better life for themselves and their families. I urge your favorable consideration of the "Millennium Challenge Act of 2003

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

March 7, 2003
JS-90

Statement by Treasury Secretary John Snow

Today's news underscores the importance of swiftly enacting President Bush's jobs and growth plan which will give our economy a much needed boost and help Americans find work. According to this Administration's analysis, our economy will add about 1.4 million new jobs under this plan by the end of next year – that's the best kind of help to a lot of families, who really need it. During my confirmation hearing, I stated clearly that I will not be content until everyone who wants to work can find a good job. Jobs give people dignity and provide hope. I know what it's like to need a job and I also know what it takes to create jobs. Congressional passage of President Bush's legislation is my number one priority and today's news underscores the need for us to act now.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

March 7, 2003
JS-91

Operation Balkan Vise: Crippling the Support Network of Radovan Karadzic, Balkan War Criminal

At 8:00am EST Momcilo "Momo" Mandic, Milovan "Cicko" Bjelica, ManCo Oil Company and Privredna Banka Sarajevo ad were designated under the Western Balkans Executive Order 13219 for their financial and material support of Radovan Karadzic a Person Indicted for War Crimes (PIFWCs) by the International Criminal Tribunal for the former Yugoslavia (ICTY). This assistance has enabled Radovan Karadzic to elude prosecution by the ICTY, thereby obstructing implementation of the Dayton Peace Accords.

In July 1995, Radovan Karadzic was indicted by the ICTY on 16 counts including genocide, crimes against humanity, crimes that were perpetrated against the civilian population and against places of worship throughout the territory of the Republic of Bosnia-Herzegovina, crimes relating to the sniping campaign against civilians in Sarajevo and crimes relating to the taking of UN peacekeepers as hostages. Radovan Karadzic led the slaughter of thousands of Bosnian Muslims and Croats. The UN reported that his murder squads killed up to 6,000 Muslims at Srebrenica in July 1995 "in order to kill, terrorize and demoralize the Bosnian Muslim and Bosnian Croat population." He shelled the city of Sarajevo and used 284 UN peacekeepers as human shields in May and June 1995. After the Dayton accord in November 1995, which ended the Bosnian war, the former nationalist president went into hiding - possibly in the mountainous south eastern area of the Serb-controlled part of Bosnia, and protected by paramilitaries.

Momcilo Mandic is a major funding source for Radovan Karadzic through Mandic's control of an elaborate network of criminal enterprises engaged in embezzlement, business fraud, fictitious loans, and various other activities that generate funds to financially support the protection of Karadzic. Mandic's influence in the Republic of Srpska, BiH allows him to control the privatization process which he uses to support the protection of Karadzic.

Mandic supports the protection of PIFWCs through his control and influence over the RS Judiciary, the RS Ministry of Internal Affairs (MUP), and the RS Intelligence Service. A former RS Justice Minister and Deputy MUP Minister, Momcilo Mandic commanded and gave orders to special police units and other forces involved in ethnic cleansing operations against non-Serbs. Momcilo Mandic has coordinated with the present RS Intelligence Chief to facilitate OBS operations and to fund the movement and protection of Persons Indicted for War Crimes.

Momcilo Mandic owns ManCo Oil Company and Privredna Banka Sarajevo ad. Mandic uses ManCo Oil Company to provide funding for the protection of Karadzic. Mandic also uses Privredna Banka Sarajevo ad to provide financial support to Karadzic and Karadzic's security detail. Radovan Karadzic uses Privredna Banka Sarajevo ad to launder money in and out of BiH.

Milovan Bjelica is also a major source of money and manpower for the protection of Radovan Karadzic through Bjelica's key part in the channeling of funds from privately owned businesses toward the protection of Karadzic. Bjelica, a long time friend and business associate of Karadzic, presides over a network of legal and illegal businesses that are also used to provide for the protection of Karadzic.

Milovan Bjelica controls special security and intelligence units charged with protecting Persons Indicted for War Crimes. Karadzic is still believed to control political and illegal activities in the RS, and both Karadzic and Bjelica are said to directly control parts of the RS Intelligence Service.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

March 7, 2003
JS-92

LOCAL Television Loan Guarantee Board Launches Website

The LOCAL Television Loan Guarantee Board (Board) today announced the launch of its website for public access, which can be found at http://www.usda.gov/rus/localtvboard. The website will be updated as new information is available.

The "Launching Our Communities' Access to Local Television Act of 2000," Pub. L. 106-553, established a LOCAL Television Loan Guarantee Program to facilitate access, on a technologically neutral basis, to signals of local television stations for households located in nonserved areas and underserved areas. The Board was established to approve loan guarantees for the LOCAL TV Program of up to 80% of the total loan amount for no more than $1.25 billion.

The Board consists of designees of the Secretaries of the Treasury, Agriculture, Commerce, and the Chairman of the Board of Governors of the Federal Reserve System. The designees are Treasury Assistant Secretary for Financial Markets and Board Chairman Brian Roseboro; Agriculture Administrator Rural Utilities Service Hilda Gay Legg; Commerce Assistant Secretary for Communications and Information and Administrator, National Telecommunications and Information Administration Nancy Victory; and Federal Reserve System Governor Edward M. Gramlich.

LOCAL Television Loan Guarantee Board

HIGHLIGHTS

On December 21, 2000, the LOCAL TV Act, "Launching Our Communities' Access to LOCAL Television Act of 2000", Pub. Law 106-553 was enacted. The LOCAL TV Act provides for the establishment of the LOCAL Television Loan Guarantee Board consisting of the Secretaries of Agriculture, Treasury, Commerce, and the Chairman of the Board of Governors of the Federal Reserve System, or their designees. The Board is authorized to approve loan guarantees of up to 80% of the total loan amount for no more than $1.25 billion in loans to facilitate access, on a technologically neutral basis, to signals of local television stations for households located in nonserved and underserved areas. This program has been fully funded through Fiscal Year 2002 appropriations and mandatory funding provided in the 2002 Farm Bill, the Farm Security and Rural Investment Act of 2002.

Meeting Minutes

September 13, 2002
January 24, 2003
February 6, 2003
May 27, 2003

Minutes of the Meeting of the
Local Television Loan Guarantee Board
September 13, 2002

The meeting of the Local Television Loan Guarantee Board ("Board") was held in the offices of the U.S. Department of Commerce, 1401 Constitution Avenue, N.W., Room 5851, Washington, D.C., on Friday, September 13, 2002 at 8:30 a.m.

The following people were present at the meeting:

Board
Brian Roseboro, Assistant Secretary Financial Markets
U.S. Department of Treasury

Hilda Gay Legg, Administrator Rural Utilities Service (RUS)
U.S. Department of Agriculture

Nancy J. Victory, Assistant Secretary for Communications and Information and Administrator, National Telecommunications and Information Administration (NTIA)
U.S. Department of Commerce/NTIA

Edward M. Gramlich, Governor
Federal Reserve Board

Others

Department of Agriculture
Roberta Purcell, Assistant Administrator – Telecommunications Program, RUS
Jonathan Claffey, Deputy Assistant Administrator – Telecommunications Program, RUS
Michael Thieman, Special Assistant to the Administrator, RUS
Michael Kelly, Assistant General Counsel, Rural Utilities Division
Frank Clover, Deputy Assistant General Counsel, Rural Utilities Division
Richard Anderson, Chief Operations Branch – Telecommunications Program, RUS
Jacqueline Rosier, Management Analyst – Telecommunications Program, RUS

Department of Commerce
Kathy Smith, Chief Counsel, NTIA
Daniel Cohen, Chief Counsel for Regulation, OGC

Federal Reserve Board
John Lopez, Special Assistant to Board
Michael Waldron, Counsel
Daniel Covitz, Economist

Department of Treasury
Roger Kodat, Deputy Assistant Secretary for Government Financial Policy

Michael Scott, Senior Advisor to the Deputy Assistant Secretary for Government Financial Policy
Paula Farrell, Acting Director, Office of Government Financing
Peter Bieger, Deputy Assistant General Counsel for Banking and Finance
Jeff King, Senior Counsel

Ms. Nancy J. Victory welcomed everyone present. She thanked Mr. Roger Kodat and the Working Group for its work, to date, to implement the provisions of the Local Television Act of 2000 ("the Act").

Ms. Hilda Gay Legg introduced Ms. Roberta Purcell, who presented a summary of the actions taken, to date, by RUS to implement the Act. Ms. Purcell provided an overview of the Act and emphasized the health, safety, and economic benefits of its implementation to rural America. She cited RUS' fifty years of experience in administering telecommunications loan and grant programs. The summary also included:

1. Information on available funding;
2. An update on the March 14, 2001, Request for Comment & Notice of Discussion Meetings, and the April 30, 2002, Notice of inquiry. Both notices were published in the *Federal Register (FR);*
3. RUS' activities regarding procurement of the independent accounting firm; and
4. An update on the draft regulations.

The Board discussed, in detail, the conditions of the current marketplace, the industry, potential applicants, lenders, and rural customers.

Mr. Roger Kodat presented a summary of the actions taken, to date, by the Working Group to implement the Act. The summary included:

1. A report on the meetings, to date, of the Working Group.
2. The committees established and tasks completed and assigned thus far; and
3. Preparations for Board meeting and next actions.

The Board discussed the role of the Working Group and its committees. The Board agreed that information should be disseminated from a central place.

The Procedural Regulations were discussed in detail. The Board voted to approve the Procedural Regulations with specified changes.

Governor Gramlich recommended that the Secretary of the Treasury's designee serve as the Chairman of the Board. The Board unanimously approved this recommendation. Mr. Brian Roseboro is the current designee of the Secretary of the Treasury.

Ms. Legg nominated Ms. Jacqueline Rosier to serve as the secretary to the Board. The Board unanimously approved her appointment.

The Board discussed the recommendations of the Working Group and unanimously approved the following:

1. The transfer, by RUS to Gov.Works, of the program's administrative funds made available through the fiscal year 2002 Agriculture appropriations for the hiring of an independent public accounting firm, external legal counsel, and other necessary consultants;

2. The selection of the recommended independent public accounting firm. The Board authorized RUS to enter into a contract with the selected independent public accounting firm no later than September 30, 2002, to assist the Board in developing underwriting criteria for the program and other tasks;

3. The identification, by the Working Group, of the funds, if any, required for the program's administration for FY 2003 and beyond;

4. The development, by the Working Group, of a statement of work to hire an external law firm to represent the interests of the Board;

5. The development, by the Working Group, of implementing regulations;

6. The development of recommendations, by the Working Group, for additional staffing requirements, if any, necessary to assist the Board; and

7. The preparation, by the Working Group, of a timeline for completion its tasks for submission to the Board.

The meeting adjourned at 9:50 a.m.

Jacqueline G. Rosier
Secretary

The Minutes of September 13, 2002, were unanimously approved by the Board. The Chair notified the Secretary on October 15, 2002.

Jacqueline G. Rosier

Minutes of the Action Without Meeting of the
LOCAL Television Loan Guarantee Board
January 24, 2003

Pursuant to 7 CFR 2200.6(g), the LOCAL Television Loan Guarantee Board ("Board") took action on January 24, 2003, without holding a meeting. The action taken was a vote to approve the following two resolutions:

1. A Resolution to grant authorization to the Working Group to proceed with Gov.Works in finalizing the statement of work, soliciting proposals, and evaluating proposals to serve as the Board's external law firm.

2. A Resolution to approve the work plan of Ernst & Young, the Board's independent accounting consulting firm.

All Members of the Board voted electronically. The vote was unanimous to approve the two resolutions.

Jacqueline G. Rosier
Secretary
LOCAL Television Loan Guarantee Board

On February 7, 2003, The Members of the Board voted electronically to approve the minutes of the January 24, 2003, action without meeting.

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Secretary

Minutes of the Meeting of the
LOCAL Television Loan Guarantee Board
February 6, 2003

The meeting of the LOCAL Television Loan Guarantee Board ("Board") was held in the offices of the U.S. Department of Commerce, 1401 Constitution Avenue, N.W., Room 5851, Washington, D.C., on Thursday, February 6, 2003. Board Chairman Brian Roseboro called the meeting to order at 2:30 p.m.

The following people were present at the meeting:

Board
Brian C. Roseboro, Board Chairman and Assistant Secretary for Financial Markets
U.S. Department of the Treasury

Hilda Gay Legg, Administrator, Rural Utilities Service (RUS)
U.S. Department of Agriculture

Nancy J. Victory, Assistant Secretary for Communications and Information and Administrator, National Telecommunications and Information Administration (NTIA)
U.S. Department of Commerce/NTIA

Edward M. Gramlich, Governor
Federal Reserve Board

Others

Department of Agriculture
Roberta Purcell, Assistant Administrator – Telecommunications Program, RUS
Michael Thieman, Special Assistant to the Administrator, RUS
Terence Brady, Acting Assistant General Counsel, Rural Utilities Division
Georgann Gutteridge, Attorney, Rural Utilities Division
Richard Anderson, Telecommunications Program Analyst – RUS
Jacqueline Rosier, Board Secretary and Management Analyst – Telecommunications Program, RUS

Department of Commerce
Kathy Smith, Chief Counsel, NTIA
Milton Brown, Deputy Chief Counsel, NTIA
Daniel Cohen, Chief Counsel for Regulation, OGC-via teleconference

Federal Reserve Board
John Lopez, Special Assistant to Board
Michael Waldron, Counsel
Daniel Covitz, Economist

Department of Treasury
Roger E. Kodat, Deputy Assistant Secretary for Government Financial Policy
Michael D. Scott, Senior Advisor to the Deputy Assistant Secretary for Government Financial Policy
Paula Farrell, Director, Office of Policy and Legislative Review
Preston Atkins, Financial Economist
Jeff King, Attorney Advisor

Ernst and Young LLP
Brian Oakley, Consultant, present for discussion on underwriting criteria only.

Chairman Roseboro welcomed everyone present and thanked the Working Group for its work, to date, to implement the provisions of the Local Television Act of 2000 ("the Act").

Mr. Roger Kodat, Chairman of the Working Group, gave an overview of the meeting agenda.

The Board reordered the items on the meeting agenda.

Mr. Dan Cohen presented an overview of the draft proposed regulations. He thanked the Working Group Regulations Drafting Committee and all who had been involved in the drafting of the proposed regulations.

The Board discussed the proposed regulations.

Mr. Roger Kodat reviewed the proposed regulation clearance process.

The Chairman requested Mr. Brian Oakley, the representative from Ernst and Young LLP, the Board's independent accounting firm, to enter the meeting. Ms. Paula Farrell presented an overview of the of the draft underwriting criteria. She thanked the Working Group Underwriting Drafting Committee and all who had been involved in the drafting of the underwriting criteria. The Board proceeded to discuss the Program's underwriting criteria.

The Board voted unanimously and signed a resolution to:

1. Approve the underwriting criteria developed by the Board's Working Group in consultation with Ernst and Young LLP, and;

2. Authorize the Board's Chairman to transmit the underwriting criteria to the Director of OMB to meet the requirement that the Board consult with OMB.

The Board then discussed the upcoming GAO audit of the Program.

The Board briefly discussed staff and task allocation.

Chairman Roseboro then indicated that staffing and task issues would be discussion items for the next Board meeting.

He directed the secretary to forward the final updated LOCAL TV Regulations via e-mail to the Board for consideration and vote.

It was noted that the LOCAL TV Board has a Website.

Ms. Hilda Legg thanked the Working Group staff for their work and all Board members concurred.

The Chairman adjourned the meeting at 4:30 pm.

Jacqueline G. Rosier
Board Secretary
LOCAL Television Loan Guarantee Board

The minutes of the February 6, 2003, LOCAL Television Loan Guarantee Board meeting were unanimously approved on March 21, 2003.

Minutes of the Meeting of the LOCAL Television Loan Guarantee Board May 27, 2003

The meeting of the LOCAL Television Loan Guarantee Board ("Board") was held via telephone conference call on Tuesday, May 27, 2003. Board Chairman Brian Roseboro called the meeting to order at 10:30 a.m.

The following people were present at the meeting:

Board
Brian C. Roseboro, Board Chairman and Assistant Secretary for Financial Markets
U.S. Department of the Treasury

Hilda Gay Legg, Administrator, Rural Utilities Service (RUS)
U.S. Department of Agriculture

Nancy J. Victory, Assistant Secretary for Communications and Information and Administrator, National Telecommunications and Information Administration (NTIA)
U.S. Department of Commerce/NTIA

Edward M. Gramlich, Governor
Federal Reserve Board

Others
Department of Agriculture
Jonathan Claffey, Deputy, Assistant Administrator – Telecommunications Program, RUS
Michael Thieman, Special Assistant to the Administrator, RUS
Terence Brady, Acting Assistant General Counsel, Rural Utilities Division
Georgann Gutteridge, Attorney, Rural Utilities Division
Richard Anderson, Telecommunications Program Analyst – RUS
Jacqueline Rosier, Board Secretary and Management Analyst – Telecommunications Program, RUS
Damian Garcia, Intern
Nathan Parsons, Intern

Department of Commerce
Milton Brown, Deputy Chief Counsel, NTIA
Daniel Cohen, Chief Counsel for Regulation

Federal Reserve Board
John Lopez, Special Assistant to Board
Michael Waldron, Counsel
Daniel Covitz, Economist

Department of the Treasury
Preston Atkins, Financial Economist
Jeff King, Attorney Advisor

Chairman Roseboro confirmed each Board Member's presence on the call and welcomed and thanked everyone participating in the teleconference meeting. He confirmed that each Board Member had received the meeting briefing materials. He then gave an overview of the meeting agenda.

Next, Chairman Roseboro announced that the first agenda item was procurement sensitive. He then chaired a closed meeting with Board Members and employees who had signed a Federal Employee Confidentiality Agreement. The Chairman introduced Mr. Jeff King who reported on the Working Group's recommendations regarding an external legal firm for the Board. After discussion, the Board unanimously voted to authorize RUS to work with Gov.Works to enter into contract as soon as possible with the selected law firm to serve the Board as independent legal counsel for the LOCAL Television Loan Guarantee Program (Program) and other tasks, as prescribed by the Board.

The Chair then reopened the meeting and presented a summary update of the Program. The Board discussed the summary.

The Board discussed the letter it received on May 9, 2003, from Mr. Marcus Peacock of the Office of Management and Budget (OMB) in response to the Board's request for OMB consultation on underwriting criteria for the Program. The Board agreed that the Chairman would contact Mr. Peacock on behalf of the Board to discuss and clarify the letter.

The Board then discussed agency staffing requirements for the Program. The Board directed the Working Group to finalize the Program's task and internal staff requirements and future funding and budget issues and to make a recommendation to the Board on these issues within 6 weeks.

The Board requested the Working Group to submit a monthly Program summary update to the Board.

Ms. Jacqueline Rosier presented a revised Program Implementation Timeline. The Board discussed the revisions and directed the Working Group to proceed expeditiously. The Board agreed that the Chairman would include timeline issues in his discussions with OMB.

The Board then heard an update on the contract with Ernst and Young presented by Mr. Milton Brown. The Board discussed the status of the contract and the recommendations submitted by the Contracting Officer's Technical Representative (COTR). The Board requested the recommendations to be included in a COTR report to the Board.

The Chairman thanked the Working Group staff for their work and indicated that the Working Group should feel free to contact any Board Member for assistance when needed. All Board Members concurred and the meeting was adjourned at 10:50 a.m.

Jacqueline G. Rosier
Board Secretary
LOCAL Television Loan Guarantee Board

The minutes were unanimously approved by the Board on June 12, 2003.

Bureau of the
PublicDebt
United States Department of the Treasury

Public Debt Announces Activity for Securities in the STRIPS Program for February 2003

FOR IMMEDIATE RELEASE

March 6, 2003

The Bureau of the Public Debt announced activity for the month of February 2003, of securities within the Separate Trading of Registered Interest and Principal of Securities program (STRIPS).

	In Thousands
Principal Outstanding (Eligible Securities)	$2,268,995,508
Held in Unstripped Form	$2,100,287,541
Held in Stripped Form	$168,707,966
Reconstituted in February	$11,155,745

The accompanying table, gives a breakdown of STRIPS activity by individual loan description. The balances in this table are subject to audit and subsequent revision. These monthly figures are included in Table V of the Monthly Statement of the Public Debt, entitled "Holdings of Treasury Securities in Stripped Form."

The STRIPS table, along with the new Monthly Statement of the Public Debt, is available on Public Debt's Internet site at: www.publicdebt.treas.gov. A wide range of information about the public debt and Treasury securities is also available at the site.

JS 93

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FROM THE OFFICE OF PUBLIC AFFAIRS

March 7, 2003
JS-94

Treasury Issues Final Regulations on compliance by Foreign Taxpayers

Today the Treasury Department issued final regulations that are intended to encourage foreign corporations and individuals to comply with U.S. tax laws.

Foreign corporations and individuals with business operations in the United States are required to file U.S. tax returns. If they do not file the required U.S. tax return on a timely basis, they generally are denied the ability to claim any deductions from their U.S. taxable income. These regulations, which replace temporary regulations issued last year, allow the IRS to waive this denial of deductions in appropriate circumstances, provided that the taxpayer comes forward and cooperates with the IRS.

The regulations will facilitate U.S. tax compliance by foreign taxpayers that become aware of their U.S. tax return filing obligations only late in the process. Providing the IRS with this flexibility in the handling of these taxpayers' returns for prior years in appropriate cases will help to ensure that these taxpayers can be brought into the U.S. tax system where they belong.

The text of the regulations is attached

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9043]

RIN 1545-AY26

Disallowance of Deductions and Credits for Failure to File Timely Return

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final regulations relating to the disallowance of deductions and credits for nonresident alien individuals and foreign corporations (collectively, foreign taxpayers) that fail to file a timely U.S. income tax return. The regulations affect foreign taxpayers that fail to file a return by the appropriate deadlines.

DATES: Effective Date: These regulations are effective March 10, 2003.

Applicability Date: For dates of applicability, see §§1.874-1(b)(4) and 1.882-4(a)(3)(iv) of these regulations.

FOR FURTHER INFORMATION CONTACT: Nina E. Chowdhry, (202) 622-3880 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to 26 CFR part 1. On January 29, 2002, final and temporary regulations (TD 8981) relating to the disallowance of deductions and credits for foreign taxpayers that fail to file a timely U.S. income tax return under sections 874 and 882 of the Internal Revenue Code (Code) were published in the **Federal Register** (67 FR 4173). A notice of proposed rulemaking (REG-107100-00) cross-referencing the temporary regulations was also published in the **Federal Register** (67 FR 4217). No public hearing was requested or held. No written or electronic comments responding to the notice of proposed rulemaking were received. The proposed regulations are adopted by this Treasury decision, and the corresponding temporary regulations are removed.

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 has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and, because the regulations do not impose a collection of information requirement on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the 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 businesses.

Drafting Information

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

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entries for "Section 1.874-1T" and "Section 1.882-4T" and adding entries in numerical order to read in part as follows:

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

Section 1.874-1 also issued under 26 U.S.C. 874. * * *

Section 1.882-4 also issued under 26 U.S.C. 882(c). * * *

Par. 2. Section 1.874-1, paragraphs (b)(2) through (b)(4) are revised to read as follows:

§1.874-1 Allowance of deductions and credits to nonresident alien individuals.

* * * * *

(b) * * *

(2) Waiver. The filing deadlines set forth in paragraph (b)(1) of this section may be waived if the nonresident alien individual establishes to the satisfaction of the Commissioner or his or her delegate that the individual, based on the facts and circumstances, acted reasonably and in good faith in failing to file a U.S. income tax return (including a protective return (as described in paragraph (b)(6) of this section)). For this purpose, a nonresident alien individual shall not be considered to have acted reasonably and in good faith if the individual knew that he or she was required to file the return and chose not to do so. In addition, a nonresident alien individual shall not be granted a waiver unless the individual cooperates in determining his or her U.S. income tax liability for the taxable year for which the return was not filed. The Commissioner or his or her delegate shall consider the following factors in determining whether the nonresident alien individual, based on the facts and circumstances, acted reasonably and in good faith in failing to file a U.S. income tax return--

(i) Whether the individual voluntarily identifies himself or herself to the Internal Revenue Service as having failed to file a U.S. income tax return before the Internal Revenue Service discovers the failure to file;

(ii) Whether the individual did not become aware of his or her ability to file a protective return (as described in paragraph (b)(6) of this section) by the deadline for filing the protective return;

(iii) Whether the individual had not previously filed a U.S. income tax return;

(iv) Whether the individual failed to file a U.S. income tax return because, after exercising reasonable diligence (taking into account his or her relevant experience and level of sophistication), the individual was unaware of the necessity for filing the return;

(v) Whether the individual failed to file a U.S. income tax return because of intervening events beyond the individual's control; and

(vi) Whether other mitigating or exacerbating factors existed.

(3) Examples. The following examples illustrate the provisions of paragraph (b). In all

examples, A is a nonresident alien individual and uses the calendar year as A's taxable year. The examples are as follows:

Example 1. Nonresident alien individual discloses own failure to file. In Year 1, A became a limited partner with a passive investment in a U.S. limited partnership that was engaged in a U.S. trade or business. During Year 1 through Year 4, A incurred losses with respect to A's U.S. partnership interest. A's foreign tax advisor incorrectly concluded that because A was a limited partner and had only losses from A's partnership interest, A was not required to file a U.S. income tax return. A was aware neither of A's obligation to file a U.S. income tax return for those years nor of A's ability to file a protective return for those years. A had never filed a U.S. income tax return before. In Year 5, A began realizing a profit rather than a loss with respect to the partnership interest and, for this reason, engaged a U.S. tax advisor to handle A's responsibility to file U.S. income tax returns. In preparing A's U.S. income tax return for Year 5, A's U.S. tax advisor discovered that returns were not filed for Year 1 through Year 4. Therefore, with respect to those years for which applicable filing deadlines in paragraph (b)(1) of this section were not met, A would be barred by paragraph (a) of this section from claiming any deductions that otherwise would have given rise to net operating losses on returns for these years, and that would have been available as loss carryforwards in subsequent years. At A's direction, A's U.S. tax advisor promptly contacted the appropriate examining personnel and cooperated with the Internal Revenue Service in determining A's income tax liability, for example, by preparing and filing the appropriate income tax returns for Year 1 through Year 4 and by making A's books and records available to an Internal Revenue Service examiner. A has met the standard described in paragraph (b)(2) of this section for waiver of any applicable filing deadlines in paragraph (b)(1) of this section.

Example 2. Nonresident alien individual refuses to cooperate. Same facts as in Example 1, except that while A's U.S. tax advisor contacted the appropriate examining personnel and filed the appropriate income tax returns for Year 1 through Year 4, A refused all requests by the Internal Revenue Service to provide supporting information (for example, books and records) with respect to those returns. Because A did not cooperate in determining A's U.S. tax liability for the taxable years for which an income tax return was not timely filed, A is not granted a waiver as described in paragraph (b)(2) of this section of any applicable filing deadlines in paragraph (b)(1) of this section.

Example 3. Nonresident alien individual fails to file a protective return. Same facts as in Example 1, except that in Year 1 through Year 4, A also consulted a U.S. tax advisor, who advised A that it was uncertain whether U.S. income tax returns were necessary for those years and that A could protect A's right subsequently to claim the loss carryforwards by filing protective returns under paragraph (b)(6) of this section. A did not file U.S. income tax returns or protective returns for those years. A did not present evidence that intervening events beyond A's control prevented A from filing an income tax return, and there were no other mitigating factors. A has not met the standard described in paragraph (b)(2) of this section for waiver of any applicable filing deadlines in paragraph (b)(1) of this section.

Example 4. Nonresident alien with effectively connected income. In Year 1, A, a computer programmer, opened an office in the United States to market and sell a software program that A had developed outside the United States. A had minimal business or tax experience internationally, and no such experience in the United States. Through A's personal efforts, U.S. sales of the software produced income effectively connected with a U.S. trade or business. A, however, did not file U.S. income tax returns for Year 1 or Year 2. A was aware neither of A's obligation to file a U.S. income tax return for those years, nor of A's ability to file a protective return for those years. A had never filed a U.S. income tax return before. In November of Year 3, A engaged U.S. counsel in connection with licensing software to an unrelated U.S. company. U.S. counsel reviewed A's U.S. activities and advised A that A should have filed U.S. income tax returns for Year 1 and Year 2. A immediately engaged a U.S. tax advisor who, at A's direction, promptly contacted the appropriate examining personnel and cooperated with the Internal Revenue Service in determining A's income tax liability, for example, by preparing and filing the appropriate income tax returns for Year 1 and Year 2 and by making A's books and records available to an Internal Revenue Service examiner. A has met the standard described in paragraph (b)(2) of this section for waiver of any applicable filing deadlines in paragraph (b)(1) of this section.

Example 5. IRS discovers nonresident alien's failure to file. In Year 1, A, a computer programmer, opened an office in the United States to market and sell a software program that A had developed outside the United States. Through A's personal efforts, U.S. sales of the software produced income effectively connected with a U.S. trade or business. A had extensive experience conducting similar business activities in other countries, including making the appropriate tax filings. A, however, was aware neither of A's obligation to file a U.S. income tax return for those years, nor of A's ability to file a protective return for those years. A had never filed a U.S. income tax return before. Despite A's extensive experience conducting similar business activities in other countries, A made no effort to seek advice in connection with A's U.S. tax obligations. A failed to file either U.S. income tax returns or protective returns for Year 1 and Year 2. In November of Year 3, an Internal Revenue Service examiner asked A for an explanation of A's failure to file U.S. income tax returns. A immediately engaged a U.S. tax advisor, and cooperated with the Internal Revenue Service in determining A's income tax liability, for example, by preparing and filing the appropriate income tax returns for Year 1 and Year 2 and by making A's books and records available to the examiner. A did not present evidence that intervening events beyond A's control prevented A from filing a return, and there were no other mitigating factors. A has not met the standard described in paragraph (b)(2) of this section for waiver of any applicable filing deadlines in paragraph (b)(1) of this section.

Example 6. Nonresident alien with prior filing history. A began a U.S. trade or business in Year 1 as a sole proprietorship. A's tax advisor filed the appropriate U.S. income tax returns for Year 1 through Year 6, reporting income effectively connected with A's U.S. trade or business. In Year 7, A replaced this tax advisor with a tax advisor unfamiliar with U.S. tax law. A did not file a U.S. income tax return for any year from Year 7 through Year 10, although A had effectively connected income for those years. A was aware of A's ability to file a protective return for those years. In Year 11, an Internal Revenue Service examiner contacted A and asked for an explanation of A's failure to file income tax returns after Year 6. A immediately engaged a U.S. tax advisor and cooperated with the Internal Revenue Service in determining A's income tax liability, for example, by preparing and filing the appropriate income tax returns for Year 7 through Year 10 and by making A's books and records available to the examiner. A did not present evidence that intervening events beyond A's control prevented A from filing a return, and there were no other mitigating factors. A has not met the standard described in paragraph (b)(2) of this section for waiver of any applicable filing deadlines in paragraph (b)(1) of this section.

(4) Effective date. Paragraphs (b)(2) and (3) of this section are applicable to open years for which a request for a waiver is filed on or after January 29, 2002.

* * * * *

§1.874-1T [Removed]

Par. 3. Section 1.874-1T is removed.

Par. 4. Section 1.882-4, paragraphs (a)(3)(ii) through (a)(3)(iv) are revised to read as follows:

§1.882-4 Allowance of deductions and credits to foreign corporations.

(a) * * *

(3) * * *

(ii) The filing deadlines set forth in paragraph (a)(3)(i) of this section may be waived if the foreign corporation establishes to the satisfaction of the Commissioner or his or her delegate that the corporation, based on the facts and circumstances, acted reasonably and in good faith in failing to file a U.S. income tax return (including a protective return (as described in paragraph (a)(3)(vi) of this section)). For this purpose, a foreign corporation shall not be considered to have acted reasonably and in good faith if it knew that it was required to file the return and chose not to do so. In addition, a foreign corporation shall not be granted a waiver unless it cooperates in the process of determining its income tax liability for the taxable year for which the return was not filed. The Commissioner or his or her delegate shall consider the following factors in determining whether the foreign corporation, based on the facts and circumstances, acted reasonably and in good faith in failing to file a U.S. income tax return--

(A) Whether the corporation voluntarily identifies itself to the Internal Revenue Service as having failed to file a U.S. income tax return before the Internal Revenue Service discovers the failure to file;

(B) Whether the corporation did not become aware of its ability to file a protective return (as described in paragraph (a)(3)(vi) of this section) by the deadline for filing a protective return;

(C) Whether the corporation had not previously filed a U.S. income tax return;

(D) Whether the corporation failed to file a U.S. income tax return because, after exercising reasonable diligence (taking into account its relevant experience and level of sophistication), the corporation was unaware of the necessity for filing the return;

(E) Whether the corporation failed to file a U.S. income tax return because of intervening events beyond its control; and

(F) Whether other mitigating or exacerbating factors existed.

(iii) The following examples illustrate the provisions of this section. In all examples, FC is a foreign corporation and uses the calendar year as its taxable year. The examples are as follows:

Example 1. Foreign corporation discloses own failure to file. In Year 1, FC became a limited partner with a passive investment in a U.S. limited partnership that was engaged in a U.S. trade or business. During Year 1 through Year 4, FC incurred losses with respect to its U.S. partnership interest. FC's foreign tax director incorrectly concluded that because it was a limited partner and had only losses from its partnership interest, FC was not required to file a U.S. income tax return. FC's management was aware neither of FC's obligation to file a U.S. income tax return for those years, nor of its ability to file a protective return for those years. FC had never filed a U.S. income tax return before. In Year 5, FC began realizing a profit rather than a loss with respect to its partnership interest and, for this reason, engaged a U.S. tax advisor to handle its responsibility to file U.S. income tax returns. In preparing FC's income tax return for Year 5, FC's U.S. tax advisor discovered that returns were not filed for Year 1 through Year 4. Therefore, with respect to those years for which applicable filing deadlines in paragraph (a)(3)(i) of this section were not met, FC would be barred by paragraph (a)(2) of this section from claiming any deductions that otherwise would have given rise to net operating losses on returns for those years, and that would have been available as loss carryforwards in subsequent years. At FC's direction, its U.S. tax advisor promptly contacted the appropriate examining personnel and cooperated with the Internal Revenue Service in determining FC's income tax liability, for example, by preparing and filing the appropriate income tax returns for Year 1 through Year 4 and by making FC's books and records available to an Internal Revenue Service examiner. FC has met the standard described in paragraph (a)(3)(ii) of this section for waiver of any applicable filing deadlines in paragraph (a)(3)(i) of this section.

Example 2. Foreign corporation refuses to cooperate. Same facts as in Example 1, except that while FC's U.S. tax advisor contacted the appropriate examining personnel and filed the appropriate income tax returns for Year 1 through Year 4, FC refused all requests by the Internal Revenue Service to provide supporting information (for example, books and records) with respect to those returns. Because FC did not cooperate in determining its U.S. tax liability for the taxable years for which an income tax return was not timely filed, FC is not granted a waiver as described in paragraph (a)(3)(ii) of this section of any applicable filing deadlines in paragraph (a)(3)(i) of this section.

Example 3. Foreign corporation fails to file a protective return. Same facts as in Example 1, except that in Year 1 through Year 4, FC's tax director also consulted a U.S. tax advisor, who advised FC's tax director that it was uncertain whether U.S. income tax returns were necessary for those years and that FC could protect its right subsequently to claim the loss carryforwards by filing protective returns under paragraph (a)(3)(vi) of this section. FC did not file U.S. income tax returns or protective returns for those years. FC did not present evidence that intervening events beyond FC's control prevented it from filing an income tax return, and there were no other mitigating factors. FC has not met the standard described in paragraph (a)(3)(ii) of this section for waiver of any applicable filing deadlines in paragraph (a)(3)(i) of this section.

Example 4. Foreign corporation with effectively connected income. In Year 1, FC, a technology company, opened an office in the United States to market and sell a software program that FC had developed outside the United States. FC had minimal business or tax experience internationally, and no such experience in the United States. Through FC's direct efforts, U.S. sales of the software produced income effectively connected with a U.S. trade or business. FC, however, did not file U.S. income tax returns for Year 1 or Year 2. FC's management was aware neither of FC's obligation to file a U.S. income tax return for those years, nor of its ability to file a protective return for those years. FC had never filed a U.S. income tax return before. In January of Year 4, FC engaged U.S. counsel in connection with licensing software to an unrelated U.S. company. U.S. counsel reviewed FC's U.S. activities and advised FC that it should have filed U.S. income tax returns for Year 1 and Year 2. FC immediately engaged a U.S. tax advisor who, at FC's direction, promptly contacted the appropriate examining personnel and cooperated with the Internal Revenue Service in determining FC's income tax liability, for example, by preparing and filing the appropriate income tax returns for Year 1 and Year 2 and by making FC's books and records available to an Internal Revenue Service examiner. FC has met the standard described in paragraph (a)(3)(ii) of this section for waiver of any applicable filing deadlines in paragraph (a)(3)(i) of this section.

Example 5. IRS discovers foreign corporation's failure to file. In Year 1, FC, a technology company, opened an office in the United States to market and sell a software program that FC had developed outside the United States. Through FC's direct efforts, U.S. sales of the software produced income effectively connected with a U.S. trade or business. FC had extensive experience conducting similar business activities in other countries, including making the appropriate tax filings. However, FC's management was aware neither of FC's obligation to file a U.S. income tax return for those years, nor of its ability to file a protective return for those years. FC had never filed a U.S. income tax return before. Despite FC's extensive experience conducting similar business activities in other countries, it made no effort to seek advice in connection with its U.S. tax obligations. FC failed to file either U.S. income tax returns or protective returns for Year 1 and Year 2. In January of Year 4, an Internal Revenue Service examiner asked FC for an explanation of FC's failure to file U.S. income tax returns. FC immediately engaged a U.S. tax advisor, and cooperated with the Internal Revenue Service in determining FC's income tax liability, for example, by preparing and filing the appropriate income tax returns for Year 1 and Year 2 and by making FC's books and records available to the examiner. FC did not present evidence that intervening events beyond its control prevented it from filing a return, and there were no other mitigating factors. FC has not met the standard described in paragraph (a)(3)(ii) of this section for waiver of any applicable filing deadlines in paragraph (a)(3)(i) of this section.

Example 6. Foreign corporation with prior filing history. FC began a U.S. trade or business in Year 1. FC's tax advisor filed the appropriate U.S. income tax returns for Year 1 through Year 6, reporting income effectively connected with FC's U.S. trade or business. In Year 7, FC replaced its tax advisor with a tax advisor unfamiliar with U.S. tax law. FC did not file a U.S. income tax return for any year from Year 7 through Year 10, although it had effectively connected income for those years. FC's management was aware of FC's ability to file a protective return for those years. In Year 11, an Internal Revenue Service examiner contacted FC and asked its chief financial officer for an explanation of FC's failure to file U.S. income tax returns after Year 6. FC immediately engaged a U.S. tax advisor and cooperated with the Internal Revenue Service in determining FC's income tax liability, for example, by preparing and filing the appropriate income tax returns for Year 7 through Year 10 and by making FC's books and records available to the examiner. FC did not present evidence that intervening events beyond its control prevented it from filing a return, and there were no other mitigating factors. FC has not met the standard described in paragraph (a)(3)(ii) of this section for waiver of any applicable filing deadlines in paragraph (a)(3)(i) of this section.

(iv) Paragraphs (a)(3)(ii) and (iii) of this section are applicable to open years for which a request for a waiver is filed on or after January 29, 2002.

* * * * *

§1.882-4T [Removed]

Par. 5. Section 1.882-4T is removed.

David A. Mader,
Assistant Deputy Commissioner.

Approved: January 17, 2003.

Pamela F. Olson,
Assistant Secretary of the Treasury.

FROM THE OFFICE OF PUBLIC AFFAIRS

March 10, 2003
JS-95

Remarks of Peter R. Fisher
Under Secretary for Domestic Finance
to RBS Greenwich Capital
Economic Lecture Seminar
Thomas J. Dodd Research Center
University of Connecticut

Two questions dominate our thoughts about the economy and fiscal policy. First, what should we do to put the economy on a path of higher growth and more rapid job creation? Second, how can we move toward the fiscal balance that we all agree we need to achieve in the long run?

To return our economy to a path of higher growth and job creation, we must do more than overcome the regular ups and downs of the economic cycle. We are recovering from the events in the 1990s, culminating in the stock market bubble and its aftermath, as well as the attacks of September 11th. To sustain economic growth in this setting, we need to support consumption and promote investment on a balanced basis. The President's Jobs and Growth Plan, if enacted by Congress, will do this.

We must recognize that while budget deficits matter, total obligations for future spending matter much more. To approach long-run fiscal balance, we first need to view the federal government's financial position with a forward-looking measure that includes all of the government's liabilities. When we do focus on total liabilities, we will recognize the powerful truth behind the President's insistence that only by growing the economy and controlling future outlays will we control future deficits.

Putting the economy on a path of higher growth and faster job creation

The President's Jobs and Growth Plan has been criticized for not being a pure short-term stimulus. Its purpose, however, is not just to deliver a short-term boost to the economy but to raise the growth rate and boost job creation for the coming decade by enhancing confidence in our long-term prospects.

We may hope that in a year or so, without any federal action, the economy will be growing rapidly. It may be that, over the next few months, business investment and job creation will spontaneously surge. But the President refuses to rest on that hope. He wants us to act now to prevent the opposite outcome. We need to prevent the risk that over the coming decade we slip toward sluggish growth more like that of Europe and Japan.

I fear that the challenge we face is not just one of overcoming another swing of the business cycle. Our economy is still recovering from the extra-ordinary events of the 1990s. First, the Federal Reserve wrung inflation expectations out of the American economy, lengthened investment horizons, and put us on a more rapid growth path. Second, one quarter of the world's humanity – China – entered the global economy. Third, the communications revolution lowered transaction costs the world over. These events contributed to our real prosperity but also fueled an historic stock market bubble. We continue to live with both the dis-inflationary consequences and the destruction of wealth as the bubble burst.

Among the policy mistakes that Japan made in trying to recover from their own bubble in the early 1990s was to use fiscal policy as a tool only for "short-term stimulus." Each year brought forth another short-term stimulus package of more roads and bridges, and each year Japan's output slipped further below its potential. The error was in failing to deliver an enduring boost to demand, balanced between consumption and investment.

An American version of Japanese-style fiscal policy might be reflected, I fear, in an excessive reliance on the short-term stimulus of rebate checks or the like as a substitute for promoting long-term economic growth.

The American people are smart enough to know the difference between a one-off check for $300 and an enduring improvement in their disposable income. When consumers re-finance their mortgages at lower rates, they gain enduring improvements in household cash flow. The same would be true of bringing forward to this year the tax rate reductions that Congress already approved, as the President has proposed. This action would provide an enduring improvement to family income and help sustain consumer demand – policy for the long-term, beginning today.

Eliminating the double taxation of corporate dividends can increase the efficiency of our entire capital investment process. It would raise the burden of proof on corporate management either to have specific reinvestment plans for the cash they have retained or to pay it out to shareholders, who can then make their own reinvestment decisions. As we speed up and re-target investment, we encourage capital formation, business formation and job creation. As we sharpen the efficiency with which American business deploys over a trillion dollars of investment each year, we can enhance our productivity and raise both our actual and potential rates of growth.

Let's not make the mistake of opting for unbalanced, short-term consumption stimulus. We should choose policies that will promote consumer confidence and business confidence, sustained consumption and investment, real economic growth and job creation, both now and over the coming decade.

Getting on the path to long-run fiscal sustainability

How can we bridge the gap from the budget deficits that it is wise to incur now to the fiscal balance that we need to achieve in the long run? Why does achieving fiscal balance – or even sensible political discussion of the topic – seem so hard?

We can bridge the gap to fiscal balance if we focus on the measures of fiscal sustainability that really matter. Indeed, the intense political focus on deficits and debt, to the virtual exclusion of other concepts, diverts attention from the real driver of our fiscal imbalance, and impedes reforms that will move us toward real balance.

The popular understanding of our national fiscal position revolves around two concepts, the annual budget deficit (or surplus) and total debt held by the public. The Congressional Budget Office now forecasts a deficit of $246 billion for this fiscal year; our debt held by the public is about $3.6 trillion. As shares of our total economy – our gross domestic product of $10.6 trillion a year – our expected deficit is about two and a half percent of GDP and our debt is around 34 percent of GDP.

These figures understate our fiscal challenge and point us in the wrong direction: the past. They reflect the government's continued reliance on cash accounting, recording transactions only when cash changes hands. They ignore the commitments we have yet to fund: our future obligations.

A more accurate and complete measure of the government's fiscal position would take account of all future obligations, calculating costs and revenues as they accrue regardless of when they must be paid. Chairman Greenspan dedicated more than half of his recent monetary policy testimony arguing this precise point.

The concept of "net present value," or NPV, is used everywhere in finance except the federal government. Similar in concept to accrual accounting, it sums the current value of all expected revenues and costs, and denominates that total in today's dollars. The federal government does not yet – but should – calculate its overall financial position based on a net present value calculation. But the rough measures we do have present an alarming picture.

Later this month, the Treasury will publish the Financial Report of the United States Government. This annual report provides an assessment of the government's net liability for Social Security, for Medicare, and for government worker and military retirement benefits. The government has assumed these obligations, and has designated taxes and revenues to pay for them. Last year's report concluded that, looking forward over 75 years, these programs collectively have a current negative net present value of $26 trillion. This figure drops slightly if we look at the whole federal fisc. Projecting total federal revenues as a share of the economy for the next 75 years at the past 40-year's average rate, the government's current net financial position is "only" negative $23 trillion.

So on a backward looking basis, only counting the amounts that we have borrowed, our debt-to-GDP ratio is 34 percent. But on a forward-looking basis, our total liabilities-to-GDP ratio is well over 200 percent.

Our problem, however, is not just one of scale but of perverse incentives and crossed signals. If we keep looking backwards rather than forwards, we are not likely to find our way.

Relying only on current deficits and debt to guide our way to fiscal balance is like trying to drive a car safely while peering only at the rear-view mirror. Even forecasts of future annual budgets, whether for five or ten years, are highly imperfect measures of our fiscal position. Forecasts of future deficits are just an artist's rendering of what we may see out the rear window once we get a little further down the road.

Our misdirected attention creates perverse incentives that weaken our real fiscal position. Budget scoring understates the cost of future promises, providing an incentive for making more of them through the creation and extension of benefit and guarantee programs. These promises do not add appreciably to current year outlays, and thus "score" well for deficits, but do add to total liabilities. Today's liabilities will be tomorrow's outlays, ultimately contributing to deficits, just not in the year of enactment. This creates a powerful bias against reforms that could move us toward real balance.

Take an example on the outlay side. Imagine a reform proposal that promises to improve overall fiscal balance: reducing the negative net present value of all future outlays and revenues. If the proposal accomplishes this by increasing today's deficits while cutting tomorrow's outlays by a larger amount, under current budget rules, we would reject it as "too expensive." The numbers that we focus on (deficits) distract us from the numbers that merit our attention (total liabilities).

And on the revenue side, with static budgetary modeling, we fail to prize ideas that will boost economic growth and, thereby, our ability to pay for future obligations.

There is only one path to fiscal discipline: to focus on total liabilities – to count them properly and to constrain their growth. In Washington budget jargon, we need a "total liability pay-go" much more than we need a "budget pay-go."

Once we have the government's total financial position in mind, and only then, can we start real discussion about closing the gap between future revenues and outlays.

From 1961 to 2001, through five Democratic and five Republican administrations, as tax debates have come and gone, total federal revenues have ranged from 17 to 21 percent of GDP. The average has been 18.6 percent. We are now operating a bit below this long-run average, as we would both hope and expect given the state of our economy. The prudent way to plan for the government's finances over the coming decades is to project that federal revenues remain around the average of the last forty years. When we plan in this cautious way, we will of course realize that federal revenues can only grow with growth in the economy.

Real fiscal discipline will only come about if we consider a forward-looking measure of the federal government's fiscal position. When we grapple with the fiscal gap that matters – between the current value of future outlays and future revenues – we will recognize the force of the President's insistence that only by growing the economy and controlling future spending will we control future deficits.

FROM THE OFFICE OF PUBLIC AFFAIRS

March 10, 2003
JS-96

U.S. Assistant Treasury Secretary Pam Olson
Remarks to the Federal Bar Association
27th Annual Tax Conference
Washington, DC

Good afternoon. Thank you for the invitation to be with you today. Speaking here is always a treat because of the unique nature of the Federal Bar Association in bringing together practitioners in government service and in the private sector. Moreover, those of you in the private sector have more often than not walked a mile in the shoes of those in government service. That gives you a special appreciation of both the rewards and the difficulties of government service, and this conference provides an opportunity for a valuable dialogue between those of you who have been in government service and those of us who are now.

I am not going to talk about shelters today. Nor am I going to talk about inversions or a lot of other things I've spoken about at nearly every outing for many months. That's not because the war on shelters has been won - far from it. Though I do believe the tide has turned, there is still much to do. It's not because we've put an effective fence around the inversion swimming hole either, though the fence of public opinion, coupled with the stated intent of Treasury and the tax-writing committees to prevent inversion transactions, one way or another, has prevented others from trying the water. I'm not going to talk about those topics because today I want to spend some time on basics.

What basics? The basics I want to talk about are the basic problems undermining our tax system. Although there are a number of basic problems, I'm going to focus on three: complexity, the inconsistency of our rules with the values of American society, and the inconsistency of our rules with our economic interests as a nation.

Let's start with complexity. It's no secret to any of us that our tax laws are extraordinarily complex. The complexity on the individual side affects all of us, but it particularly affects low and moderate income taxpayers who must grapple with overlapping, inconsistent, and mutually exclusive credits, deductions, and exclusions, and a myriad of phase-outs overlaying it all. The IRS recently completed an analysis of the burden and cost of complexity to individual taxpayers. That analysis put the burden on individual taxpayers well in excess of three billion hours per year and the cost well in excess of $60 billion per year. And that's just the individual side.

The complexity on the business side is even worse. While large businesses can grapple with it, many small and medium-size businesses cannot. The challenge for businesses trying to comply with the law - or the IRS trying to administer and enforce it - is enormous.

Last week, we met with folks from the IRS's Large and Mid-Sized Business (LMSB) Division on audit difficulties and later with representatives of a business on compliance difficulties. At the LMSB meeting, we learned of the difficulties LMSB was encountering in enforcing the law, many of which are caused or exacerbated by the complexity of the rules. At the meeting with the business, we learned of the rather extraordinary lengths to which the business – and those similarly situated – is going to comply with the complex rules and to avoid creating liabilities for taxes that economically make no sense.

The meetings were striking for their similarities. Both were about complexity. The role of the complexity of the laws in creating shadows for the dishonest to hide from their tax responsibilities cannot be overstated. At the same time, the burden the complexity of the rules places on American businesses and workers struggling to comply cannot be overstated.

The meetings were also striking for their differences. The LMSB meeting was about the opportunities complexity affords the noncompliant. The business meeting was about the costs complexity visits on the compliant. Needless to say, the complexity makes it extremely difficult for the IRS to sort the compliant from the noncompliant.

Last week, an ABA colleague of mine, Bob McKenzie, sent me this quote. "It is difficult to predict the future of an economy in which it takes more brains to figure out the tax on our income than it does to earn it." I'm not sure to whom the quote should be attributed, but it is worth remembering.

Our income tax system began as a system intended simply to fund the government. Over the years, successive Congresses and Administrations have proposed and enacted both minor changes and major overhauls. We have grafted on more and more components to the point that the system is nearing collapse.

To be sure, many of the components reflect an increasingly complicated world. But many do not. Often changes have been designed to hit a revenue target or to patch a hole, real or perceived. Whatever the case, changes have been made too frequently, without coherent or consistent policy design, with insufficient overall consideration of their effect on our country or its relation to the global economy, and without adequate thought to how each of the new components fits with the others.

In the tax world, we have done exactly the opposite of what the business world has done to increase productivity – a key to the incredible economic growth the county has experienced in the recent past. What is it the business world has done to increase productivity? Simplify. A key way that companies have raised productivity is by simplifying. Take every process down to its constituent parts, and cut out the inefficiencies, the points of friction, the drags that prevent the most streamlined operation and the standardization of transactions. Instead of simplifying to increase productivity in tax compliance and administration, we keep adding complexity – more rules, more limitations, more terms, more conditions, more qualifiers, more provisos, more exceptions. The result is that our system gets slower and slower and more inefficient. We burn more fuel, and emit ever more heat and smoke, and yet with all that burning, there's less and less light to show for it.

The numerous savings vehicles we have in the Code are a prime example of this. Two decades ago – before the '86 Tax Reform Act fixed all sorts of things that weren't broken – there was one kind of IRA and it worked for everyone. As Matt Fink of the Investment Company Institute has noted, from 1980 to 1986, contributions to IRAs rose nearly ten-fold, from $4 billion to $38 billion. Even more significant, however, is that the median income of contributing workers declined from $41,000 in 1982 to $29,000 in 1986. The '86 Act added provisos to the simple IRA that limited its availability. Provisos based on income and pension plan availability. The result: participation dropped particularly among those still eligible to participate. Confusion over eligibility, deductibility, and the benefits of continuing to contribute sidelined many former participants.

The complexity also sidelined our financial institutions whose marketing abilities – coupled with the convenience of payroll deductions or automatic transfers – had made the IRA popular and successful. The limitations, qualifiers, and provisos made it impossible for them to standardize transactions. In short, we told simplicity – and the efficiency and productivity simplicity brings – to take a hike. It has never returned. Instead of going back to basics to fix the decline in participation, we have added more complexity. We now have three versions of the IRA – traditional, nondeductible, and Roth. All operate differently, including with different limitations, qualifiers, and provisos – and, of course, they are mutually exclusive.

Recognizing that more people would be willing to set aside cash for retirement if they knew they could withdraw it in certain circumstances, we made exceptions for certain kinds of withdrawals in certain situations and added more complexity.

As the list of sympathetic withdrawals lengthened, we added new savings accounts for the new purposes. ESAs, QSTPs, MSAs. Hardly a month goes by that someone doesn't propose yet another account for yet another purpose.

And so the complexity grows, the inability to standardize transactions grows, the cost of administration grows, and the confusion multiplies!

Implicit in all of these complicated provisions are two important points. First, we don't trust the American taxpayer to make the right decisions for him- or herself and his or her family. If we did, we wouldn't need the long list of qualifiers, provisos, and exceptions, backed up by penalties. (Penalties, incidentally, that particularly discourage participation by lower and moderate income families.)

Second, we recognize that our system penalizes those who save their money instead of spending it, even though we will only reduce the penalty for those who agree to save, and in fact do save, for the purposes dictated by us here in Washington.

We need to go back to the drawing board – back to the drawing board with faith in the American people to do the right thing. The President's budget proposals for retirement and lifetime savings accounts would do just that.

The proposed simplification of the retirement savings accounts and the addition of a lifetime savings account accessible to all Americans would bring other simplification benefits. In a matter of less than a decade, the proposed retirement and lifetime savings accounts would permit all lower and moderate income Americans to enjoy the benefits of tax-free compounding and freedom from the complexity of Schedule B and Schedule D.

Let me turn to another basic problem with our tax system. It is filled with rules that contradict our values.

Many of these contradictions are familiar to you. We tax you more if you marry. We tax your family when you die. I've helped some very wealthy families – and some not that wealthy families – as they try to sort out what happens to the assets on the death of the parent. I've watched businesses shrink, life-long employees lose their jobs, and debts mount, while the family grieves not just over the loss of their loved one, but over the demise of stability as they struggle to pay the estate tax. And the estate tax doesn't just take the assets of the elderly. It hits young families who have been planning for their future, but not for an untimely death. These experiences have left me with the firm view that the occasion of someone's death is a lousy reason for society to help itself to the property left behind.

Some of the features of our tax system that contradict our values have become such an engrained part of our system that they've become second nature to us – we don't realize the effect they're having. I've already mentioned one of them – we tax those who save more than those who spend.

Take a simplistic example. Two families – identical except that one of them spends everything and the other saves some – to buy a new home, for continuing education, for a rainy day, for unexpected emergencies, for their children's future, for their own retirement security. Over time, the family that saves will see its tax bill increase relative to the family that spends everything. We justify that on the basis that the family that saved has more income and a greater ability to pay. But the reason they have more income is because they chose to do the right thing. Virtue may be its own reward, but we're going to get less of it if we attach penalties to it. And mind you, the additional taxes aren't limited to the tax owed on the savings income. Nor are the penalties for this virtue limited to the tax code.

Let me turn to one more problem with our tax system. We've designed a system that is inconsistent with America's best interests because it distorts economic decision-making. In doing so, it gets in the way of taxpayers making the right decisions.

The Treasury Department has identified a number of ways in which our international rules harm American companies. What is particularly troubling is that some seem to believe that rules harming American companies aren't a problem – as though the companies were somehow disconnected from the rest of society. But that's wrong. What we must recognize is that rules that harm American companies harm their employees, their shareholders, their creditors, their suppliers, and their customers.

In the international area, we have rules that increase taxes for organizing foreign marketing operations more efficiently and rules that make it more expensive to reinvest profits in the U.S. where it may mean a job or higher productivity for an American worker. The rules are antiquated and poorly reflect our participation in the global economy today. We must redesign those rules and do so taking into account the practical effects of the rules on American companies and American workers.

Perhaps the most obvious example today of the way in which our tax system distorts economic decision-making is our corporate tax system. It favors debt over equity, retained earnings over dividends, and distributions of earnings via complicated transactions like share repurchases over simple dividend checks. There's nothing wrong with debt, retaining earnings, or repurchasing shares, but there's no reason for the tax code to prefer them either. Debt can cause instability, particularly during an economic downturn. Projects financed with retained earnings may be subject to a lower hurdle and avoid public scrutiny. And the share repurchase, which tends to occur when the stock price is attractive – read low – is like a cheap date while the dividend means commitment.

Think about how different the '90s might have been had dividends not been disdained as "tax inefficient." The President's dividend exclusion proposal is a powerful corporate accountability package. Think about what might have happened with corporate tax shelters if the President's proposal, which makes corporate tax payments an asset to shareholders, were already law.

Virtue may be its own reward, but we're going to have less of it if we attach significant financial penalties to its exercise. As American businesses align themselves as never before with the interests of their shareholders, creditors, employees, customers, and suppliers, it is time for us to align our corporate tax system with the best interests of America. It is time for Congress to bring to an end the economic distortions in our corporate tax rules.

Like the Chinese curse, we live in interesting times. In the past three years we have seen the pendulum of public opinion swing from lionizing American corporations and business leaders to the opposite: widespread public skepticism toward the notion that businesses can be a force for good, and a general doubt that businesspeople can rise to serve causes higher than their personal enrichment. The American businessman has gone from hero to zero in nothing flat.

Perhaps American business leaders should never have been so lionized – we all have feet of clay – but neither should they be demonized. Above all, we must remember that much of what has happened was caused by the outrageous acts of a few. It would be foolhardy for us to judge the many on the basis of those few.

Even Enron, a name now synonymous with greed, financial chicanery, and the new economy's fall from grace, was comprised of thousands of dedicated, idealistic and enthusiastic employees, who saw their plans, their dreams, and their life's savings go down with the company. The actual perpetrators were a small but crooked band, operating at the top of the pyramid. Yet the shadow of the few at the top has fallen over the many good people below them, and over firms large and small across our nation.

Though stories of corporate criminality still dominate business magazine covers and headlines – just as the haloed portraits of those same men now indicted once graced the same glossy sheets – the truth is that American businessmen and women have upheld and will continue to uphold the great strengths and virtues of American society.

In the late '70s, I subscribed to Quest – a magazine dedicated to reporting on "the pursuit of excellence in all fields." With catastrophes and misdeeds well-covered in other periodicals, Quest set itself apart with stories accentuating the positive – successes and human conquests and victories.

One of the stories I remember from Quest was about a local San Francisco brewery, founded in the 1860s and about to go bust in 1965. The quality of the beer was inconsistent and it was available only on tap – customers had to come to the brewery to pick up the kegs themselves.

Fritz Maytag – yes, of the Maytag appliance family – had fallen in love with the beer, and although he had no experience in brewing, he bought the brewery. Maytag, serving as president and brew master, made it his mission to save the old brewery and preserve the art of classical brewing. He succeeded. Maybe you've heard of that old brewery – Anchor – or had one of the beers – Anchor Steam. Not only do customers not need to go to the brewery to pick up a keg anymore, you can usually find an Anchor Steam at my house.

A story about the revival of a local brewery might seem a curious one, especially when offered as an antidote to allegations of corporate graft on a billion-dollar scale. But it's the kind of everyday story of American businessmen and women making a huge difference in a community.

Since Quest is no longer around to deliver a pollyanna message, it's also my starting point for telling you that, in my experience, business in itself is a force for good, and most businesspeople go above and beyond their obligations to contribute to their communities.

Let me give you a few of my favorite examples.

William J. Bennett, in a recent speech about teaching virtues, remarked on the negative stereotype that businessmen have been given: "American businessmen traveling across the country with their laptops." Yet, on that fateful day of September 11th, 2001, it was American businessmen on American Airlines Flight 93 who waited until they were over a rural area and then rushed the cockpit.

Ordinary American businessmen, but what those men did on September 11th was anything but.

If you look, I believe you'll find that in the business world, ordinary people show extraordinary character every day. Let me give you two examples from the tax world.

A few years back, I was working with a client for whom I had just wrapped up a lengthy and somewhat contentious audit. The client's quick review of the IRS's calculation of the additional tax due indicated several million dollars had been left out of the calculation. After a more careful review confirmed the mistake, the client picked up the phone and called the IRS to advise of the mistake.

Another client, similarly following a lengthy and somewhat contentious audit, received a refund check for millions of dollars more than had been anticipated. After a careful review of the computations, the client determined the IRS had made a mistake in its interest calculation and returned the overpayment.

Besides integrity, if you look, you'll find that American businesses are also known for extraordinary generosity. In fact, our charitable giving practices make the U.S. the envy of some of our major trading partners. Consider Ford Motor Company, which not only opened automotive plants in Mexico, but, in 1966, launched a school construction program, an initiative to increase the possibilities for development and economic well-being for Mexican children. Ford schools serve more than 60,000 students across Mexico and have served more than 1.5 million children since their inception.

Or consider the Youth Automotive Training Center, a school founded by a Florida businessman that takes each year a crop of about 20 young men, who have committed some of the most serious crimes, and turns them around. At the school, the young men's physical and emotional needs are attended to, they work towards completing their high school diploma, and they learn a trade that allows them to leave a year later with gainful employment awaiting them.

American companies are a force for good at home and abroad because they share American values. In effect, they are exporting ethical business practices along with investments of capital and know-how. One of my favorite examples involves an investment by U.S. Steel in Slovakia. U.S. companies are subject to various restrictions on their business practices abroad, including the Foreign Corrupt Practices Act, which can make doing business in countries accustomed to graft a challenge. But U.S. Steel took ethical practices a step further on its own.

When U.S. Steel acquired a large plant in Slovakia, it ran a full-page ad making clear that it would neither pay nor accept any corrupt payments and that any suppliers or employees making or accepting such payments would be terminated or dismissed. The knock on effect changed the culture for business investment in Slovakia, for the benefit of all Slovakians.

Besides exporting ethical business practices, we have exported high standards for transparency in the financial sector. In the summer of 2001, Former Treasury Secretary Paul O'Neill challenged Treasury staff to increase the number of tax information exchange agreements we have with other countries. These agreements help us gain access to the information we need to enforce our tax laws. Many significant offshore financial centers were reluctant to enter into these agreements fearing they would lose business. But the Cayman Islands, the largest financial center in the Caribbean, stepped up to the plate and signed a tax information exchange agreement with us. It was the first agreement the U.S. had concluded in more than a decade. Since then several other significant financial centers have entered into such agreements with us and we are hopeful that other countries, including some of our major trading partners, will follow their lead so we can improve our tax information exchange relationships with them.

Let me close by reminding you of the three basic problems we should all be working to fix –

(1) Complexity.
(2) Inconsistency with our values.
(3) Inconsistency with our best interests as a nation.

Finally, don't forget to look for the good in those around you. There's a lot more of it than the headlines would lead you to believe.

Thank you.

PRESS ROOM

FROM THE OFFICE OF PUBLIC AFFAIRS

March 11, 2003
JS-97

Treasury Revises Regulations to Prevent Loss Duplication

Today the Treasury Department and the Internal Revenue Service issued temporary regulations that prevent groups of corporations filing consolidated returns from obtaining more than one tax benefit for a single economic loss.

The temporary regulations provide rules that are effective as of March 7, 2002. They are substantially similar to the regulations that were proposed in October 2002, but include few revisions based on comments we received.

On March 7, 2002, the IRS issued Notice 2002-18 announcing that regulations would be promulgated to defer or limit the use of losses in transactions structured by corporations to artificially accelerate losses or to claim more than one tax loss with respect to a single economic loss. The Notice stated that the regulations would apply to dispositions occurring on or after March 7, 2002.

The text of the temporary and proposed regulations is attached.

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[TD 9048]

RIN 1545-BB95

Guidance Under Section 1502; Suspension of Losses on Certain Stock Dispositions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary regulations under section 1502 that redetermine the basis of stock of a subsidiary member of a consolidated group immediately prior to certain transfers of such stock and certain deconsolidations of a subsidiary member. In addition, this document contains temporary regulations that suspend certain losses recognized on the disposition of stock of a subsidiary member. The regulations apply to corporations filing consolidated returns. The text of the temporary regulations serves as the text of the proposed regulations set forth in the Proposed Rules section of this issue of the **Federal Register**.

DATES: Effective date: These regulations are effective March 14, 2003.

Applicability Date: For dates of applicability, see §§ 1.1502-21T(h)(7), 1.1502-32T(h)(6), and 1.1502-35T(j).

FOR FURTHER INFORMATION CONTACT: Aimee K. Meacham, (202) 622-7530 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

These regulations are being issued without prior notice and public procedure pursuant to the Administrative Procedure Act (5 U.S.C. 553). For this reason, the collection of information contained in these temporary regulations has been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget (OMB) under 44 U.S.C. 3507 and assigned control number 1545-1828. Responses to this collection of information are voluntary.

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

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

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

Background and Explanation of Provisions

On October 18, 2002, the IRS and Treasury Department issued a notice of proposed rulemaking (REG-131478-02, 2002-47 I.R.B. 892 [67 F.R. 65060]) that included proposed regulations reflecting the principle set forth in Notice 2002-18 (2002-12 I.R.B. 644) that a consolidated group should not be able to obtain more than one tax benefit from a single economic loss. The rules in the proposed regulations were intended to address at least two situations in which a group may obtain more than one tax benefit from a single economic loss. In one situation, a group first recognizes and absorbs a subsidiary member's inside loss (e.g., a loss carryforward, a deferred deduction, or a loss inherent in an asset) and a member of the group later recognizes a loss on the subsidiary member's stock that is duplicative of the previously recognized and absorbed inside loss. In the second situation, a member of the group recognizes a loss on a non-deconsolidating disposition of the subsidiary member's stock, the stock loss duplicates an unrecognized or unabsorbed loss of the subsidiary member, and the group later recognizes and absorbs the subsidiary's inside loss.

The proposed regulations consist primarily of two rules: a basis redetermination rule and a loss suspension rule. The proposed regulations also include a basis reduction rule that addresses certain cases of loss duplication that are not within the scope of the loss suspension rule, such as losses arising from the worthlessness of subsidiary member stock.

No public hearing regarding the proposed regulations was requested or held. Comments, however, were submitted.

The IRS and Treasury Department have studied, and are continuing to study, the comments received. The IRS and Treasury Department believe that the comments received, as well as the issues more generally raised by Notice 2002-18 and the proposed regulations, require significant further consideration. Accordingly, the IRS and

Treasury Department will continue to study these issues and, as more fully set forth below, request comments on, and suggestions for possible alternative approaches to, the issues addressed in the regulations. Nonetheless, the IRS and Treasury Department believe that immediately effective rules are necessary to address the duplication of loss within a consolidated group so as to clearly reflect the income tax liability of the group. Accordingly, the IRS and Treasury Department are promulgating the proposed regulations as temporary regulations in this Treasury decision. The temporary regulations are substantially similar to the proposed regulations, but reflect certain revisions that were made based on comments received. The following sections describe these revisions.

A. <u>Application of Basis Redetermination Rule Upon Deconsolidation of a Subsidiary Member</u>

The proposed regulations require the reallocation of the basis of subsidiary member stock held by members of the group upon certain dispositions and deconsolidations of subsidiary member stock. The rule applies differently when the subsidiary remains a member of the group from when the subsidiary does not remain a member of the group. The IRS and Treasury Department received several technical comments regarding the basis redetermination rule applicable when a subsidiary member leaves the group. The temporary regulations revise that rule in a manner that addresses these comments and clarifies its application.

In particular, under the temporary regulations, subject to certain exceptions, the rule applies upon a deconsolidation of a subsidiary member when any stock of the subsidiary member owned by a member of the group has a basis in excess of value.

The revised rule generally applies regardless of whether the subsidiary member is deconsolidated as a result of a transfer of a gain share, a transfer of a loss share, or a stock issuance because, in each case, the effect is the same, i.e., each share of subsidiary member stock owned by group members is deconsolidated. Further, in computing the basis that is reallocated, the revised rule takes into account all loss on members' shares of the subsidiary's stock and all prior negative basis adjustments to members' shares of the subsidiary stock that are not loss shares. The revised rule reflects that, unless all deconsolidations and all deconsolidated shares are treated similarly, opportunities to duplicate losses will continue to exist.

B. Application of Loss Suspension Rule

Under the loss suspension rule, if, after application of the basis redetermination rule, a member of a consolidated group recognizes a loss on the disposition of stock of a subsidiary member of the same group, and the subsidiary member is a member of the same group immediately after the disposition, then the selling member's stock loss is suspended to the extent of the duplicated loss with respect to such stock. Because a suspended stock loss reflects the subsidiary member's unrecognized or unabsorbed deductions and losses, under the proposed regulations, the suspended loss is reduced, with the result that it will not later be allowed, as the subsidiary member's deductions and losses are taken into account (i.e., absorbed) in determining the group's consolidated taxable income (or loss). One comment received regarding the proposed regulations was that, in certain cases, the loss suspension rule could disallow a tax loss for an economic loss. This result was not intended. Accordingly, these temporary regulations include two changes from the proposed regulations that are intended to prevent this result.

First, the temporary regulations provide that the amount by which a suspended stock loss is reduced cannot exceed the excess of the amount of the subsidiary member's items of loss and deduction over the amount of such items that are taken into account in determining the basis adjustments made to stock of the subsidiary member (or any successor) owned by members of the group under the investment adjustment rules.

Second, they also include a provision stating that the loss suspension rule is not to be applied in a manner that permanently disallows an otherwise allowable deduction for an economic loss. Whether the loss suspension rule has resulted in such a disallowance is determined on the earlier of the date of the deconsolidation of the subsidiary (or any successor) the stock of which gave rise to the suspended stock loss and the date on which the stock of such subsidiary is determined to be worthless. When it is determined that the application of the loss suspension rule has permanently disallowed a deduction for an economic loss, the taxpayer will be permitted to treat the suspended stock loss as restored to the extent of such disallowance. The restoration of the suspended loss is deemed to occur immediately prior to the deconsolidation of the subsidiary or the determination of worthlessness.

C. <u>Basis Reduction Rule For Worthless Stock and Stock of a Subsidiary With No Separate Return Year</u>

The proposed regulations include a basis reduction rule intended to prevent the duplication of unabsorbed losses generated by a subsidiary member and loss with respect to the stock of that member if either (i) the stock of the subsidiary member becomes worthless or (ii) the stock of the subsidiary is disposed of and, immediately after the disposition, the subsidiary is no longer a member of the group and does not have a separate return year. Under this rule, immediately before a determination of worthlessness, or immediately before a disposition of a subsidiary that is not folowed by a separate return year, the basis of the subsidiary's stock is reduced by the amount of any loss carryforwards that would be treated as attributable to the subsidiary under the principles of §1.1502-21. This provision was included because neither situation was subject to the loss suspension rule and, without such a rule, taxpayers might take the position that a group is entitled to a subsidiary member's loss carryforwards even after the group has enjoyed full basis recovery through a worthless stock or other deduction. Such a result, however, would be in contravention of the principles of Notice 2002-18.

The proposed provision raised questions about the operation of the existing rules governing this situation. Commentators contended that the basis reduction rule could deny the group a single tax loss for its economic loss. As stated above, the proposed regulations, including the basis reduction rule, were not intended to disallow a tax loss for an economic loss, but rather were intended only to ensure that a group obtains no more than a single tax loss for an economic loss.

The temporary regulations address this situation by providing that the unabsorbed losses generated by the subsidiary do not remain available to the group. Specifically, the temporary regulations provide that, if stock of a subsidiary member is treated as worthless under section 165 (taking into account the provisions of §1.1502-80(c)), or if a member of a group disposes of subsidiary member stock and on the following day the subsidiary is not a member of the group and does not have a separate return year, then all losses treated as attributable to the subsidiary member under the principles of §1.1502-21, after computing the taxable income of the group, the subsidiary member, or a group of which the subsidiary member was previously a member for the taxable year that includes the determination of worthlessness or the disposition and any prior taxable year, shall be treated as expired, but not as absorbed by the group, as of the beginning of the group's taxable year that follows the taxable year that includes the determination of worthlessness or the disposition. Under this rule, the stock loss (or reduced stock gain), unreduced by any loss carryforwards attributable to the subsidiary member, is allowed. Moreover, because the losses are treated as expired, there is no possibility of a later, duplicative use of the loss carryforwards. This approach is consistent with the nature of a loss realized upon such a determination or disposition, i.e., a loss on an investment in the subsidiary member.

Because the provisions of the proposed regulations raised questions about the operation of the existing rules, the temporary regulations include a special election for determinations of worthlessness and dispositions that occurred on or after March 7, 2002, and before March 14, 2003. In such cases, as an alternative to the treatment described above, the common parent of the group may make an irrevocable election to reattribute to itself all or a portion of the losses attributable to the subsidiary member under the principles of §1.1502-21. For purposes of applying the investment adjustment rules to stock of the subsidiary member owned by the group, the reattributed losses are treated as absorbed by the group immediately prior to the allowance of any loss or inclusion of any income or gain with respect to the determination of worthlessness or the disposition. The common parent, however, is treated as succeeding to the subsidiary's losses in a transaction described in section 381.

The IRS and Treasury Department request comments regarding whether a subsidiary member the stock of which is determined to be worthless (under the standards of §1.1502-80(c)) should be treated as a new corporation for purposes of the Internal Revenue Code as of the date of the determination of worthlessness. In addition, the IRS and Treasury Department request comments regarding the desirability of further clarification or changes regarding the standards that govern determinations of worthlessness and the deductibility of losses (or the inclusion of excess loss accounts) when stock of a subsidiary member is determined to be worthless.

D. Deferral and Elimination of Gain

One comment noted that the basis redetermination rule of the proposed regulations could be used to shift the location of gain and loss within a consolidated group and even to eliminate gain in a manner that is unintended and contrary to the purposes underlying section 337(d). The following example illustrates this concern.

P, the common parent of a consolidated group, owns all of the stock of S1 and S2. The S2 stock has a basis of $400 and a value of $500. S1 owns 50% of the stock of the S3 common stock with a basis of $150 and value equal to such amount. S2 owns the remaining 50% of the S3 common stock with a basis of $100 and a value of $200 and one share of S3 preferred stock with a basis of $10 and a value of $9. P intends to sell all of its S2 stock to an unrelated buyer that does not want to acquire S3. P, therefore, engages in the following steps to dispose of S2 without recognizing a substantial portion of the built-in gain in S2. First, P causes a recapitalization of S3 in which S2's S3 common stock is exchanged for new S3 preferred shares. P then sells all of its S2 stock. Although the sale does not deconsolidate S3 (because all the S3 common stock is still held by S1), it does deconsolidate the S3 preferred shares held by S2, including the one share with a built-in loss. Accordingly, under the proposed regulations, the bases of all shares of S3 stock must be redetermined immediately before P's sale of S2. Under the basis redetermination rule, the total basis of S3 stock held by members of the P group is allocated first to the S3 preferred shares, up to their value of $209, and then to the remaining shares of S3 common held by S1. S2's aggregate basis in the S3 preferred stock is increased from $110 to $209. This increase tiers up and increases P's basis in the S2 stock from $400 to $499. Accordingly, P will recognize only $1 of gain on the sale of its S2 stock. Afterwards, P can cause S3 to redeem its preferred stock for $209. S2 will recognize no gain or loss from the redemption. Although the unrecognized gain is preserved in P's basis in S1, and S1's basis in S3, the group can defer or avoid recognizing that gain.

In this case, there is no significant duplication of loss. Moreover, the steps were structured with a view to avoiding the recognition of gain on a disposition of stock. The IRS and Treasury Department do not intend that the basis redetermination rule be applied to defer or eliminate gain in such cases. The IRS and Treasury Department considered adopting a mechanical test to prevent the application of the basis redetermination rule in such cases. They concluded that such a rule would not provide the flexibility necessary to obtain an appropriate balancing of the concerns underlying this regulation and those underlying section 337(d). Therefore, these temporary regulations include an anti-abuse rule that provides that, if a transaction is structured with a view to, and has the effect of, deferring or avoiding the recognition of gain on a disposition of stock by invoking application of the basis redetermination rule, and the stock loss attributable to the transferred shares or the duplicated loss of the subsidiary member that is reflected in subsidiary member stock owned by members of the group is not significant, the basis redetermination and loss suspension rules will not apply.

E. Request For Comments

As described above, the IRS and Treasury Department are continuing to study the comments received regarding the proposed regulations. In addition, the IRS and Treasury Department are considering alternative regimes that would prevent the duplication of loss within the group.

In particular, the IRS and Treasury Department are studying a comment that suggested applying the principles of section 704(c) to allocate negative investment adjustments arising from loss items at the subsidiary member level where there have been transfers of loss property to the subsidiary member. The comment asserts that this approach would address the case where the recognition and absorption of the inside loss precedes the recognition of the stock loss. The IRS and Treasury Department are concerned that this alternative approach addresses only duplicative losses that arise as a result of contributions of loss property, not duplicative losses that arise as a result of a loss incurred by a subsidiary member. In addition, the IRS and Treasury Department are concerned that the application of the principles of section 704(c) may be complex, especially in cases where there have been issuances of subsidiary member stock at different times. The IRS and Treasury Department request comments regarding how the principles of section 704(c) should be applied in the consolidated return context to prevent the duplication of loss.

The IRS and Treasury Department are also studying a suggestion that the type of transaction in which the stock loss is recognized prior to the absorption of the inside loss be addressed by a rule that allows the stock loss but limits the use of the subsidiary member's items of loss and deduction if there have been contributions of loss property with respect to the subsidiary member and there is any loss duplication at the subsidiary member level at the time the stock loss is recognized. That rule would not permit the use of the subsidiary's items of loss and deduction that are duplicative of the stock loss to offset income of another member of the group, but would permit such items to offset income of the subsidiary.

This rule effectively would permit the acceleration of stock loss. The IRS and Treasury Department request comments regarding whether permitting such acceleration would clearly reflect the income of the group.

In addition, because this rule would permit the subsidiary's losses to offset its items of income and gain, it would not prevent the duplication of losses within the group to that extent. The IRS and Treasury Department request comments regarding whether this duplication is appropriate given that the benefits associated with the subsidiary and its shareholder being members of the group (e.g., positive basis adjustments to the shareholder member's stock of the subsidiary member that reflect income of the subsidiary member and the group's ability to use the loss recognized by another member to offset income of the subsidiary member of the group) have been enjoyed by the group.

Finally, this rule would address only cases of duplication where there have been contributions of loss property. As described above, the IRS and Treasury Department are concerned that contributions of loss property are not the only types of transactions in which a group can obtain more than one tax benefit from a single economic loss.

The IRS and Treasury Department are considering a variation of this suggested rule to address the situation where the stock loss is recognized prior to the absorption of the inside loss. This variation would allow the stock loss when recognized, but would disallow the inside losses of the subsidiary to the extent that such losses reflect losses that were duplicate losses at the time of the recognition of the stock loss. Such losses may be attributable to contributed property or losses that arose in the subsidiary member. The IRS and Treasury Department request comments regarding this variation.

Finally, the IRS and Treasury Department continue to request comments regarding any other approaches that could be implemented to address the duplication of loss within a consolidated group.

Special Analyses

In Rite Aid Corp. v. United States, 255 F.3d 1357 (Fed. Cir. 2001), the United States Court of Appeals for the Federal Circuit held that the duplicated loss component of §1.1502-20 was an invalid exercise of regulatory authority. In response to the Rite Aid decision, the IRS and Treasury Department issued Notice 2002-11 (2002-7 I.R.B. 526), stating that the interests of sound tax administration would not be served by the continued litigation of the validity of the duplicated loss component of §1.1502-20. Notice 2002-11 also announced that because of the interrelationship in the operation of all of the loss disallowance factors, new rules governing loss disallowance on sales of subsidiary stock by members of consolidated groups should be implemented.

In Notice 2002-18 (2002-12 I.R.B. 644), the IRS and Treasury Department stated that regulations would be promulgated that would defer or otherwise limit the utilization of a loss on stock (or another asset that reflects the basis of stock) in transactions that facilitate the group's utilization of a single economic loss more than once. Notice 2002-18 further stated that such regulations would apply to dispositions occurring on or after March 7, 2002. These temporary regulations implement Notice 2002-18 and are necessary to provide taxpayers with immediate guidance regarding stock basis and allowable loss in connection with transfers of subsidiary member stock. Accordingly, good cause is found for dispensing with a delayed effective date pursuant to 5 U.S.C. 553(d)(3).

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations do not have a significant impact on a substantial number of small entities. This certification is based on the fact that these regulations will primarily affect affiliated groups of corporations, which tend to be larger businesses. Moreover, the number of taxpayers affected and the average burden are minimal. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small businesses.

Drafting Information

The principle author of these regulations is Aimee K. Meacham of the Office of Chief Counsel (Corporate). However, other personnel from the IRS and Treasury

Department participated in their development.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

Amendments to the Regulations

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

PART 1--INCOME TAXES

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

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

Section 1.1502-21T(b)(1) and (b)(3)(v) also issued under 26 U.S.C. 1502. * * *

Section 1.1502-32T(a)(2), (b)(3)(iii)(C), (b)(3)(iii)(D), and (b)(4)(vi) also issued under 26 U.S.C. 1502. * * *

Section 1.1502-35T also issued under 26 U.S.C. 1502. * * *

Par. 2. In the list below, for each section indicated in the left column, remove the wording indicated in the middle column, and add the wording indicated in the right column.

Affected Section	Remove	Add
§1.267(f)-1(k)	§§1.337(d)-1, 1.337(d)-2, 1.1502-13(f)(6), and 1.1502-20	§§1.337(d)-2T, 1.1502-13(f)(6), and 1.1502-35T
	Loss disallowance. For	

§1.597-3(e)	purposes of §1.1502-20, FFA and the amount described in §1.597-4(g)(3) are treated as an extraordinary gain disposition within the meaning of §1.1502-20(c)(2)(i) and a Taxable Transfer is treated as an applicable asset acquisition under section 1060(c) within the meaning of §1.1502-20(c)(2)(i)(A)(4).	[Reserved].
§1.597-4(g)(2)(v), second sentence	(See §§1.337(d)-1 and 1.1502-20 for potential limitations on the group's worthless stock deduction.)	(See §§1.337(d)-2T and 1.1502-35T(f) for rules applicable when a member of a consolidated group is entitled to a worthless stock deduction with respect to stock of another member of the group.)
§1.1502-11(b)(3)(ii) Example (c), third sentence.	See also §1.1502-20 for rules applicable to losses from the sale of stock of subsidiaries.	See also §§1.337(d)-2T and 1.1502-35T for rules relating to basis adjustments and allowance of stock loss on dispositions of stock of a subsidiary member.
§1.1502-12(r)	For rulings relating to loss disallowance or basis reduction on the disposition or deconsolidation of stock of a subsidiary, see §§1.337(d)-1, 1.337(d)-2 and 1.1502-20.	See §§1.337(d)-2T and 1.1502-35T(f) for rules relating to basis adjustments and allowance of stock loss on dispositions of stock of a subsidiary member.
§1.1502-13(f)(7), Example 1(e), sixth sentence	See also §1.1502-20(b) (additional stock basis reductions applicable to certain deconsolidations).	

§1.1502-15(b)(2)(iii), first sentence	(e.g., under §1.1502-20 or section 267)	(e.g., under §§1.337(d)-2T, 1.1502-35T, or section 267)
§1.1502-21(b)(2)(i), third sentence	For rules permitting the reattribution of losses of a subsidiary to the common parent when loss is disallowed on the disposition of subsidiary stock, see §1.1502-20(g).	
§1.1502-32(b)(3)(iii)(B), third sentence	§1.1502-20(b), or §1.1502-20(g)	§1.1502-35T(b) or (f)(2)
§1.1502-32(b)(5)(ii), Example 2(b), last sentence	See also §1.1502-20(b) (possible stock basis reduction on the deconsolidation of S).	
§1.1502-32(e)(2), Example 4(a), fourth sentence	(Section §1.1502-20(b) does not reduce P's basis in the S stock as a result of S's deconsolidation.)	
§1.1502-80(c), last sentence	See §1.1502-11(c) and 1.1502-20 for additional rules relating to stock loss.	See §1.1502-11(c) and 1.1502-35T for additional rules relating to stock loss.
§1.1502-91(h)(2), first sentence	(unless disallowed under §1.1502-20 or otherwise)	(unless disallowed under §1.337(d)-2T, 1.1502-35T, or otherwise)

Par. 3. Section 1.1502-21 is amended by:

1. Revising paragraph (b)(1).

2. Adding paragraphs (b)(3)(v) and (h)(7).

The revisions and addition read as follows:

<u>§1.1502-21 Net operating losses</u>.

* * * * *

(b) * * *

(1) [Reserved]. For further guidance, see §1.1502-21T(b)(1).

* * * * *

(3) * * *

(v) [Reserved]. For further guidance, see §1.1502-21T(b)(3)(v).

* * * * *

(h) * * *

(7) [Reserved]. For further guidance, see §1.1502-21T(h)(7).

Par. 4. Section 1.1502-21T is revised to read as follows:

§1.1502-21T Net operating losses (temporary).

(a) [Reserved]. For further guidance, see §1.1502-21(a).

(b) [Reserved]. For further guidance, see §1.1502-21(b).

(1) Carryovers and carrybacks generally. The net operating loss carryovers and carrybacks to a taxable year are determined under the principles of section 172 and this section. Thus, losses permitted to be absorbed in a consolidated return year generally are absorbed in the order of the taxable years in which they arose, and losses carried from taxable years ending on the same date, and which are available to offset consolidated taxable income for the year, generally are absorbed on a pro rata basis. Additional rules under the Internal Revenue Code or regulations also apply. See, e.g., section 382(l)(2)(B) (if losses are carried from the same taxable year, losses subject to limitation under section 382 are absorbed before losses that are not subject to limitation under section 382). See Example 2 of paragraph (c)(1)(iii) of this section for an illustration of pro rata absorption of losses subject to a SRLY limitation. See paragraph

(b)(3)(v) of this section regarding the treatment of any loss that is treated as expired under §1.1502-35T(f)(1).

(b)(2) through (b)(3)(iv) [Reserved]. For further guidance, see §1.1502-21(b)(2) through (b)(3)(iv).

(b)(3)(v) Losses treated as expired under §1.1502-35T(f)(1). No loss treated as expired by §1.1502-35T(f)(1) may be carried over to any consolidated return year of the group.

(c) through (h)(6) [Reserved]. For further guidance, see §1.1502-21(c) through (h)(6).

(h)(7) Losses treated as expired under §1.1502-35T(f)(1). Paragraph (b)(3)(v) of this section is effective for losses treated as expired under §1.1502-35T(f)(1) on and after March 7, 2002, and no later than March 11, 2006.

Par. 5. Section 1.1502-32 is amended by:

1. Revising paragraph (a)(2).

2. Adding paragraphs (b)(3)(iii)(C), (b)(3)(iii)(D), (b)(4)(vi), and (h)(6).

The revision and additions read as follows:

§1.1502-32 Investment adjustments.

* * * * *

(a)(2) [Reserved]. For further guidance, see §1.1502-32T(a)(2).

(b)(3)(iii)(C) and (D) [Reserved]. For further guidance, see §1.1502-32T(b)(3)(iii)(C) and (D).

* * * * *

(b)(4)(vi) [Reserved]. For further guidance, see §1.1502-32T(b)(4)(vi).

* * * * *

(h)(6) [Reserved]. For further guidance, see §1.1502-32T(h)(6).

Par. 6. Section 1.1502-32T is revised to read as follows:

§1.1502-32T Investment adjustments (temporary).

(a) and (a)(1) [Reserved]. For further guidance, see §1.1502-32(a) and (a)(1).

(a)(2) Application of other rules of law. The rules of this section are in addition to other rules of law. See, e.g., section 358 (basis determinations for distributees), section 1016 (adjustments to basis), §1.1502-11(b) (limitations on the use of losses), §1.1502-19 (treatment of excess loss accounts), §1.1502-31 (basis after a group structure change), and §1.1502-35T (additional rules relating to stock loss, including losses attributable to worthlessness and certain dispositions not followed by a separate return year). P's basis in S's stock must not be adjusted under this section and other rules of law in a manner that has the effect of duplicating an adjustment. For example, if pursuant to §1.1502-35T(c)(3) and paragraph (b)(3)(iii)(C) of this section the basis in stock is reduced to take into account a loss suspended under §1.1502-35T(c)(1), such basis shall not be further reduced to take into account such loss, or a portion of such loss, if any, that is later allowed pursuant to §1.1502-35T(c)(5). See also paragraph (h)(5) of this section for basis reductions applicable to certain former subsidiaries.

(b) through (b)(3)(iii)(B) [Reserved]. For further guidance, see §1.1502-32(b) through (b)(3)(iii)(B).

(b)(3)(iii)(C) Loss suspended under §1.1502-35T(c). Any loss suspended pursuant to §1.1502-35T(c) is treated as a noncapital, nondeductible expense incurred during the taxable year that includes the date of the disposition to which such section applies. See §1.1502-35T(c)(3). Consequently, the basis of a higher-tier member's stock of P is reduced by the suspended loss in the year it is suspended.

(D) Loss disallowed under §1.1502-35T(g)(3)(iii). Any loss or deduction the use of which is disallowed pursuant to §1.1502-35T(g)(3)(iii) (other than a loss or deduction described in §1.1502-35T(g)(3)(i)(B)(11)), and with respect to which no waiver described in paragraph (b)(4) of this section is filed, is treated as a noncapital, nondeductible expense incurred during the taxable year that such loss would otherwise be absorbed. See §1.1502-35T(g)(3)(iv).

(b)(4) through (b)(4)(v) [Reserved]. For further guidance, see §1.1502-32(b)(4) through (b)(4)(v).

(b)(4)(vi) Special rules in the case of certain transactions subject to §1.1502-35T. If a member of a consolidated group transfers stock of a subsidiary member and such stock has a basis that exceeds its value immediately before such transfer or a subsidiary member is deconsolidated and any stock of such subsidiary member owned by members of the group immediately before such deconsolidation has a basis that exceeds its value, all members of the group are subject to the provisions of §1.1502-35T(b), which generally require a redetermination of members' basis in all shares of subsidiary stock. In addition, if stock of a subsidiary member is treated as worthless under section 165 (taking into account the provisions of §1.1502-80(c)), or if a member of a group disposes of subsidiary member stock and on the following day the subsidiary is not a member of the group and does not have a separate return year, and the common parent makes an election under §1.1502-35T(f)(2) to reattribute to itself the losses treated as attributable to such subsidiary member, §1.1502-35T(f)(2) requires a reduction of members' basis in shares of subsidiary stock.

(c) through (h)(5)(ii) [Reserved]. For further guidance, see §1.1502-32(c) through (h)(5)(ii).

(h)(6) Loss suspended under §1.1502-35T(c) or disallowed under §1.1502-35T(g)(3)(iii). Paragraphs (a)(2), (b)(3)(iii)(C), (b)(3)(iii)(D) and (b)(4)(vi) of this section are effective on and after March 7, 2002, and expire on March 11, 2006.

Par. 7. Section 1.1502-35T is added to read as follows:

§1.1502-35T Transfers of subsidiary member stock and deconsolidations of subsidiary members (temporary).

(a) Purpose. The purpose of this section is to prevent a group from obtaining more than one tax benefit from a single economic loss. The provisions of this section shall be construed in a manner consistent with that purpose and in a manner that reasonably carries out that purpose.

(b) Redetermination of basis on certain nondeconsolidating transfers of subsidiary member stock and on certain deconsolidations of subsidiary members--(1) Redetermination of basis on certain nondeconsolidating transfers of subsidiary member stock. Except as provided in paragraph (b)(3)(i) of this section, if, immediately after a transfer of stock of a subsidiary member that has a basis that exceeds its value, the subsidiary member remains a member of the group, then the basis in each share of subsidiary member stock owned by each member of the group shall be redetermined in accordance with the provisions of this paragraph (b)(1) immediately before such transfer. All of the members' bases in the shares of subsidiary member stock immediately before such transfer shall be aggregated. Such aggregated basis shall be allocated first to the shares of the subsidiary member's preferred stock that are owned by the members of the group immediately before such transfer, in proportion to, but not in excess of, the value of those shares at such time. After allocation of the aggregated basis to all shares of the preferred stock of the subsidiary member pursuant to the preceding sentence, any remaining basis shall be allocated among all common shares of subsidiary member stock held by members of the group immediately before the transfer, in proportion to the value of such shares at such time.

(2) Redetermination of basis on certain deconsolidations of subsidiary members.--(i) Allocation of reallocable basis amount. Except as provided in paragraph (b)(3)(ii) of this section, if, immediately before a deconsolidation of a subsidiary member, any share of stock of such subsidiary owned by a member of the group has a basis that exceeds its value, then the basis in each share of the subsidiary member's stock owned by each member of the group shall be redetermined in accordance with the provisions of this paragraph (b)(2) immediately before such deconsolidation. The basis in each share of the subsidiary member's stock held by members of the group immediately before the deconsolidation that has a basis in excess of value at such time shall be reduced, but not below such share's value, in a manner that, to the greatest extent possible, causes the ratio of the basis to the value of each such share to be the same; provided, however, that the aggregate amount of such reduction shall not exceed the reallocable basis amount (as computed pursuant to paragraph (b)(2)(ii) of this section). Then, to the extent of the reallocable basis amount, the basis of each share of the preferred

stock of the subsidiary member that are held by members of the group immediately before the deconsolidation shall be increased, but not above such share's value, in a manner that, to the greatest extent possible, causes the ratio of the basis to the value of each such share to be the same. Then, to the extent that the reallocable basis amount does not increase the basis of shares of preferred stock of the subsidiary member pursuant to the third sentence of this paragraph (b)(2)(i), such amount shall increase the basis of all common shares of the subsidiary member's stock held by members of the group immediately before the deconsolidation in a manner that, to the greatest extent possible, causes the ratio of the basis to the value of each such share to be the same.

(ii) Calculation of reallocable basis amount. The reallocable basis amount shall equal the lesser of--

(A) The aggregate of all amounts by which, immediately before the deconsolidation, the basis exceeds the value of a share of subsidiary member stock owned by any member of the group at such time; and

(B) The total of the subsidiary member's (and any predecessor's) items of deduction and loss, and the subsidiary member's (and any predecessor's) allocable share of items of deduction and loss of all lower-tier subsidiary members, that were taken into account in computing the adjustment under §1.1502-32 to the bases of shares of stock of the subsidiary member (and any predecessor) held by members of the group immediately before the deconsolidation, other than shares that have bases in excess of value immediately before the deconsolidation.

(3) Exceptions to application of redetermination rules. (i) Paragraph (b)(1) of this section shall not apply to a transfer of subsidiary member stock if --

(A) during the taxable year of such transfer, in one or more fully taxable transactions, the members of the group dispose of all of the shares of the subsidiary member stock that they own immediately before the transfer, other than the shares the transfer of which would otherwise trigger the application of paragraph (b)(1) of this section, to a person or persons that are not members of the group;

(B) during the taxable year of such transfer, the members of the group are allowed a worthless stock loss under section 165(g) (taking into account the provisions of §1.1502-80(c)) with respect to all of the shares of subsidiary member stock that they own immediately before the transfer, other than the shares the transfer of which would otherwise trigger the application of paragraph (b)(1) of this section; or

(C) such transfer is to a member of the group and section 332 (provided the stock is transferred to an 80-percent distributee), section 351, or section 361 applies to such transfer.

(ii) Paragraph (b)(2) of this section shall not apply to a deconsolidation of a subsidiary member if –

(A) during the taxable year of such deconsolidation, in one or more fully taxable transactions, the members of the group dispose of all of the shares of the subsidiary member stock that they own immediately before the deconsolidation to a person or persons that are not members of the group;

(B) such deconsolidation results from a fully taxable disposition, to a person or persons that are not members of the group, of some of the shares of the subsidiary member, and, during the taxable year of such deconsolidation, the members of the group are allowed a worthless stock loss under section 165(g) with respect to all of the shares of subsidiary member stock that they own immediately after the deconsolidation; or

(C) the deconsolidation of the subsidiary member results from the deconsolidation of a higher-tier subsidiary member and, immediately after the deconsolidation of the subsidiary member, none of the stock of the subsidiary member is owned by a group member.

(4) Special rule for lower-tier subsidiaries. If, immediately after a transfer of subsidiary member stock or a deconsolidation of a subsidiary member, a lower-tier subsidiary member some of the stock of which is owned by the subsidiary member is a member of the group, then, for purposes of applying paragraph (b) of this section, the subsidiary member shall be treated as having transferred its stock of the lower-tier subsidiary member. This principle shall apply to stock of subsidiary members that are owned by such lower-tier subsidiary member.

(5) Stock basis adjustments for higher-tier stock. The basis adjustments required under this paragraph (b) result in basis adjustments to higher-tier member stock. The adjustments are applied in the order of the tiers, from the lowest to highest. For example, if a common parent owns stock of a subsidiary member that owns stock of a lower-tier subsidiary member and the subsidiary member recognizes a loss on the disposition of a portion of its shares of the lower-tier subsidiary member stock, the common parent must adjust its basis in its subsidiary member stock under the principles of §1.1502-32 to reflect the adjustments that the subsidiary member must make to its basis in its stock of the lower-tier subsidiary member.

(6) Ordering rules. (i) The rules of this paragraph (b) apply after the rules of §1.1502-32 are applied.

(ii) The rules of this paragraph (b) apply before the rules of §1.337(d)-2T and paragraph (c) of this section are applied.

(iii) Paragraph (b) of this section (and any resulting basis adjustments to higher-tier member stock made pursuant to paragraph (b)(5) of this section) applies to redetermine the basis of stock of a lower-tier subsidiary member before paragraph (b) of this section applies to a higher-tier member of such lower-tier subsidiary member.

(c) Loss suspension--(1) General rule. Any loss recognized by a member of a consolidated group with respect to the disposition of a share of subsidiary member stock shall be suspended to the extent of the duplicated loss with respect to such share of stock if, immediately after the disposition, the subsidiary is a member of the consolidated group of which it was a member immediately prior to the disposition (or any successor group).

(2) Special rule for lower-tier subsidiaries. This paragraph (c)(2) applies if neither paragraph (c)(1) nor (f) of this section applies to a member's disposition of a share of stock of a subsidiary member (the departing member), a loss is recognized on the disposition of such share, and the departing member owns stock of one or more other subsidiary members (a remaining member) that is a member of such group immediately after the disposition. In that case, such loss shall be suspended to the extent the duplicated loss with respect to the departing member stock disposed of is attributable to the remaining member or members.

(3) Treatment of suspended loss. For purposes of the rules of §1.1502-32, any loss suspended pursuant to paragraph (c)(1) or (c)(2) of this section is treated as a noncapital, nondeductible expense of the member that disposes of subsidiary member stock, incurred during the taxable year that includes the date of the disposition of stock to which paragraph (c)(1) or (c)(2) of this section applies. See §1.1502-32T(b)(3)(iii)(C). Consequently, the basis of a higher-tier member's stock of the member that disposes of subsidiary member stock is reduced by the suspended loss in the year it is suspended.

(4) Reduction of suspended loss--(i) General rule. The amount of any loss suspended pursuant to paragraphs (c)(1) and (c)(2) of this section shall be reduced, but not below zero, by the subsidiary member's (and any successor's) items of deduction and loss, and the subsidiary member's (and any successor's) allocable share of items of deduction and loss of all lower-tier subsidiary members, that are allocable to the period beginning on the date of the disposition that gave rise to the suspended loss and ending on the day before the first date on which the subsidiary member (or any successor) is not a member of the group of which it was a member immediately prior to the disposition (or any successor group), and that are taken into account in determining consolidated taxable income (or loss) of such group for any taxable year that includes any date on or after the date of the disposition and before the first date on which the subsidiary member (or any successor) is not a member of such group; provided, however, that such reduction shall not exceed the excess of the amount of such items over the amount of such items that are taken into account in determining the basis adjustments made under §1.1502-32 to stock of the subsidiary member (or any successor) owned by members of the group. The preceding sentence shall not apply to

items of deduction and loss to the extent that the group can establish that all or a portion of such items was not reflected in the computation of the duplicated loss with respect to the subsidiary member on the date of the disposition of stock that gave rise to the suspended loss.

(ii) Operating rules--(A) Year in which deduction or loss is taken into account. For purposes of paragraph (c)(4)(i) of this section, a subsidiary member's (or any successor's) deductions and losses are treated as taken into account when and to the extent they are absorbed by the subsidiary member (or any successor) or any other member. To the extent that the subsidiary member's (or any successor's) deduction or loss is absorbed in the year it arises or is carried forward and absorbed in a subsequent year (e.g., under section 172, 465, or 1212), the deduction is treated as taken into account in the year in which it is absorbed. To the extent that a subsidiary member's (or any successor's) deduction or loss is carried back and absorbed in a prior year (whether consolidated or separate), the deduction or loss is treated as taken into account in the year in which it arises and not in the year in which it is absorbed.

(B) Determination of items that are allocable to the post-disposition, pre-deconsolidation period. For purposes of paragraph (c)(4)(i) of this section, the determination of whether a subsidiary member's (or any successor's) items of deduction and loss and allocable share of items of deduction and loss of all lower-tier subsidiary members are allocable to the period beginning on the date of the disposition of subsidiary stock that gave rise to the suspended loss and ending on the day before the first date on which the subsidiary member (or any successor) is not a member of the consolidated group of which it was a member immediately prior to the disposition (or any successor group) is determined pursuant to the rules of §1.1502-76(b)(2), without regard to §1.1502-76(b)(2)(ii)(D), as if the subsidiary member ceased to be a member of the group at the end of the day before the disposition and filed separate returns for the period beginning on the date of the disposition and ending on the day before the first date on which it is not a member of such group.

(5) Allowable loss--(i) General rule. To the extent not reduced under paragraph (c)(4) of this section, any loss suspended pursuant to paragraph (c)(1) or (c)(2) of this section shall be allowed, to the extent otherwise allowable under applicable provisions of the Internal Revenue Code and regulations thereunder, on a return filed by the group of which the subsidiary was a member on the date of the disposition of subsidiary stock that gave rise to the suspended loss (or any successor group) for the taxable year that includes the day before the first date on which the subsidiary (or any successor) is not a member of such group or the date the group is allowed a worthless stock loss under section 165(g) (taking into account the provisions of §1.1502-80(c)) with respect to all of the subsidiary member stock owned by members.

(ii) No tiering up of certain adjustments. No adjustments shall be made to a member's basis of stock of a subsidiary member (or any successor) for a suspended loss that is taken into account under paragraph (c)(5)(i) of this section. See §1.1502-32T(a)(2).

(iii) Statement of allowed loss. Paragraph (c)(5)(i) of this section applies only if the separate statement required under this paragraph (c)(5)(iii) is filed with, or as part of, the taxpayer's return for the year in which the loss is allowable. The statement must be entitled "ALLOWED LOSS UNDER §1.1502-35T(c)(5)" and must contain the name and employer identification number of the subsidiary the stock of which gave rise to the loss.

(6) Special rule for dispositions of certain carryover basis assets. If--

(i) A member of a group recognizes a loss on the disposition of an asset other than stock of a subsidiary member;

(ii) Such member's basis in the asset disposed of was determined, directly or indirectly, in whole or in part, by reference to the basis of stock of a subsidiary member and, at the time of the determination of the member's basis in the asset disposed of, there was a duplicated loss with respect to such stock of the subsidiary member; and

(iii) Immediately after the disposition, the subsidiary member is a member of such group, then such loss shall be suspended pursuant to the principles of paragraphs (c)(1) and (c)(2) of this section to the extent of the duplicated loss with respect to such stock at the time of the determination of basis of the asset disposed of. Principles similar to those set forth in paragraphs (c)(3), (c)(4), and (c)(5) of this section shall apply to a loss suspended pursuant to this paragraph (c)(6).

(7) Coordination with loss deferral, loss disallowance, and other rules--(i) In general. Loss recognized on the disposition of subsidiary member stock or another asset is subject to redetermination, deferral, or disallowance under other applicable provisions of the Internal Revenue Code and regulations thereunder, including sections 267(f) and 482. Paragraphs (c)(1), (c)(2), and (c)(6) of this section do not apply to a loss that is disallowed under any other provision. If loss is deferred under any other provision, paragraphs (c)(1), (c)(2), and (c)(6) of this section apply when the loss would otherwise be taken into account under such other provision. However, if an overriding

event described in paragraph (c)(7)(ii) of this section occurs before the deferred loss is taken into account, paragraphs (c)(1), (c)(2), and (c)(6) of this section apply to the loss immediately before the event occurs, even though the loss may not be taken into account until a later time.

(ii) Overriding events. For purposes of paragraph (c)(7)(i) of this section, the following are overriding events--

(A) The stock ceases to be owned by a member of the consolidated group;

(B) The stock is canceled or redeemed (regardless of whether it is retired or held as treasury stock); or

(C) The stock is treated as disposed of under §1.1502-19(c)(1)(ii)(B) or (c)(1)(iii).

(8) Application. This paragraph (c) shall not be applied in a manner that permanently disallows a deduction for an economic loss, provided that such deduction is otherwise allowable. If the application of any provision of this paragraph (c) results in such a disallowance, proper adjustment may be made to prevent such a disallowance. Whether a provision of this paragraph (c) has resulted in such a disallowance is determined on the date on which the subsidiary (or any successor) the disposition of the stock of which gave rise to a suspended stock loss is not a member of the group or the date the group is allowed a worthless stock loss under section 165(g) (taking into account the provisions of §1.1502-80(c)) with respect to all of such subsidiary member stock owned by members. Proper adjustment in such cases shall be made by restoring the suspended stock loss immediately before the subsidiary ceases to be a member of the group or the group is allowed a worthless stock loss under section 165(g) (taking into account the provisions of §1.1502-80(c)) with respect to all of such subsidiary

member stock owned by members, to the extent that its reduction pursuant to paragraph (c)(4) of this section had the result of permanently disallowing a deduction for an economic loss.

(9) Ordering rule. The rules of this paragraph (c) apply after the rules of paragraph (b) of this section and §1.337(d)-2T are applied.

(d) Definitions--(1) Disposition. Disposition means any event in which gain or loss is recognized, in whole or in part.

(2) Deconsolidation. Deconsolidation means any event that causes a subsidiary member to no longer be a member of the consolidated group.

(3) Value. Value means fair market value.

(4) Duplicated loss--(i) In general. Duplicated loss is determined immediately after a disposition and equals the excess, if any, of--

(A) The sum of--

(1) The aggregate adjusted basis of the subsidiary member's assets other than any stock that subsidiary member owns in another subsidiary member; and

(2) Any losses attributable to the subsidiary member and carried to the subsidiary member's first taxable year following the disposition; and

(3) Any deductions of the subsidiary member that have been recognized but are deferred under a provision of the Internal Revenue Code (such as deductions deferred under section 469); over

(B) The sum of--

(1) The value of the subsidiary member's stock; and

(2) Any liabilities of the subsidiary member that have been taken account for tax purposes.

(ii) Special rules. (A) The amounts determined under paragraph (d)(4)(i) (other than amounts described in paragraph (d)(4)(i)(B)(1)) of this section with respect to a subsidiary member include its allocable share of corresponding amounts with respect to all lower-tier subsidiary members. If 80 percent or more in value of the stock of a subsidiary member is acquired by purchase in a single transaction (or in a series of related transactions during any 12-month period), the value of the subsidiary member's stock may not exceed the purchase price of the stock divided by the percentage of the stock (by value) so purchased. For this purpose, stock is acquired by purchase if the transferee is not related to the transferor within the meaning of sections 267(b) and 707(b)(1), using the language "'10 percent'" instead of "'50 percent'" each place that it appears, and the transferee's basis in the stock is determined wholly by reference to the consideration paid for such stock.

(B) The amounts determined under paragraph (d)(4)(i) of this section are not applied more than once to suspend a loss under this section.

(5) Predecessor and Successor. A predecessor is a transferor of assets to a transferee (the successor) in a transaction--

(i) To which section 381(a) applies;

(ii) In which substantially all of the assets of the transferor are transferred to members in a complete liquidation;

(iii) In which the successor's basis in assets is determined (directly or indirectly, in whole or in part) by reference to the transferor's basis in such assets, but the transferee is a successor only with respect to the assets the basis of which is so determined; or

(iv) Which is an intercompany transaction, but only with respect to assets that are being accounted for by the transferor in a prior intercompany transaction.

(6) Successor group. A surviving group is treated as a successor group of a consolidated group (the terminating group) that ceases to exist as a result of--

(i) The acquisition by a member of another consolidated group of either the assets of the common parent of the terminating group in a reorganization described in section 381(a)(2), or the stock of the common parent of the terminating group; or

(ii) The application of the principles of §1.1502-75(d)(2) or (3).

(7) Preferred stock, common stock. Preferred stock and common stock shall have the meanings set forth in §1.1502-32(d)(2) and (3), respectively.

(8) Higher-tier. A subsidiary member is higher-tier with respect to a member if or to the extent investment basis adjustments under §1.1502-32 with respect to the stock of the latter member would affect investment basis adjustments with respect to the stock of the former member.

(9) Lower-tier. A subsidiary member is lower-tier with respect to a member if or to the extent investment basis adjustments under §1.1502-32 with respect to the stock of the former member would affect investment basis adjustments with respect to the stock of the latter member.

(e) Examples. For purposes of the examples in this section, all groups file consolidated returns on a calendar-year basis, the facts set forth the only corporate activity, all transactions are between unrelated persons unless otherwise specified, and tax liabilities are disregarded. The principles of paragraphs (a) through (d) of this section are illustrated by the following examples:

Example 1. Nondeconsolidating sale of preferred stock of lower-tier subsidiary member. (i) Facts. P owns 100 percent of the common stock of each of S1 and S2. S1 and S2 each have only one class of stock outstanding. P's basis in the stock of S1 is $100 and the value of such stock is $130. P's basis in the stock of S2 is $120 and the value of such stock is $90. P, S1, and S2 are all members of the P group. S1 and S2 form S3. In Year 1, in transfers to which section 351 applies, S1 contributes $100 to S3 in exchange for all of the common stock of S3 and S2 contributes an asset with a basis of $50 and a value of $20 to S3 in exchange for all of the preferred stock of S3. S3 becomes a member of the P group. In Year 3, in a transaction that is not part of the plan that includes the contributions to S3, S2 sells the preferred stock of S3 for $20. Immediately after the sale, S3 is a member of the P group.

(ii) Application of basis redetermination rule. Because S2's basis in the preferred stock of S3 exceeds its value immediately prior to the sale and S3 is a member of the P group immediately after the sale, all of the P group members' bases in the stock of S3 is redetermined pursuant to paragraph (b)(1) of this section. Of the group members' total basis of $150 in the S3 stock, $20 is allocated to the preferred stock, the fair market value of the preferred stock on the date of the sale, and $130 is allocated to the common stock. S2's sale of the preferred stock results in the recognition of $0 of gain/loss. Pursuant to paragraph (b)(5) of this section, the redetermination of S1's and S2's bases in the stock of S3 results in adjustments to P's basis in the stock of S1 and S2. In particular, P's basis in the stock of S1 is increased by $30 to $130 and its basis in the stock of S2 is decreased by $30 to $90.

Example 2. Deconsolidating sale of common stock. (i) Facts. In Year 1, in a transfer to which section 351 applies, P contributes Asset A with a basis of $900 and a value of $200 to S in exchange for one share of S common stock (CS1). In Years 2 and 3, in successive but unrelated transfers to which section 351 applies, P transfers $200 to S in exchange for one share of S common stock (CS2), Asset B with a basis of $300 and a value of $200 in exchange for one share of S common stock (CS3), and Asset C with a basis of $1000 and a value of $200 in exchange for one share of S common stock (CS4). In Year 4, S sells Asset A for $200, recognizing $700 of loss that is used to offset income of P recognized during Year 4. As a result of the sale of Asset A, the basis of each of P's four shares of S common stock is reduced by $175. Therefore, the basis of CS1 is $725. The basis of CS2 is $25. The basis of CS3 is $125, and the basis of CS4 is $825. In Year 5 in a transaction that is not part of a plan that includes the Year 1 contribution, P sells CS4 for $200. Immediately after the sale of CS4, S is not a member of the P group.

(ii) Application of basis redetermination rule. Because P's basis in each of CS1 and CS4 exceeds its value immediately prior to the deconsolidation of S, P's basis in its shares of S common stock is redetermined pursuant to paragraph (b)(2) of this section. Pursuant to paragraph (b)(2)(ii) of this section, the reallocable basis amount is $350 (the lesser of $1150, the gross loss inherent in the stock of S owned by P immediately before the sale, and $350, the aggregate amount of S's items of deduction and loss that were previously taken into account in the computation of the adjustment to the basis of the stock of S that P did not hold at a loss immediately before the deconsolidation). Pursuant to paragraph (b)(2)(i) of this section, first, P's basis in CS1 is reduced from $725 to $600 and P's basis in CS4 is reduced from $825 to $600. Then, the reallocable basis amount increases P's basis in CS2 from $25 to $250 and P's basis in CS3 from $125 to $250. P recognizes $400 of loss on the sale of CS4. The loss suspension rule does not apply because S is no longer a member of the P group. Thus, the loss is allowable at that time.

Example 3. Nondeconsolidating sale of common stock. (i) Facts. In Year 1, P forms S with a contribution of $80 in exchange for 80 shares of the common stock of S, which at that time represents all of the outstanding stock of S. S becomes a member of the P group. In Year 2, P contributes Asset A with a basis of $50 and a value of $20 in exchange for 20 shares of the common stock of S in a transfer to which section 351 applies. In Year 3, in a transaction that is not part of the plan that includes the Year 2 contribution, P sells the 20 shares of the common stock of S that it acquired in Year 2 for $20. Immediately after the Year 3 stock sale, S is a member of the P group. At the time of the Year 3 stock sale, S has $80 and Asset A. In Year 4, S sells Asset A , the basis and value of which have not changed since its contribution to S. On the sale of Asset A for $20, S recognizes a $30 loss. The P group cannot establish that all or a portion of the $30 loss was not reflected in the calculation of the duplicated loss of S on the date of the Year 3 stock sale. The $30 loss is used on the P group return to offset income of P. In Year 5, P sells its remaining S common stock for $80.

(ii) Application of basis redetermination and loss suspension rules. Because P's basis in the common stock sold exceeds its value immediately prior to the sale and S is a member of the P group immediately after the sale, P's basis in all of the stock of S is redetermined pursuant to paragraph (b)(1) of this section. Of P's total basis of $130 in the S common stock, a proportionate amount is allocated to each of the 100 shares of S common stock. Accordingly, $26 is allocated to the common stock of S that is sold and $104 is allocated to the common stock of S that is retained. On P's sale of the 20 shares of the common stock of S for $20, P recognizes a loss of $6. Because the sale of the 20 shares of common stock of S does not result in the deconsolidation of S, under paragraph (c)(1) of this section, that loss is suspended to the extent of the duplicated loss with respect to the shares sold. The duplicated loss with respect to the shares sold is $6. Therefore, the entire $6 loss is suspended.

(iii) Effect of subsequent asset sale on stock basis. Of the $30 loss recognized on the sale of Asset A, $24 is taken into account in determining the basis adjustments made under §1.1502-32 to the stock of S owned by P. Accordingly, P's basis in its S stock is reduced by $24 from $104 to $80.

(iv) Effect of subsequent asset sale on suspended loss. Because P cannot establish that all or a portion of the loss recognized on the sale of Asset A was not reflected in the calculation of the duplicated loss of S on the date of the Year 3 stock sale and such loss is allocable to the period beginning on the date of the Year 3 disposition of the S stock and ending on the day before the first date on which S is not a member of the P group and is taken into account in determining consolidated taxable income (or loss) of the P group for a taxable year that includes a date on or after the date of the Year 3 disposition and before the first date on which S is not a member of the P group, such asset loss reduces the suspended loss pursuant to paragraph (c)(4) of this section. The amount of such reduction, however, cannot exceed $6, the excess of the amount of such loss, $30, over the amount of such loss that is taken into account in determining the basis adjustment made to the stock of S owned by P, $24. Therefore, the suspended loss is reduced to zero.

(v) Effect of subsequent stock sale. P recognizes $0 gain/loss on the Year 5 sale of its remaining S common stock. No amount of suspended loss remains to be allowed under paragraph (c)(5) of this section.

Example 4. Nondeconsolidating sale of common stock of lower-tier subsidiary. (i) Facts. In Year 1, P forms S1 with a contribution of $200 in exchange for all of the common stock of S1, which represents all of the outstanding stock of S1. In the same year, S1 forms S2 with a contribution of $80 in exchange for 80 shares of the common stock of S2, which at that time represents all of the outstanding stock of S2. S1 and S2 become members of the P group. In the same year, S2 purchases Asset A for $80. In Year 2, S1 contributes Asset B with a basis of $50 and a value of $20 in exchange for 20 shares of the common stock of S2 in a transfer to which section 351 applies. In Year 3, S1 sells the 20 shares of the common stock of S2 that it acquired in Year 2 for $20. Immediately after the Year 3 stock sale, S2 is a member of the P group. At the time of the Year 3 stock sale, the bases and values of Asset A and Asset B are unchanged. In Year 4, S2 sells Asset B for $45, recognizing a $5 loss. The P group cannot establish that all or a portion of the $5 loss was not reflected in the calculation of the duplicated loss of S2 on the date of the Year 3 stock sale. The $5 loss is used on the P group return to offset income of P. In Year 5, S1 sells its remaining S2 common stock for $100.

(ii) Application of basis redetermination and loss suspension rules. Because S1's basis in the S2 common stock sold exceeds its value immediately prior to the sale and S2 is a member of the P group immediately after the sale, S1's basis in all of the stock of S2 is redetermined pursuant to paragraph (b)(1) of this section. Of S1's total basis of $130 in the S2 common stock, a proportionate amount is allocated to each of the 100 shares of S2 common stock. Accordingly, a total of $26 is allocated to the common stock of S2 that is sold and $104 is allocated to the common stock of S2 that is retained. On S1's sale of the 20 shares of the common stock of S2 for $20, S1 recognizes a loss of $6. Because the sale of the 20 shares of common stock of S2 does not result in the deconsolidation of S2, under paragraph (c)(1) of this section, that loss is suspended to the extent of the duplicated loss with respect to the shares sold. The duplicated loss with respect to the shares sold is $6. Therefore, the entire $6 loss is suspended. Pursuant to paragraph (c)(3) of this section and §1.1502-32T(b)(3)(iii)(C), the suspended loss is treated as a noncapital, nondeductible expense incurred by S1 during the tax year that includes the date of the disposition of stock to which paragraph (c)(1) of this section applies. Accordingly, P's basis in its S1 stock is reduced from $200 to $194.

(iii) Effect of subsequent asset sale on stock basis. Of the $5 loss recognized on the sale of Asset B, $4 is taken into account in determining the basis adjustments made under §1.1502-32 to the stock of S2 owned by S1. Accordingly, S1's basis in its S2 stock is reduced by $4 from $104 to $100 and P's basis in its S1 stock is reduced by $4 from $194 to $190.

(iv) Effect of subsequent asset sale on suspended loss. Because P cannot establish that all or a portion of the loss recognized on the sale of Asset B was not reflected in the calculation of the duplicated loss of S2 on the date of the Year 3 stock sale and such loss is allocable to the period beginning on the date of the Year 3 disposition of the S2 stock and ending on the day before the first date on which S2 is not a member of the P group and is taken into account in determining consolidated taxable income (or loss) of the P group for a taxable year that includes a date on or after the date of the Year 3 disposition and before the first date on which S2 is not a member of the P group, such asset loss reduces the suspended loss pursuant to paragraph (c)(4) of this section. The amount of such reduction, however, cannot exceed $1, the excess of the amount of such loss, $5, over the amount of such loss that is taken into account in determining the basis adjustment made to the stock of S2 owned by members of the P group, $4. Therefore, the suspended loss is reduced to $5.

(v) Effect of subsequent stock sale. In Year 5, when S1 sells its remaining S2 stock for $100, it recognizes $0 gain/loss. Pursuant to paragraph (c)(5) of this section, the remaining $5 of the suspended loss is allowed on the P group's return for Year 5 when S1 sells its remaining S2 stock.

Example 5. Deconsolidating sale of subsidiary member owning stock of another subsidiary member that remains in group. (i) Facts. In Year 1, P forms S1 with a contribution of Asset A with a basis of $50 and a value of $20 in exchange for 100 shares of common stock of S1 in a transfer to which section 351 applies. Also in Year 1, P and S1 form S2. P contributes $80 to S2 in exchange for 80 shares of common stock of S2. S1 contributes Asset A to S2 in exchange for 20 shares of common stock of S2 in a transfer to which section 351 applies. In Year 3, in a transaction that is not part of a plan that includes the Year 1 contributions, P sells its 100 shares of S1 common stock for $20. Immediately after the Year 3 stock sale, S2 is a member of the P group. At the time of the Year 3 stock sale, S1 owns 20 shares of common stock of S2, and S2 has $80 and Asset A. In Year 4, S2 sells Asset A, the basis and value of which have not changed since its contribution to S2. On the sale of Asset A for $20, S2 recognizes a $30 loss. That $30 loss is used on the P group return to offset income of P. In Year 5, P sells its S2 common stock for $80.

(ii) Application of basis redetermination and loss suspension rules. Pursuant to paragraph (b)(4) of this section, because immediately before P's transfer of S1 stock S1 owns stock of S2 (another subsidiary member of the same group) that has a basis that exceeds its value, paragraph (b) of this section applies as if S1 had transferred its stock of S2. Because S2 is a member of the group immediately after the transfer of the S1 stock, the group member's basis in the S2 stock is redetermined pursuant to paragraph (b)(1) of this section immediately prior to the sale of the S1 stock. Of the group members' total basis of $130 in the S2 stock, $26 is allocated to S1's 20 shares of S2 common stock and $104 is allocated to P's 80 shares of S2 common stock. Pursuant to paragraph (b)(5) of this section, the redetermination of S1's basis in the stock of S2 results in an adjustment to P's basis in the stock of S1. In particular, P's basis in the stock of S1 is decreased by $24 to $26. On P's sale of its 100 shares of S1 common stock for $20, P recognizes a loss of $6. Because S1 is not a member of the P group immediately after P's sale of the S1 stock, paragraph (c)(1) of this section does not apply to suspend such loss. However, because P recognizes a loss with respect to the disposition of the S1 stock and S1 owns stock of S2 (which is a member of the P group immediately after the disposition), paragraph (c)(2) of this section does apply to suspend up to $6 of that loss, an amount equal to the amount by which the duplicated loss with respect to the stock of S1 sold is attributable to S2's adjusted basis in its assets, loss carryforwards, and deferred deductions.

(iii) Effect of subsequent asset sale on stock basis. Of the $30 loss recognized on the sale of Asset A, $24 is taken into account in determining the basis adjustments made under §1.1502-32 to the stock of S2 owned by P. Accordingly, P's basis in its S2 stock is reduced by $24 from $104 to $80.

(iv) Effect of subsequent asset sale on suspended loss. Because P cannot establish that all or a portion of the loss recognized on the sale of Asset A was not reflected in the calculation of the duplicated loss of S2 on the date of the Year 3 stock sale and such loss is allocable to the period beginning on the date of the Year 3 deemed disposition of the S2 stock and ending on the day before the first date on which S2 is not a member of the P group and is taken into account in determining consolidated taxable income (or loss) of the P group for a taxable year that includes a date on or after the date of the Year 3 deemed disposition and before the first date on which S2 is not a member of the P group, such asset loss reduces the suspended loss pursuant to paragraph (c)(4) of this section. The amount of such reduction, however, cannot exceed $6, the excess of the amount of such loss, $30, over the amount of such loss that is taken into account in determining the basis adjustment made to the stock of S2 owned by P, $24. Therefore, the suspended loss is reduced to zero.

(v) Effect of subsequent stock sale. P recognizes $0 gain/loss on the Year 5 sale of its remaining S2 common stock. No amount of suspended loss remains to be allowed under paragraph (c)(5) of this section.

Example 6. Loss recognized on asset with basis determined by reference to stock basis of subsidiary member. (i) Facts. In Year 1, P forms S with a contribution of $80 in exchange for 80 shares of common stock of S which at that time represents all of the outstanding stock of S. S becomes a member of the P group. In Year 2, P contributes Asset A with a basis of $50 and a value of $20 in exchange for 20 shares of common stock of S in a transfer to which section 351 applies. In Year 3, in a transaction that is not part of a plan that includes the Year 1 and Year 2 contributions, P contributes the 20 shares of S common stock it acquired in Year 2 to PS, a partnership, in exchange for a 20 percent capital and profits interest in a transaction described in section 721. Immediately after the contribution to PS, S is a member of the P group. In Year 4, P sells its interest in PS for $20, recognizing a $30 loss.

(ii) Application of basis redetermination rule upon nonrecognition transfer. Because P's basis in the S common stock contributed to PS exceeds its value immediately prior to the transfer and S is a member of the P group immediately after the transfer, P's basis in all of the S stock is redetermined pursuant to paragraph (b)(1) of this section. Of P's total basis of $130 in the common stock of S, a proportionate amount is allocated to each share of S common stock. Accordingly, $26 is allocated to the S common stock that is contributed to PS and, under section 722, P's basis in its interest in PS is $26.

(iii) Application of loss suspension rule on disposition of asset with basis determined by reference to stock basis of subsidiary member. P recognizes a $6 loss on its disposition of its interest in PS. Because P's basis in its interest in PS was determined by reference to the basis of S stock and at the time of the determination of P's basis in its interest in PS such S stock had a duplicated loss of $6, and, immediately after the disposition, S is a member of the P group, such loss is suspended to the extent of such duplicated loss. Principles similar to those of paragraphs (c)(3), (c)(4), and (c)(5) of this section shall apply to such suspended loss.

(f) Worthlessness and certain dispositions not followed by separate return years--

(1) General rule. Notwithstanding any other provision in the regulations under section 1502, if stock of a subsidiary member is treated as worthless under section 165 (taking into account the provisions of §1.1502-80(c)), or if a member of a group disposes of subsidiary member stock and on the following day the subsidiary is not a member of the group and does not have a separate return year, then all losses treated as attributable

to the subsidiary member under the principles of §1.1502-21(b)(2)(iv), after computing the taxable income of the group, the subsidiary member, or a group of which the subsidiary member was previously a member for the taxable year that includes the determination of worthlessness or the disposition and any prior taxable year, shall be treated as expired, but not as absorbed by the group, as of the beginning of the group's taxable year that follows the taxable year that includes the determination of worthlessness or the disposition.

(2) Election in the case of determinations of worthlessness and dispositions not followed by a separate return that occurred prior to March 14, 2003. If stock of a subsidiary member is treated as worthless under section 165 (taking into account the provisions of §1.1502-80(c)) on or after March 7, 2002, and prior to March 14, 2003, or if a member of a group disposes of subsidiary member stock on or after March 7, 2002, and prior to March 14, 2003 and on the following day the subsidiary is not a member of the group and does not have a separate return year, then, notwithstanding paragraph (f)(1) of this section, the common parent may make an irrevocable election to reattribute to itself all or any portion of the losses treated as attributable to such subsidiary member under the principles of §1.1502-21(b)(2)(iv). The election shall be in the form of a statement filed with or as part of the group's return for the taxable year in which the worthlessness is established or the disposition occurs. The statement shall be entitled "Election under Section 1.1502-35T(f)(2)" and must state that the common parent is making an irrevocable election under this paragraph (f)(2) to reattribute to itself the losses of the subsidiary member the stock of which is worthless or disposed of. In addition, it must identify the subsidiary to which the election relates and the portion of

losses subject to the election. If the election provided in this paragraph is made, the common parent shall be treated as succeeding to the reattributed losses as if the losses were succeeded to in a transaction described in section 381(a). For purposes of applying the provisions of §1.1502-32, the reattributed losses shall be treated as absorbed by the group immediately prior to the allowance of any loss or inclusion of any income or gain with respect to the determination of worthlessness or the disposition. In the case of an election to reattribute less than all of the losses otherwise treated as attributable to such subsidiary member under the principles of §1.1502-21(b)(2)(iv), paragraph (f)(1) of this section shall apply to that portion of the losses for which an election under this paragraph (f)(2) is not made.

(g) Anti-avoidance rules--(1) Transfer of share without a loss in avoidance. If a share of subsidiary member stock has a basis that does not exceed its value and the share is transferred with a view to avoiding application of the rules of paragraph (b) of this section prior to the transfer of a share of subsidiary member stock that has a basis that does exceed its value or a deconsolidation of a subsidiary member, the rules of paragraph (b) of this section shall apply immediately prior to the transfer of stock that has a basis that does not exceed its value.

(2) Transfers of loss property in avoidance. If a member of a consolidated group contributes an asset with a basis that exceeds its value to a partnership in a transaction described in section 721 or a corporation that is not a member of such group in a transfer described in section 351, such partnership or corporation contributes such asset to a subsidiary member in a transfer described in section 351, and such

contributions are undertaken with a view to avoiding the rules of paragraph (b) or (c) of this section, adjustments must be made to carry out the purposes of this section.

(3) Anti-loss reimportation--(i) Application. This paragraph (g)(3) applies if--

(A) A member of a group recognizes and is allowed a loss on the disposition of a share of stock of a subsidiary member with respect to which there is a duplicated loss; and

(B) Within the 10-year period beginning on the date the subsidiary member (or any successor) ceases to be a member of such group--

(1) The subsidiary member (or any successor) again becomes a member of such group (or any successor group) when the subsidiary member (or any successor) owns any asset that has a basis in excess of value at such time and that was owned by the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor) and that had a basis in excess of value on such date;

(2) The subsidiary member (or any successor) again becomes a member of such group (or any successor group) when the subsidiary member (or any successor) owns any asset that has a basis in excess of value at such time and that has a basis that reflects, directly or indirectly, in whole or in part, the basis of any asset that was owned by the subsidiary member on the date of a disposition of stock of such subsidiary member (or any successor) and that had a basis in excess of value on such date;

(3) In a transaction described in section 381 or section 351, any member of such group (or any successor group) acquires any asset of the subsidiary member (or any successor) that was owned by the subsidiary member (or any successor) on the date of

a disposition of stock of such subsidiary member (or any successor) and that had a basis in excess of its value on such date, or any asset that has a basis that reflects, directly or indirectly, in whole or in part, the basis of any asset that was owned by the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor) and that had a basis in excess of its value on such date, and, immediately after the acquisition of such asset, such asset has a basis in excess of its value;

(4) The subsidiary member (or any successor) again becomes a member of such group (or any successor group) when the subsidiary member (or any successor) has a liability (within the meaning of section 358(h)(3)) that it had on the date of a disposition of stock of such subsidiary member (or any successor) and such liability will give rise to a deduction;

(5) In a transaction described in section 381 or section 351, any member of such group (or any successor group) assumes a liability (within the meaning of section 358(h)(3)) that was a liability of the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor);

(6) The subsidiary member (or any successor) again becomes a member of such group (or any successor group) when the subsidiary member (or any successor) has any losses or deferred deductions that were losses or deferred deductions of the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor);

(7) The subsidiary member (or any successor) again becomes a member of such group (or any successor group) when the subsidiary member (or any successor) has

any losses or deferred deductions that are attributable to any asset that was owned by the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor) and that had a basis in excess of value on such date;

(8) The subsidiary member (or any successor) again becomes a member of such group (or any successor group) when the subsidiary member (or any successor) has any losses or deferred deductions that are attributable to any asset that had a basis that reflected, directly or indirectly, in whole or in part, the basis of any asset that was owned by the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor) and that had a basis in excess of value on such date;

(9) The subsidiary member (or any successor) again becomes a member of such group (or any successor group) when the subsidiary member (or any successor) has any losses or deferred deductions that are attributable to a liability (within the meaning of section 358(h)(3)) that it had on the date of a disposition of stock of such subsidiary member (or any successor);

(10) Any member of such group (or any successor group) succeeds to any losses or deferred deductions of the subsidiary member (or any successor) that were losses or deferred deductions of the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor), that are attributable to any asset that was owned by the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor) and that had a basis in excess of value on such date, that are attributable to any asset that

had a basis that reflected, directly or indirectly, in whole or in part, the basis of any asset that was owned by the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor) and that had a basis in excess of value on such date, or that are attributable to a liability (within the meaning of section 358(h)(3)) of the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor); or

(11) Any losses or deferred deductions of the subsidiary member (or any successor) that were losses or deferred deductions of the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor), that are attributable to any asset that was owned by the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor) and that had a basis in excess of value on such date, that are attributable to any asset that had a basis that reflected, directly or indirectly, in whole or in part, the basis of any asset that was owned by the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor) and that had a basis in excess of value on such date, or that are attributable to a liability (within the meaning of section 358(h)(3)) of the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor) are carried back to a pre-disposition taxable year of the subsidiary member.

(ii) Operating rules. (A) For purposes of paragraph (g)(3)(i)(B) of this section, assets shall include stock and securities and the subsidiary member (or any successor) shall be treated as having its allocable share of losses and deferred deductions of all lower-tier subsidiary members and as owning its allocable share of each asset of all lower-tier subsidiary members.

(B) For purposes of paragraphs (g)(3)(i)(B)(6), (7), (8), and (9) of this section, unless the group can establish otherwise, if the subsidiary member (or any successor) again becomes a member of such group (or any successor group) at a time when the subsidiary member (or any successor) has any losses or deferred deductions, such losses and deferred deductions shall be treated as losses or deferred deductions that were losses or deferred deductions of the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor), losses or deferred deductions that are attributable to assets that were owned by the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor) and that had bases in excess of value on such date, losses or deferred deductions that are attributable to assets that had bases that reflected, directly or indirectly, in whole or in part, the bases of assets that were owned by the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor) and that had bases in excess of value on such date, or losses or deferred deductions attributable to a liability (within the meaning of section 358(h)(3)) of the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor).

(C) For purposes of paragraph (g)(3)(i)(B)(10) of this section, unless the group can establish otherwise, if a member of such group (or any successor group) succeeds to any losses or deferred deductions of the subsidiary member (or any successor), such losses and deferred deductions shall be treated as losses or deferred deductions that were losses or deferred deductions of the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor), losses or deferred deductions that are attributable to assets that were owned by the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor) and that had bases in excess of value on such date, losses or deferred deductions that are attributable to assets that had bases that reflected, directly or indirectly, in whole or in part, the bases of assets that were owned by the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor) and that had bases in excess of value on such date, or losses or deferred deductions attributable to a liability (within the meaning of section 358(h)(3)) of the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor).

(D) For purposes of paragraph (g)(3)(i)(B)(11) of this section, unless the group can establish otherwise, if any losses or deferred deductions of the subsidiary member (or any successor) are carried back to a pre-disposition taxable year of the subsidiary member, such losses and deferred deductions shall be treated as losses or deferred deductions that were losses or deferred deductions of the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor), losses or deferred deductions that are attributable to assets that were owned by the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor) and that had a basis in excess of value on such date, losses or deferred deductions that are attributable to assets that had bases that reflected, directly or indirectly, in whole or in part, the bases of assets that were owned by the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor) and that had a basis in excess of value on such date, or losses or deferred deductions that are attributable to a liability (within the meaning of section 358(h)(3)) of the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor).

(iii) Loss disallowance. If this paragraph (g)(3) applies, then, to the extent that the aggregate amount of loss recognized by members of the group (and any successor group) on dispositions of the subsidiary member stock was attributable to a duplicated loss of such subsidiary member that was allowed, such group (or any successor group) will be denied the use of--

(A) Any loss recognized that is attributable to, directly or indirectly, an asset that was owned by the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor) and that had a basis in excess of value on such date, to the extent of the lesser of the loss inherent in such asset on the date of a disposition of the stock of the subsidiary member (or any successor) and the loss inherent in such asset on the date of the event described in paragraph (g)(3)(i)(B) of this section that gives rise to the application of this paragraph (g)(3);

(B) Any loss recognized that is attributable to, directly or indirectly, an asset that has a basis that reflects, directly or indirectly, in whole or in part, the basis of any asset that was owned by the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor) and that had a basis in excess of its value on such date, to the extent of the lesser of the loss inherent in the asset that was owned by the subsidiary member (or any successor) on the date of a disposition of stock of such subsidiary member (or any successor) the basis of which is reflected, directly or indirectly, in whole or in part, in the basis of such asset on the date of the disposition and the loss inherent in such asset on the date of the event described in paragraph (g)(3)(i)(B) of this section that gives rise to the application of this paragraph (g)(3);

(C) Any loss or deduction that is attributable to a liability described in paragraph (g)(3)(i)(B)(4) or (5) of this section; and

(D) Any loss or deduction described in paragraph (g)(3)(i)(B)(6), (7), (8), (9), (10), or (11) of this section, provided that a loss or deferred deduction described in paragraph (g)(3)(i)(B)(11) of this section shall be allowed to be carried forward to a post-disposition taxable year of the subsidiary member.

(iv) Treatment of disallowed loss. For purposes of §1.1502-32(b)(3)(iii), any loss or deduction the use of which is disallowed pursuant to paragraph (g)(3)(iii) of this section (other than a loss or deduction described in paragraph (g)(3)(i)(B)(11) of this section), and with respect to which no waiver described in §1.1502-32(b)(4) is filed, is treated as a noncapital, nondeductible expense incurred during the taxable year that such loss would otherwise be absorbed.

(4) Avoidance of recognition of gain. (i) If a transaction is structured with a view to, and has the effect of, deferring or avoiding the recognition of gain on a disposition of stock by invoking the application of paragraph (b)(1) of this section to redetermine the basis of stock of a subsidiary member, and the stock loss that gives rise to the

application of paragraph (b)(1) of this section is not significant, paragraphs (b) and (c) of this section shall not apply.

(ii) If a transaction is structured with a view to, and has the effect of, deferring or avoiding the recognition of gain on a disposition of stock by invoking the application of paragraph (b)(2) of this section to redetermine the basis of stock of a subsidiary member, and the duplicated loss of the subsidiary member that is reflected in stock of the subsidiary member owned by members of the group immediately before the deconsolidation is not significant, paragraphs (b) and (c) of this section shall not apply.

(5) Examples. The principles of this paragraph (g) are illustrated by the following examples:

Example 1. Transfers of property in avoidance of basis redetermination rule. (i) Facts. In Year 1, P forms S with a contribution of $100 in exchange for 100 shares of common stock of S which at that time represents all of the outstanding stock of S. S becomes a member of the P group. In Year 2, P contributes 20 shares of common stock of S to PS, a partnership, in exchange for a 20 percent capital and profits interest in a transaction described in section 721. In Year 3, P contributes Asset A with a basis of $50 and a value of $20 to PS in exchange for an additional capital and profits interest in PS in a transaction described in section 721. Also in Year 3, PS contributes Asset A to S and P contributes an additional $80 to S in transfers to which section 351 applies. In Year 4, S sells Asset A for $20, recognizing a loss of $30. The P group uses that loss to offset income of P. Also in Year 4, P sells its entire interest in PS for $40, recognizing a loss of $30.

(ii) Analysis. Pursuant to paragraph (g)(2) of this section, if P's contributions of S stock and Asset A to PS were undertaken with a view to avoiding the application of the basis redetermination or the loss suspension rule, adjustments must be made such that the group does not obtain more than one tax benefit from the $30 loss inherent in Asset A.

Example 2. Transfers effecting a reimportation of loss. (i) Facts. In Year 1, P forms S with a contribution of Asset A with a value of $100 and a basis of $120, Asset B with a value of $50 and a basis of $70, Asset C with a value of $90 and a basis of $100 in exchange for all of the common stock of S and S becomes a member of the P group. In Year 2, in a transaction that is not part of a plan that includes the contribution, P sells the stock of S for $240, recognizing a loss of $50. At such time, the bases and values of Assets A, B, and C have not changed since their contribution to S. In Year 3, S sells Asset A, recognizing a $20 loss. In Year 3, S merges into M in a reorganization described in section 368(a)(1)(A). In Year 8, P purchases all of the stock of M for $300. At that time, M has a $10 net operating loss. In addition, M owns Asset D, which was acquired in an exchange described in section 1031 in connection with the surrender of Asset B. Asset C has a value of $80 and a basis of $100. Asset D has a value of $60 and a basis of $70. In Year 9, P has operating income of $100 and M recognizes $20 of loss on the sale of Asset C. In Year 10, P has operating income of $50 and M recognizes $50 of loss on the sale of Asset D.

(ii) Analysis. P's $50 loss on the sale of S stock is entirely attributable to duplicated loss. Therefore, pursuant to paragraph (g)(3) of this section, assuming the P group cannot establish otherwise, M's $10 net operating loss is treated as attributable to assets that were owned by S on the date of the disposition and that had bases in excess of value on such date. Without regard to any other limitations on the group's use of M's net operating loss, the P group cannot use M's $10 net operating loss pursuant to paragraph (g)(3)(iii)(D) of this section. Pursuant to paragraph (g)(3)(iv) of this section and §1.1502-32T(b)(3)(iii)(D), such loss is treated as a noncapital, nondeductible expense of M incurred during the taxable year that includes the day after the reorganization. In addition, the P group is denied the use of $10 of the loss recognized on the sale of Asset C. Finally, the P group is denied the use of $10 of the loss recognized on the sale of Asset D. Pursuant to paragraph (g)(3)(iv) of this section and §1.1502-32T(b)(3)(iii)(D), each such disallowed loss is treated as a noncapital, nondeductible expense of M incurred during the taxable year that includes the date of the disposition of the asset with respect to which such loss was recognized.

Example 3. Transfers to avoid recognition of gain. (i) Facts. P owns all of the stock of S1 and S2. The S2 stock has a basis of $400 and a value of $500. S1 owns 50% of the stock of the S3 common stock with a basis of $150. S2 owns the remaining 50% of the S3 common stock with a basis of $100 and a value of $200 and one share of S3 preferred stock with a basis of $10 and a value of $9. P intends to sell all of its S2 stock to an unrelated buyer. P, therefore, engages in the following steps to dispose of S2 without recognizing a substantial portion of the built-in gain in S2. First, P causes a recapitalization of S3 in which S2's S3 common stock is exchanged for new S3 preferred shares. P then sells all of its S2 stock. Immediately after the sale of the S2 stock, S3 is a member of the P group.

(ii) Analysis. Pursuant to paragraph (b)(4) of this section, because S2 owns stock of S3 (another subsidiary member of the same group) and, immediately after the sale of the S2 stock, S3 is a member of the group, then for purposes of applying paragraph (b) of this section, S2 is deemed to have transferred its S3 stock. Because S3 is a member of the group immediately after the transfer of the S2 stock and the S3 stock deemed transferred has a basis in excess of value, the group member's basis in the S3 stock is redetermined pursuant to paragraph (b)(1) of this section immediately prior to the sale of the S2 stock. Pursuant to paragraph (b)(1) of this section, the total basis of S3 stock held by members of the P group is allocated first to the S3 preferred shares, up to their value of $209, and then to the remaining shares of S3 common held by S1. S2's aggregate basis in the S3 preferred stock is increased from $110 to $209. This increase tiers up and increases P's basis in the S2 stock from $400 to $499. Accordingly, P will recognize only $1 of gain on the sale of its S2 stock. However, because the recapitalization of S3 was structured with a view to, and has the effect of, avoiding the recognition of gain on a disposition of stock by invoking the application of paragraph (b) of this section, paragraph (g)(4)(i) of this section applies. Accordingly, paragraph (b) of this section does not apply upon P's disposition of the S2 stock and P recognizes $100 of gain on the disposition of the S2 stock.

(h) Application of other anti-abuse rules. The rules of this section do not preclude the application of anti-abuse rules under other provisions of the Internal Revenue Code and regulations thereunder.

(i) [Reserved].

(j) Effective date. This section, except for paragraph (g)(3) of this section, applies with respect to stock transfers, deconsolidations of subsidiary members, determinations of worthlessness, and stock dispositions on or after March 7, 2002, and no later than March 11, 2006, but only if such events occur during a taxable year the original return for which is due (without regard to extensions) after March 14, 2003. Paragraph (g)(3) of this section applies to events described in paragraph (g)(3)(iii) of this section occurring on or after October 18, 2002, and no later than March 11, 2006, but only if such events occur during a taxable year the original return for which is due (without regard to extensions) after March 14, 2003.

Par. 8. The authority citation for part 602 continues to read as follows:

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

Par. 9. In §602.101, paragraph (b) is amended by adding an entry to the table in numerical order for to read as follows:

§602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.1502-35T	1545-1828
* * * * *	

Assistant Deputy Commissioner of Internal Revenue

Approved:

Assistant Secretary of the Treasury

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
March 11, 2003

CONTACT: Office of Financing
202-691-3550

RESULTS OF TREASURY'S AUCTION OF 4-WEEK BILLS

Term:	28-Day Bill
Issue Date:	March 13, 2003
Maturity Date:	April 10, 2003
CUSIP Number:	912795MG3

High Rate: 1.120% Investment Rate 1/: 1.138% Price: 99.913

All noncompetitive and successful competitive bidders were awarded securities at the high rate. Tenders at the high discount rate were allotted 2.73%. All tenders at lower rates were accepted in full.

AMOUNTS TENDERED AND ACCEPTED (in thousands)

Tender Type	Tendered	Accepted
Competitive	$ 49,307,000	$ 21,947,550
Noncompetitive	52,588	52,588
FIMA (noncompetitive)	0	0
SUBTOTAL	49,359,588	22,000,138
Federal Reserve	1,459,975	1,459,975
TOTAL	$ 50,819,563	$ 23,460,113

Median rate 1.110%: 50% of the amount of accepted competitive tenders was tendered at or below that rate. Low rate 1.090%: 5% of the amount of accepted competitive tenders was tendered at or below that rate.

Bid-to-Cover Ratio = 49,359,588 / 22,000,138 = 2.24

1/ Equivalent coupon-issue yield.

JS-97

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
March 10, 2003

CONTACT: Office of Financing
202-691-3550

RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Term:	182-Day Bill
Issue Date:	March 13, 2003
Maturity Date:	September 11, 2003
CUSIP Number:	912795NM9

High Rate: 1.030% Investment Rate 1/: 1.053% Price: 99.479

All noncompetitive and successful competitive bidders were awarded securities at the high rate. Tenders at the high discount rate were allotted 56.77%. All tenders at lower rates were accepted in full.

AMOUNTS TENDERED AND ACCEPTED (in thousands)

Tender Type	Tendered	Accepted
Competitive	$ 41,317,190	$ 15,657,150
Noncompetitive	1,193,236	1,193,236
FIMA (noncompetitive)	150,000	150,000
SUBTOTAL	42,660,426	17,000,386 2/
Federal Reserve	5,549,928	5,549,928
TOTAL	$ 48,210,354	$ 22,550,314

Median rate 1.020%: 50% of the amount of accepted competitive tenders was tendered at or below that rate. Low rate 1.000%: 5% of the amount of accepted competitive tenders was tendered at or below that rate.

Bid-to-Cover Ratio = 42,660,426 / 17,000,386 = 2.51

1/ Equivalent coupon-issue yield.
2/ Awards to TREASURY DIRECT = $894,201,000

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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
March 10, 2003

CONTACT: Office of Financing
202-691-3550

RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Term:	91-Day Bill
Issue Date:	March 13, 2003
Maturity Date:	June 12, 2003
CUSIP Number:	912795MR9

High Rate: 1.055% Investment Rate 1/: 1.077% Price: 99.733

All noncompetitive and successful competitive bidders were awarded securities at the high rate. Tenders at the high discount rate were allotted 12.10%. All tenders at lower rates were accepted in full.

AMOUNTS TENDERED AND ACCEPTED (in thousands)

Tender Type	Tendered	Accepted
Competitive	$ 35,494,780	$ 15,355,945
Noncompetitive	1,519,142	1,519,142
FIMA (noncompetitive)	125,000	125,000
SUBTOTAL	37,138,922	17,000,087 2/
Federal Reserve	4,754,585	4,754,585
TOTAL	$ 41,893,507	$ 21,754,672

Median rate 1.050%: 50% of the amount of accepted competitive tenders was tendered at or below that rate. Low rate 1.015%: 5% of the amount of accepted competitive tenders was tendered at or below that rate.

Bid-to-Cover Ratio = 37,138,922 / 17,000,087 = 2.18

1/ Equivalent coupon-issue yield.
2/ Awards to TREASURY DIRECT = $1,182,621,000

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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.
March 10, 2003

Contact: Office of Financing
202/691-3550

TREASURY OFFERS 4-WEEK BILLS

The Treasury will auction 4-week Treasury bills totaling $22,000 million to refund an estimated $20,000 million of publicly held 4-week Treasury bills maturing March 13, 2003, and to raise new cash of approximately $2,000 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 $11,764 million of the Treasury bills maturing on March 13, 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.

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

JS 120

HIGHLIGHTS OF TREASURY OFFERING
OF 4-WEEK BILLS TO BE ISSUED MARCH 13, 2003

March 10, 2003

Offering Amount	$22,000 million
Maximum Award (35% of Offering Amount)	$ 7,700 million
Maximum Recognized Bid at a Single Rate	$ 7,700 million
NLP Reporting Threshold	$ 7,700 million
NLP Exclusion Amount	$10,100 million

Description of Offering:

Term and type of security	28-day bill
CUSIP number	912795 MG 3
Auction date	March 11, 2003
Issue date	March 13, 2003
Maturity date	April 10, 2003
Original issue date	October 10, 2002
Currently outstanding	$39,720 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.

FROM THE OFFICE OF PUBLIC AFFAIRS

March 12, 2003
JS-101

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 $79,653 million as of the end of that week, compared to $78,719 million as of the end of the prior week.

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

	February 28, 2003			March 7, 2003		
TOTAL	78,719			79,653		
1. Foreign Currency Reserves [1]	**Euro**	**Yen**	**TOTAL**	**Euro**	**Yen**	**TOTAL**
a. Securities	7,082	13,306	20,387	7,247	13,505	20,753
Of which, issuer headquartered in the U.S.			0			0
b. Total deposits with:						
b.i. Other central banks and BIS	11,564	2,671	14,235	11,822	2,711	14,533
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]			21,687			21,848
3. Special Drawing Rights (SDRs) [2]			11,368			11,477
4. Gold Stock [3]			11,043			11,043
5. Other Reserve Assets			0			0

II. Predetermined Short-Term Drains on Foreign Currency Assets

	February 28, 2003			March 7, 2003		
	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

	February 28, 2003			**March 7, 2003**		
	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

March 12, 2003
JS-102

Treasury Secretary John Snow Travels to Ohio to Promote President Bush's Economic Agenda

Treasury Secretary John Snow will travel to Cincinnati and Columbus, Ohio, Friday, March 14th to promote President Bush's economic agenda.

During this trip, the Secretary will participate in three open press events.

In Columbus, at a local community center, the Secretary and CDFI Fund Director Tony Brown will announce the organizations selected to receive the first $2.5 billion in tax credit allocations under the New Markets Tax Credit (NMTC) program aimed at stimulating growth and job creation in low-income communities.

The NMTC is a tax credit to investors who make "qualified equity investment" in privately managed investment vehicles called "community development entities" or CDEs. The tax credit provided to the investor will cover a seven-year period. The credit provided to the investor totals 39 percent of the investment in a CDE and is claimed over the seven-year period.

At this event, the Secretary will be accompanied by Senator George Voinovich, Governor Bob Taft, and Congresswoman Deborah Pryce.

In Cincinnati, the Secretary will speak with employers and workers at a chamber of commerce to hear about local economic conditions and to discuss President George W. Bush's efforts to strengthen the economic recovery. This stop is part of the Secretary's objective to meet with people on the front lines of the American economy - small business owners, employees, individual investors, business leaders, economists and farmers - to discuss where our economy stands, the impact of the policies we have put in place, and the steps we are taking as we move forward. The Secretary will discuss the President's jobs and growth plan in his remarks.

Also in Cincinnati, the Secretary will meet with several senior citizens to discuss the elimination of the double taxation of dividends – a key component of President Bush's jobs and growth plan.
Roughly 35 million American households receive dividend income that is taxable and will directly benefit under the President's plan. More than half of these dividends go to America's seniors, many of whom rely on these checks for a steady source of income in their retirement.

Almost half of all savings from the dividend exclusion under the President's plan would go to taxpayers 65 and older. The average tax savings for the 9.8 million seniors receiving dividends would be $936.

At both events in Cincinnati, the Secretary will be accompanied by Representative Rob Portman.

Friday March, 15, 2003

Columbus, Ohio

9:00 AM NEW MARKETS TAX CREDIT EVENT
OPEN PRESS
The J. Ashburn Jr. Youth Center, inc
85 S. Clarendon Ave.
Columbus, OH 43223

Cincinnati, Ohio

1:00 PM **REMARKS TO THE GREATER CINCINNATI OHIO CHAMBER OF COMMERCE.**
OPEN PRESS
Anderson Mercy Health and Wellness Center
7995 State Road
Anderson Township, OH 45255
513-460-1342

2:30 PM **SENIOR CITIZENS ROUND TABLE**
OPEN PRESS
The New England club
8135 Beechmont Avenue
Cincinnati, OH
513-791-0381

Impact of the President's Growth Package on Ohio

The package will provide benefits to 3.9 million Ohio taxpayers.

REDUCING TAXES

• 3.9 million taxpayers in Ohio will have lower income tax bills in 2003 under the President's growth package.

• More than 920,000 business taxpayers can use their tax savings to invest in new equipment, hire additional workers, and increase pay.

ACCELERATE 10-PERCENT BRACKET EXPANSION

• More than 3.1 million married couples and single filers will benefit from the acceleration to 2003 of the expansion of the 10-percent bracket scheduled for 2008.

ACCELERATE REDUCTION IN INCOME TAX RATES

• More than 1.1 million taxpayers in Ohio will benefit from the acceleration to 2003 of the reductions in income tax rates in excess of 15-percent scheduled for 2004 and 2006.

ACCELERATE REDUCTION IN MARRIAGE PENALTY

• More than 1.3 million married couples in Ohio will benefit from the acceleration to 2003 of provisions that increase the standard deduction for joint filers to double the amount for single filers and increase the width of the 15-percent bracket to twice the width for single filers. These two provisions were scheduled to phase in between 2005 and 2009.

ACCELERATE INCREASE IN CHILD TAX CREDIT

• More than 985,000 married couples and single parents in Ohio will benefit from the acceleration to 2003 of the increase in the child tax credit from $600 to $1,000 that was scheduled to phase in between 2005 and 2010.

EXCLUSION FOR CORPORATE DIVIDENDS

• More than 1.3 million taxpayers in Ohio will benefit from the exclusion of dividends paid from previously-taxed corporate income.

federal financing bank NEWS
WASHINGTON, D.C. 20220

FEDERAL FINANCING BANK

2003 PRESS RELEASE

March 2003

Gary Burner, Manager, Federal Financing Bank (FFB) announced the following activity for the month of March 2003.

FFB holdings of obligations issued, sold or guaranteed by other Federal agencies totaled $35.8 billion on March 31, 2003, posting a decrease of $14.3 million from the level on February 28, 2003. This net change was the result of a decrease in holdings of government-guaranteed loans of $14.3 million. The FFB made 50 disbursements and received 6 prepayments during the month of March. The FFB also extended the maturities of 148 loans guaranteed by the Rural Utilities Service ("RUS") during the month of March.

Below are tables presenting FFB March loan activity and FFB holdings as of March 31, 2003.

**FEDERAL FINANCING BANK
March 2003 ACTIVITY**

Borrower	Date 2003	Amt. Of Advance	Final Maturity Century 2000	Int. Rate	Semi-Annual or Quarterly
GOVERNMENT-GUARANTEED LOANS					
GENERAL SERVICES ADMINISTRATION					
San Francisco Bldg Lease	3/03	$302,849.27	8/1/2005	1.813%	Semi-Annually
San Francisco OB	3/18	$132,507.93	8/1/2005	1.909%	Semi-Annually
San Francisco Bldg Lease	3/24	$109,003.00	8/1/2005	2.096%	Semi-Annually
Chamblee Office Building	3/26	$89,278.29	10/1/2026	4.692%	Semi-Annually
San Francisco OB	3/26	$125,000.00	8/1/2005	1.971%	Semi-Annually
Chamblee Office Building	3/27	$170,464.42	10/1/2026	4.685%	Semi-Annually
DEPARTMENT OF EDUCATION					

JS 103

Livingstone College	3/18	$123,821.85	7/1/2031	4.587%	Semi-Annually
Virginia Union Univ.	3/20	$96,210.47	1/2/2032	4.736%	Semi-Annually
RURAL UTILITIES SERVICE					
Dunn Electric Coop. #861	3/03	$720,000.00	12/31/2036	4.575%	Quarterly
Shelby Energy Coop. #758	3/03	$1,000,000.00	12/31/2035	4.554%	Quarterly
A & N Electric #868	3/07	$1,492,000.00	12/31/2036	4.578%	Quarterly
Dairyland Power #588	3/07	$8,122,521.00	1/3/2028	4.442%	Quarterly
Dairyland Power #867	3/07	$3,753,637.00	1/3/2017	3.471%	Quarterly
Dairyland Power #865	3/07	$12,373,135.00	12/31/2031	4.457%	Quarterly
Dairyland Power #864	3/07	$1,004,707.00	12/37/2031	4.457%	Quarterly
East River Power #453	3/07	$186,000.00	6/30/2003	1.304%	Quarterly
East River Power #601	3/07	$4,391,000.00	6/30/2003	1.179%	Quarterly
Greystone Power Corp. #875	3/07	$2,255,205.00	12/31/2031	4.459%	Quarterly
Niobrara Electric Assoc. #860	3/07	$391,999.00	12/31/2036	4.409%	Quarterly
South Texas Electric #845	3/07	$7,000,000.00	12/31/2024	4.170%	Quarterly
Carroll Elec. #618	3/10	$500,000.00	1/3/2034	4.475%	Quarterly
Clairborne Electric Coop. #200	3/10	$921,000.00	12/31/2031	4.424%	Quarterly
North Carolina RSA 3 Tele #200	3/10	$9,600,000.00	6/30/2003	1.116%	Quarterly
E. Nebraska Tele. #398	3/11	$308,000.00	1/3/2017	3.501%	Quarterly
Georgia Trans. Corp. #849	3/11	$18,566,342.00	12/31/2025	4.152%	Quarterly
Glades Elec. Coop. #838	3/11	$2,500,000.00	12/31/2031	4.393%	Quarterly
Maquoketa Valley #201	3/11	$1,500,000.00	12/31/2036	4.522%	Quarterly
Coop. Power Assoc. #722	3/12	$4,717,000.00	1/2/2029	4.130%	Quarterly
Southeast Colorado Power #201	3/12	$3,831,000.00	12/31/2036	4.524%	Quarterly
United Power Assoc. #721	3/12	$5,009,000.00	12/31/2030	4.196%	Quarterly
Union Electric #783	3/13	$10,000,000.00	1/2/2024	4.020%	Quarterly
North Georgia Elec. #781	3/17	$2,595,000.00	12/31/2035	4.580%	Quarterly
East Otter Tele. #435	3/19	$300,000.00	12/31/2015	3.753%	Quarterly
Farmer's Telephone #459	3/19	$58,242.00	1/2/2018	3.937%	Quarterly
Flint Elec. #201	3/19	$10,000,000.00	1/3/2034	4.704%	Quarterly
North Central Elec Coop. #201	3/19	$4,400,000.00	12/31/2036	4.763%	Quarterly
Tri-County Electric Ass. #830	3/20	$838,000.00	6/30/2003	1.161%	Quarterly
S. Illinois Power #818	3/21	$3,114,000.00	1/3/2034	4.799%	Quarterly
S. Illinois Power #819	3/21	$2,617,000.00	12/31/2030	4.721%	Quarterly
Cornbelt Power #565	3/24	$1,735,000.00	1/3/2028	4.668%	Quarterly

Block Island Power #652	3/25	$684,000.00	12/31/2024	4.444%	Quarterly
Laurens Elec. #553	3/25	$450,000.00	1/3/2034	4.775%	Quarterly
N.E. Louisiana Tel. #544	3/26	$365,000.00	12/31/2018	4.101%	Quarterly
McLeod Coop. Power #554	3/27	$1,300,000.00	6/30/2003	1.182%	Quarterly
Northern Neck Elec. #713	3/27	$3,500,000.00	1/2/2035	4.793%	Quarterly
Arkansas Elec. #812	3/28	$13,900,000.00	12/31/2031	4.710%	Quarterly
Blue Ridge Elec. #897	3/28	$4,000,000.00	12/31/2036	4.830%	Quarterly
Grayson Rural Elec. #619	3/28	$2,500,000.00	6/30/2003	1.162%	Quarterly
*Amicalola Electric #664	3/31	$6,864,339.65	6/30/2003	1.142%	Quarterly
*Atlantic Telephone Mem. #805	3/31	$5,931,000.00	6/30/2003	1.142%	Quarterly
*Bailey County Elec. #856	3/31	$1,896,000.00	6/30/2003	1.142%	Quarterly
*Basin Electric #425	3/31	$13,078,347.58	6/30/2003	1.267%	Quarterly
*Big Sand Elec. #540	3/31	$769,446.32	6/30/2003	1.142%	Quarterly
*Big Sand Elec. #540	3/31	$577,084.73	6/30/2003	1.142%	Quarterly
*Big Sand Elec. #540	3/31	$964,760.37	6/30/2003	1.142%	Quarterly
*Big Sand Elec. #540	3/31.	$2,243,778.39	6/30/2003	1.142%	Quarterly
*Blue Grass Energy #674	3/31	$1,975,649.24	6/30/2003	1.142%	Quarterly
*Brazos Electric #917	3/31	$2,499,739.32	6/30/2003	1.142%	Quarterly
*Brazos Electric#917	3/31	$1,912,631.51	6/30/2003	1.142%	Quarterly
*Brazos Electric #917	3/31	$1,558,964.78	6/30/2003	1.142%	Quarterly
*Brazos Electric #917	3/31	$1,174,432.40	6/30/2003	1.142%	Quarterly
*Brazos Electric #917	3/31	$1,554,366.62	6/30/2003	1.142%	Quarterly
*Brazos Electric #917	3/31	$199,505.85	6/30/2003	1.142%	Quarterly
*Brazos Electric #917	3/31	$1,785,160.91	6/30/2003	1.142%	Quarterly
*Brazos Electric #91.7	3/31	$1,669,335.20	6/30/2003	1.142%	Quarterly
*Brazos Electric #917	3/31	$417,786.99	6/30/2003	1.142%	Quarterly
*Brazos Electric #917	3/31	$850,855.79	6/30/2003	1.142%	Quarterly
*Brazos Electric #917	3/31	$13,826.33	6/30/2003	1.142%	Quarterly
*Brazos Electric #917	3/31	$365,589.17	6/30/2003	1.142%	Quarterly
*Brazos Electric #917	3/31	$342,935.42	6/30/2003	1.142%	Quarterly
*Brazos Electric #917	3/31	$2,871,445.86	6/30/2003	1.142%	Quarterly
*Brazos Electric #917	3/31	$760,673.46	6/30/2003	1.142%	Quarterly
*Brazos Electric #917	3/31	$834,909.29	6/30/2003	1.142%	Quarterly
*Brazos Electric #917	3/31	$1,275,375.12	6/30/2003	1.142%	Quarterly
*Brazos Electric #917	3/31	$320,619.34	6/30/2003	1.142%	Quarterly

*Brazos Electric #917	3/31	$739,528.07	6/30/2003	1.142%	Quarterly
*Brazos Electric #917	3/31	$965,594.54	6/30/2003	1.142%	Quarterly
*Brazos Electric #917	3/31	$643,025.20	6/30/2003	1.142%	Quarterly
*Brazos Electric #917	3/31	$369,704.92	6/30/2003	1.142%	Quarterly
*Brazos Electric #917	3/31	$691,193.34	6/30/2003	1.142%	Quarterly
*Brazos Electric #917	3/31	$840,257.44	6/30/2003	1.142%	Quarterly
*Brazos Electric #917	3/31	$270,956.82	6/30/2003	1.142%	Quarterly
*Brazos Electric #917	3/31	$196,649.79	6/30/2003	1.142%	Quarterly
*Brazos Electric #917	3/31	$1,750,471.05	6/30/2003	1.142%	Quarterly
*Brazos Electric #917	3/31	$2,040,977.34	6/30/2003	1.142%	Quarterly
*Brazos Electric #561	3/31	$2,295,621.17	1/3/2023	4.256%	Quarterly
*Brazos Electric #844	3/31	$10,000,000.00	1/3/2023	4.706%	Quarterly
*Brazos Electric #844	3/31	$10,000,000.00	1/3/2023	4.706%	Quarterly
*Brown County Elec. #687	3/31	$245,500.44	6/30/2003	1.142%	Quarterly
*Brown County Elec. #687	3/31	$589,201.07	6/30/2003	1.142%	Quarterly
*Brown County Elec. #687	3/31	$294,648.02	6/30/2003	1.142%	Quarterly
*Brown County Elec. #687	3/31	$642,017.62	6/30/2003	1.142%	Quarterly
*Citizens Elec. #742	3/31	$2,694,000.00	6/30/2003	1.142%	Quarterly
*Citizens Elec. #878	3/31	$3,000,000.00	6/30/2003	1.142%	Quarterly
*Clark Energy Coop. #611	3/31	$2,894,281.08	6/30/2003	1.142%	Quarterly
*Clark Energy Coop. #611	3/31	$1,923,322.69	6/30/2003	1.142%	Quarterly
*Clark Energy Coop. #611	3/31	$4,292,273.45	6/30/2003	1.142%	Quarterly
*Clark Energy Coop. #611	3/31	$3,589,610.11	6/30/2003	1.142%	Quarterly
*Cumberland Valley #668	3/31	$4,124,407.51	6/30/2003	1.142%	Quarterly
*Cooper Valley Tel. #648	3/31	$988,223.33	6/30/2003	1.142%	Quarterly
*Darien Telephone Co. #719	3/31	$1,861,044.13	6/30/2003	1.142%	Quarterly
*Darien Telephone Co. #719	3/31	$428,713.45	6/30/2003	1.142%	Quarterly
*Darien Telephone Co. #719	3/31	$206,632.16	6/30/2003	1.142%	Quarterly
*Darien Telephone Co. #719	3/31	$244,289.42	6/30/2003	1.142%	Quarterly
*Darien Telephone Co. #719	3/31	$177,665.03	6/30/2003	1.142%	Quarterly
*Darien Telephone Co. #719	3/31	$263,600.83	6/30/2003	1.142%	Quarterly
*Darien Telephone Co. #719	3/31	$217,062.46	6/30/2003	1.142%	Quarterly
*Darien Telephone Co. #719	3/31	$1,475,068.82	6/30/2003	1.142%	Quarterly
*Darien Telephone Co. #719	3/31	$275,191.29	6/30/2003	1.142%	Quarterly
*Delaware County Elec. #682	3/31	$914,269.56	6/30/2003	1.142%	Quarterly

*East River Power #453	3/31	$377,490.12	6/30/2003	1.267%	Quarterly
*East River Power #601	3/31	$3,314,831.32	6/30/2003	1.142%	Quarterly
*East River Power #793	3/31	$632,897.75	6/30/2003	1.142%	Quarterly
*Fairfield Elec. #684	3/31	$3,175,536.64	6/30/2003	1.142%	Quarterly
*Farmer's Telephone #459	3/31	$21,726.56	6/30/2003	1.267%	Quarterly
*Farmer's Telephone #459	3/31	$207,804.34	6/30/2003	1.267%	Quarterly
*Flemiing-Mason Energy #644	3/31	$2,508,376.92	6/30/2003	1.142%	Quarterly
*Fleming-Mason Energy #644	3/31	$1,350,664.48	6/30/2003	1.142%	Quarterly
*Fleming-Mason Energy #644	3/31	$1,447,140.52	6/30/2003	1.142%	Quarterly
*Fleming-Mason Energy #644	3/31	$2,122,472.78	6/30/2003	1.142%	Quarterly
*Fleming-Mason Energy #644	3/31	$1,350,664.48	6/30/2003	1.142%	Quarterly
*Fleming-Mason Energy #644	3/31	$2,926,658.66	6/30/2003	1.142%	Quarterly
*Freeborn-Mower Coop. #736	3/31	$740,789.55	6/30/2003	1.142%	Quarterly
*Freeborn-Mower Coop. #736	3/31	$493,874.20	6/30/2003	1.142%	Quarterly
*Freeborn-Mower Coop. #736	3/31	$198,738.73	6/30/2003	1.142%	Quarterly
*FTC Communications #709	3/31	$2,594,608.63	6/30/2003	1.142%	Quarterly
*Georgia Trans. Corp. #446	3/31	$10,370,658.58	3/31/2005	1.544%	Quarterly
*Glades Elec. Coop. ##604	3/31	$2,956,820.54	12/31/2030	4.656%	Quarterly
*Grady Electric #690	3/31	$3,133,776.12	6/30/2003	1.142%	Quarterly
*Grady Electric #746	3/31	$3,229,830.72	6/30/2003	1.142%	Quarterly
*Grayson Rural Elec. #619	3/31	$1,157,712.43	6/30/2003	1.142%	Quarterly
*Grayson Rural Elec. #619	3/31	$578,856.22	6/30/2003	1.142%	Quarterly
*Grayson Rural Elec. #619	3/31	$964,760.37	6/30/2003	1.142%	Quarterly
*Grayson Rural Elec. #619	3/31	$1,249,876.73	6/30/2003	1.142%	Quarterly
*Grayson Rural Elec. #619	3/31	$987,273.77	6/30/2003	1.142%	Quarterly
*Greenbelt Elec. #743	3/31	$1,739,000.00	6/30/2003	1.142%	Quarterly
*Greenbelt Elec. #743	3/31	$502,000.00	6/30/2003	1.142%	Quarterly
*Grundy Elec.Coop. #744	3/31	$1,242,242.58	6/30/2003	1.142%	Quarterly
*Grundy Elec.Coop. #744	3/31	$993,927.87	6/30/2003	1.142%	Quarterly
*Harrison County,#532	3/31	$960,836.97	6/30/2003	1.142%	Quarterly
*Harrison County #532	3/31	$864,753.28	6/30/2003	1.142%	Quarterly
*Harrison County #532	3/31	$967,319.42	6/30/2003	1.142%	Quarterly
*Harrison County #532	3/31	$1,577,369.57	6/30/2003	1.142%	Quarterly
*Harrison County #532	3/31	$1,698,230.81	6/30/2003	1.142%	Quarterly
*Hudson Valley Datanet #833	3/31	$5,000,000.00	6/30/2003	1.142%	Quarterly

*Hudson Valley Datanet #833	3/31	$2,000,000.00	6/30/2003	1.142%	Quarterly
*Inter-County Energy #592	3/31	$1,441,255.45	6/30/2003	1.142%	Quarterly
*Inter-County Energy #592	3/31	$1,921,673.94	6/30/2003	1.142%	Quarterly
*Inter-County Energy #592	3/31	$2,504,901.98	6/30/2003	1.142%	Quarterly
*Inter-County Energy #592	3/31	$213,212.04	6/30/2003	1.142%	Quarterly
*Inter-County Energy #850	3/31	$4,000,000.00	6/30/2003	1.142%	Quarterly
*Inter-County Energy #850	3/31	$2,000,000.00	6/30/2003	1.142%	Quarterly
*Jackson Energy #794	3/31	$4,000,000.00	6/30/2003	1.142%	Quarterly
*Jackson Energy #794	3/31	$3,000,000.00	6/30/2003	1.142%	Quarterly
*Jackson Energy #794	3/31	$4,700,000.00	6/30/2003	1.142%	Quarterly
*Jackson Energy #794	3/31	$2,000,000.00	6/30/2003	1.142%	Quarterly
*Jackson Energy #794	3/31	$2,500,000.00	6/30/2003	1.142%	Quarterly
*Johnson County E1ec. #482.	3/31	$1,543,335.73	6/30/2003	1.267%	Quarterly
*Karnes Elec. #568	3/31	$1,452,817.36	3/31/2008	2.813%	Quarterly
*Karnes Elec. #568	3/31	$1,295,215.53	3/31/2008	2.813%	Quarterly
*Licking Valley Elec. #522	3/31	$2,641,340.83	6/30/2003	1.142%	Quarterly
*Magnolia Electric #560	3/31	$4,809,744.97	6/30/2003	1.267%	Quarterly
*Meade County Elec. #662	3/31	$5,351,799.93	3/31/2008	2.815%	Quarterly
*New Horizon Elec. #791	3/31	$2,051,000.00	6/30/2003	1.142%	Quarterly
*Nolin Rural. Elec. #528	3/31	$1,818,864.38	6/30/2003	1.142%	Quarterly
*Noli.n Rural.. Elee. #577	3/31	$2;481;841.90	6/30/2003	1.142%	Quarterly
*Nolin Rural El.ec. #577.	3/31	$2,481,841.90	6/30/2003	1.142%	Quarterly
*Northstar Technology #811	3/31	$1,833,492.00	6/30/2003	1.142%	Quarterly
*Oglethorpe Power #445	3/31	$13,833,494.86	1/2/2024	4.306%	Quarterly
*Owen Electric #525	3/31	$1,924,356.93	6/30/2003	1.142%	Quarterly
*Owen Electric #525	3/31	$1,920,470.66	6/30/2003	1.142%	Quarterly
*Owen Electric #525	3/31	$968,912.28	6/30/2003	1.142%	Quarterly
*Owen Electric #525	3/31	$1,953,921.18	6/30/2003	1.142%	Quarterly
*Pee Dee Elec. #547	3/31	$5,320;126.69	12/31/2029	4.622%	Quarterly
*Pee Dee Elec. #547	3/31	$2,411,268.69	12/31/2029	4.622%	Quarterly
*Pennyrile Elec. #513	3/31	$5,885,862.61	6/30/2003	1.267%	Quarterly
Pennyrile Elec. #513	3/31	$5,533,000.00	9/30/2003	1.268%	Quarterly
*Piedmont Tel. #566	3/31	$151,779.43	12/31/2018	3.902%	Quarterly
*Piedmont Tel. #566	3/31	$214,055.21	12/31/2018	3.902%	Quarterly
*PRTCommunications #798	3/31	$4,802,000.00	6/30/2003	1.142%	Quarterly

*PRTCommunications #798	3/31	$1,800,000.00	6/30/2003	1.142%	Quarterly
*San Miguel Electric #919	3/31	$7,559,330.24	6/30/2003	1.142%	Quarterly
*San Miguel Electric #919	3/31	$7,937,385.21	6/30/2003	1.142%	Quarterly
Sangre De Cristo Elec. #732	3/31	$500,000.00	1/3/2034	4.742%	Quarterly
*Steams Cooperative #733	3/31	$2,385,105.77	12/31/2035	4.787%	Quarterly
*Steams Cooperative #733	3/31	$1,391,311.70	12/31/2035	4.787%	Quarterly
*Surry-Yadkin Elec. #534	3/31	$949,139.17	6/30/2003	1.142%	Quarterly
*Surry-Yadkin Elec. #534	3/31	$949,139.17	6/30/2003	1.142%	Quarterly
*Surry-Yadkin Elec. #534	3/31	$474,569.59	6/30/2003	1.142%	Quarterly
*Surry-Yadkin Elec. #534	3/31	$949,139.17	6/30/2003	1.142%	Quarterly
*Surry-Yadkin Elec. #534	3/31	$949,139.17	6/30/2003	1.142%	Quarterly
*Surry-Yadkin Elec. #534	3/31	$964,700.85	6/30/2003	1.142%	Quarterly
*Surry-Yadkin Elec. #534	3/31	$970,981.05	6/30/2003	1.142%	Quarterly
*Surry-Yadkin Elec. #534	3/31	$2,243,054.61	6/30/2003	1.142%	Quarterly
*Surry-Yadkin Elec. #852	3/31	$1,000,000.00	6/30/2003	1.142%	Quarterly
*Tex-La Electric #389	3/31	$1,411,328.36	6/30/2003	1.267%	Quarterly
*United Elec. Coop. #870	3/31	$12,000,000.00	6/30/2003	1.142%	Quarterly
*Webster Electric #705	3/31	$2,188,614.62	6/30/2003	1.142%	Quarterly

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FEDERAL FINANCING BANK HOLDINGS
(in millions of dollars)

Program	March 31, 2003	February 28, 2003	Monthly Net Change 3/1/03- 3/31/03	Fiscal Year Net Change 10/1/02- 3/31/03
Agency Debt: U.S. Postal Service	$7,273.40	$7,273.40	$0.00	($3,840.60)
Subtotal*	$7,273.40	$7,273.40	$0.00	($3,840.60)
Agency Assets:				
FmHA-RDIF	$950.00	$950.00	$0.00	$0.00
FmHA-RHIF	$2,530.00	$2,530.00	$0.00	($375.00)
Rural Utilities Service-CBO	$4,270.20	$4,270.20	$0.00	$0.00
Subtotal*	$7,750.20	$7,750.20	$0.00	($375.00)
Government-Guaranteed Lending:				
DOD-Foreign Military Sales	$1,805.40	$1,823.1	($17.70)	($117.10)
DoEd-HBCU+	$74.20	$74.20	$0.00	$5.60
DHUD-Community Dev. Block Grant	$3.90	$3.90	$0.00	($1.20)
DHUD-Public Housing Notes	$1,133.20	$1,133.20	$0.00	($74.10)
General Services Administration+	$2,172.00	$2,176.40	($4.40)	($33.60)

DOI-Virgin Islands	$10.10	$10.10	$0.00	($1.30)
DON-Ship Lease Financing	$705.30	$705.30	$0.00	($75.40)
Rural Utilities Service	$14,759.90	$14,750.30	$9.60	$701.60
SBA-State/Local Development Cos.	$89.00	$90.70	($1.70)	($13.40)
DOT-Section 511	$3.20	$3.20	$0.00	($0.10)
Subtotal*	$20,755.20	$20,770.50	($14.30)	$391.10
Grand total*	**$35,779.90**	**$35,794.10**	**($14.30)**	**($3,824.50)**

[*figures may not total due to rounding; +does not include capitalized interest]

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